An Economic Impact Assessment of 'Safety Net' Wage Increases

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1. Introduction

This analysis examines the impact of the Australian Council of Trade Unions' (ACTU) application to the 1994 National Wage Case, on economic indicators such as employment, inflation, business investment, gross domestic product, interest rates and the current account balance by using the well respected econometric model devised by Mr Chris Murphy. The economic impact is assessed by inputting specific shocks to the Murphy Model along the lines of the wage increases proposed by the ACTU.

This paper examines the differences in outcomes between arbitrated wages increases and wage movements consistent with market conditions. Given the likely detrimental effect of wage increases sanctioned by tribunals, particularly on unemployment, there are a number of policy implications. These policy implications will also be examined.

2. The Economic Model

The Murphy Model is a quarterly macro-econometric model of Australia designed for forecasting and policy analysis. It contains 16 stochastic equations, 3 behavioural identities and 80 other identities, giving a total of 99 equations.

Most of the model's parameters are estimated using quarterly data extending from 1976 to the present. Special attention is paid to dynamic behaviour and statistical diagnostic testing.

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Models cannot provide precise estimates of the future but they do provide a rigorous transparent and quantitative cross check on the qualitative views propounded to wage setting tribunals such as the Industrial Relations Commission. However, they can be used to support judgements about the likely broad economic impact of wage rises.

3. Economic Assumptions

The Murphy Model structure has three key features. First, prices and wages are slow to adjust to shocks, so the model has short run Keynesian properties. Second, financial markets are forward-looking and deregulated, so floating exchange rates and market-determined bond rates are responsive to new information, adding another dimension to the model's short run properties. Third, in the long run there is optimising behaviour in production, implying that employment, pricing, investment, exporting and importing decisions of the business sector are treated in an integrated and consistent manner.

It is important to note that together with other detailed assumptions, the optimising assumption implies that in the long run, the model will return to an equilibrium position with unemployment being equal to the non-accelerating inflation rate of unemployment (NAIRU).

Impulse shocks from the proposed wage increases are applied to the model under the optimal policy response regime. When a shock is applied to the model, various adjustment processes are set in train with the result that, economic agents adjust with different speeds in the financial and labour markets, and there are constraints on how quickly capital stocks can be changed.

In the model, the growth rate of nominal wages is determined by:

- the rate of technical progress, reflecting long run growth in productivity;
- a weighted average of actual and expected consumer price inflation;
- the gap between the actual unemployment rate and the NAIRU; and
- the change in the unemployment rate.

The following assumptions are specific to this particular analysis:

- That an $8.00 per week wage increase is granted and operative from the middle of August 1994.
- That an $8.00 per week wage increase is granted and operative from August 1995. (Consistent with Accord Mk VII).

- That an $8.00 per week increase equates to a 1.4 percent wage increase per worker.
- That 80 percent of the Australian workforce is covered by either State or Federal industrial awards.
- That 50 percent of award employees will receive this 'safety net' increase.
- That 70 percent of the Australian workforce will receive superannuation increases in 1994, 1995 and 1996, consistent with the Superannuation Guarantee Legislation.

4. Non-Market v Market Conditions

The following table illustrates an alternative representation of the wage increases between 1994–1997. It assesses the impact of wage increases that are not determined by the market.

Table 1 Impact of labour cost increases greater than those consistent with market conditions*

	Percent							
	Wages	CPI	Unemployment Rate	Employment Growth	Business Investment	GDP	Interest Rates	Current Account Balance**
1994/95	1.7	0.4	0.1	-0.3	-0.1	-0.1	0.1	-0.2
1995/96	2.9	2.3	0.3	-0.6	-1.3	-0.4	1.4	-0.4
1996/97	2.8	3.0	0.5	-1.0	-3.9	-1.3	1.6	0.0

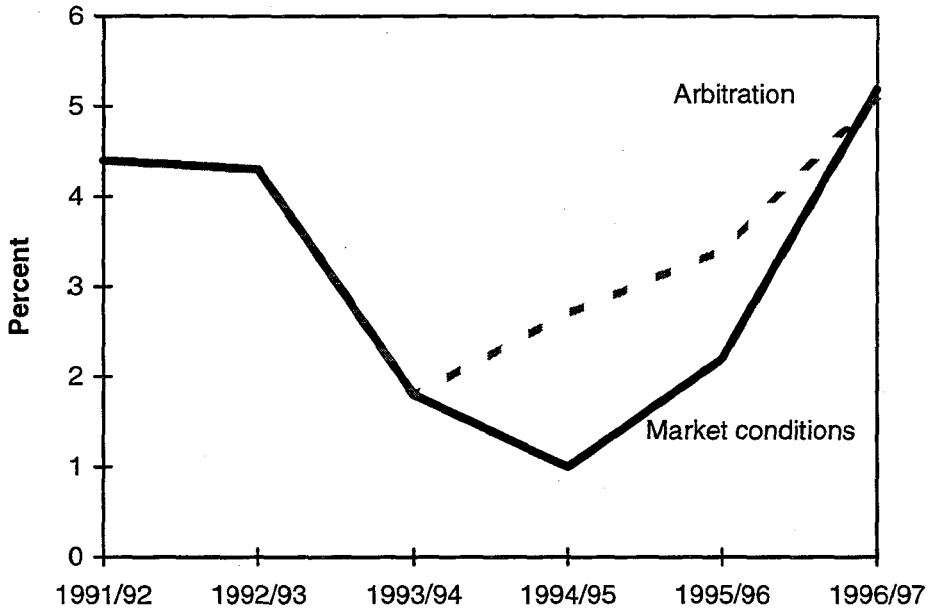
* These figures are expressed as the deviation from the rate of wage increase which is consistent with underlying market conditions. (That is, they are baseline conditions forecast by the model with no arbitration decisions imposed upon them). Business investment and GDP are expressed in real terms with wages being nominal.

** Expressed as a percentage of GDP

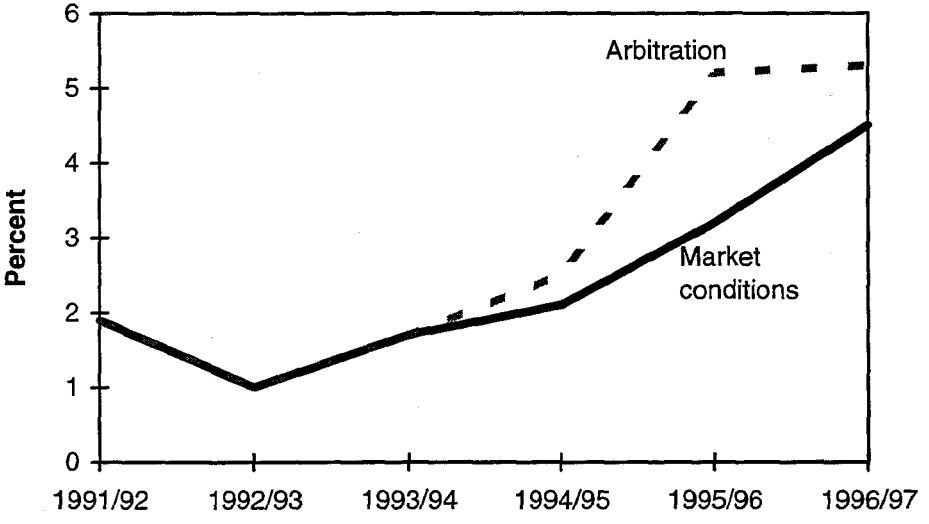
The following graphs are drawn from the above data and illustrate the effect of non-market determined wage increases (such as arbitration) on wages, inflation and employment.

https://doi.org/10.1177/103530469400500211 Published online by Cambridge University Press

Graph 1
Wages



Graph 2
Consumer Price Index



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Graph 3
Unemployment Rate

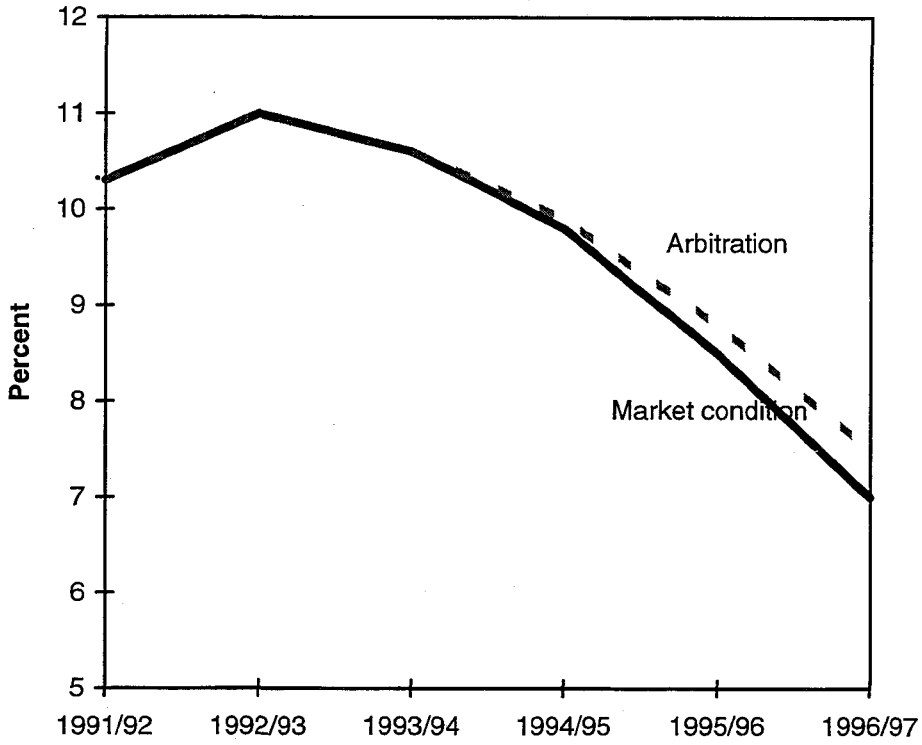

Table 1 and Graphs 1 to 3 suggest that wage increases, over and above those consistent with market conditions, will have adverse effects. The sequence of events that lead to these outcomes is as follows. Inflation increases in response to the increase in wages, which adversely impacts upon interest rates. As a result, business investment decreases and economic growth is weakened. The effect of this is to stifle employment growth and increase the unemployment rate.

The results of this analysis confirm the hypothesis that an upward shock to wages leads to higher marginal costs of production which feed into prices with a lag. As a result, real wages increase, reducing the profit-maximising levels of business sector output and employment. Higher wages raise marginal cost relative to price which requires a reduction in output. In addition, higher real wages also reduce the incentive to invest in business fixed capital. Lower growth in the business capital stock will, over time, also reduce employment growth.

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5. Policy Implications and Conclusion

Although prices and incomes were rightly high priorities of wages policy in the early eighties, they certainly date Accord Mk VII which will extend into 1996.

In the 1980's inflation in Australia was well above the rates of our trading partners and there was little support for setting monetary policy with a view to achieving low and stable inflation. As a result, a wages policy needed to deal with inflation and under the Accord the Government set macroeconomic wage targets.

However, circumstances have changed. The inflation outlook is more favourable, in part because the authorities have signalled that they are prepared to adjust monetary policy pre-emptively to suppress inflationary pressures. There is also greater recognition of the need to make the economy, and especially the labour market, more flexible if economic growth is to be sustained and unemployment reduced. Therefore wages policy today should be dealing with productivity issues.

In contrast, the Accord retains a strong focus on centralised control of wage outcomes. The corner stone of Accord Mk VII is the 'safety net' wage adjustments which were purported to provide modest increases to those employees who were unsuccessful at enterprise bargaining. Although it was hoped that safety net wage increases would address unemployment, the results of this analysis indicate that this is not the case.

At the same time, the Accord restricts the capacity to deliver wage and workplace flexibility. Genuine enterprise bargaining, which is consistent with market conditions, has a greater likelihood of achieving employment growth and productivity increases. This should be the policy strategy of Government, the union movement and industry.

The results of this analysis indicate that a wages policy has to be more in tune with market conditions, if unemployment is to be properly addressed. Ironically if there is not a change in the wages policy of the eighties, then the benefits that the Accords delivered will not be optimised.