The Road Back To Full Employment

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Abstract

Over the last two years the Committee for Economic Development of Australia (CEDA) carried out a major project: a vision for the Australian economy and practical policies to attain that vision by the year 2000. One of the key goals was to halve the official unemployment rate. The results are outlined in this article. Emphasis is placed on a policy and incentive structure that is skewed in favour of exports, productive investment and savings, a more structurally efficient and flexible labour market, responsible aggregate wage outcomes and acceptance that growth is only sustainable if the short-term costs of structural reform are borne equitably.

1. Background; The Full Employment Vision

Australia cannot afford a repeat of the economic performance of the last two decades. Yet that is what most economic pundits are predicting for the next few years. The consensus view is that Australia's growth rate will average about 3% per annum over the next decade (Bankers Trust Australia Economics, AFR 13/10/93).

If this turns out to be the case, we will remain "stuck" on unemployment of at least 8 to 10%; we will have a near-permanent under-class of nearly half a million long-term unemployed who are totally alienated from the rest of society; internationally, we will continue to slip in relative living standards and our role and influence

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will diminish; and we will not be able to make great inroads into poverty. We must aim for a better economic future than that.

Two years ago CEDA embarked on an ambitious project "An Australia that Works; a Vision for Australia". In a series of reports, it defined a number of primary economic and social goals and a set of intermediate targets for the year 2000/1. It also outlined a long–term economic strategy.[1]

One of the key goals was to halve the official unemployment rate by 2000/1.

2. Australia's Productive Potential

The CEDA vision is about realising Australia's full productive potential. The potential growth of the Australian economy can be viewed as a product of the potential growth in employment (number of workers in the labour force employed full–time or part–time) and the potential growth in output per worker (which will be loosely referred to as "labour productivity").

2.1 Potential for employment growth

The CEDA study argues that the potential growth in employment is of the order of 2.5% per annum over the next eight years. This is made up as follows:

- through net immigration: + 0.4% per annum (a little more than in the last two years but below the longer term trend);
- through natural increase: + 0.8% per annum
- through increased labour force participation: + 0.3% per annum
- through reductions in official unemployment: + 0.9% per annum

Reductions in unemployment of 0.9% of the labour force would achieve the CEDA goal of halving the official unemployment rate by 2000/1. There is scope also for reductions in "unofficial" unemployment i.e. under–utilised workers, but this will show up as higher labour productivity and is discussed in section 2.2.

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2.2 Potential growth in labour productivity

The CEDA report argues that labour productivity (output per worker) is capable of growing by 2 to 2.5% per annum over the next eight years. This is some 50% better than we achieved in the last two decades. There are a number of reasons for this.

Firstly, it is widely accepted that, over the rest of this decade, factor productivity (productivity of both labour and capital) will accelerate appreciably in all developed countries, because the potential of new information technologies will be much more fully realised, and because efficiency and innovation will receive a strong fillip from more intensive competition in world markets and the growing integration of the world economy. Australian productivity growth should benefit equally from these developments.

Secondly, just like many Asian countries are catching up with Western standards, Australia has a significant potential for "catch up" relative to the rest of the developed world: our efficiency levels in the business sector are 10 to 15% below the *OECD average* (EPAC 1993 p. 19); and the typical Australian enterprise is operating on average some 30% below what they see as world *best practice* (Hilmer report, BCA Bulletin, August 1993, page 7).

Thirdly, Australia is starting the period with a relatively large pool of "under-employed" labour, including workers officially in employment but working shorter hours than they would like. With stronger economic growth, these people will work longer hours and this will manifest itself as an increase in output per worker.

In brief, labour productivity growth in Australia has the potential to perform much better in the next 7 or 8 years than in the past two decades. How much better is a matter of judgment. CEDA projects a range of 2 to 2.5% per annum.

It should be stressed that this is not a forecast but a projection of the *potential* growth in labour productivity if other goals and targets of the CEDA vision (e.g. on investment) are realised, and if there is some convergence towards average OECD experience.

If this estimate is accepted, it follows that, to achieve CEDA's target unemployment rate in the year 2000/1, real GDP needs to grow by 4.5 to 5% per annum (employment 2.5% and labour productivity 2 to 2.5%). This compares with normal "trend" growth of about 3% per annum (employment 1.5% and labour productivity 1.5%).

2.3 Is strong productivity growth consistent with strong employment growth?

Some people see scope for tension between strong labour productivity growth and strong employment growth. Won't productivity growth of 2.5% per annum, they say, make it impossible to achieve employment growth of 2.5% per annum? Is there a risk of "jobless growth"? The implicit answer given in the CEDA report is no, but the issue needs to be addressed.

In the short-term, accelerated growth in labour productivity (from labour-saving microeconomic and workplace reform) may indeed be a mixed blessing for unemployment. It tends to be associated with destruction of many existing and traditional jobs; so domestic output (real GDP) has to grow that much faster to achieve a given increase in employment. There may also be a tendency for frictional and structural unemployment to increase, because of a greater degree of mismatching in the labour market as a result of technological and structural change.

As well, there may be an initial reduction in aggregate consumer spending because of increased employment uncertainty and income distribution effects. However, provided the gains in productivity are taken partly in the form of lower output prices and higher returns to capital (and not fully as higher nominal wages), these "negative" effects on labour demand and supply should *in the medium-term* be *more than offset* by:

- some substitution of labour for capital in response to lower real unit labour costs;
- increased business investment in response to higher returns on capital;
- increased net exports in response to increased competitiveness (subject to some qualifications noted below); and
- higher real consumption by employed persons earning higher real incomes.

In the medium to long term, therefore, it is likely the increase in demand for labour from these various sources will be sufficient to offset the negative effects noted earlier, producing either a net improvement in employment or at worst little or no change in employment. (This is on the basis of empirical observations, a priori reasoning, and model estimations –Freebairn 1993)

The effect of faster productivity growth on employment *in the short term* is not so clear–cut; as it depends on the *timing* of new investment, which may be slow to respond to higher profits, on the way the productivity gains are distributed, and on the speed with which Australian industry responds to improved competitiveness.

If one takes a medium term perspective (as the CEDA study does), faster average growth in output per worker should not (of itself) inhibit major reductions in unemployment. It is much more likely to have a positive impact: the demand forces driving medium–term growth – stronger exports and investment – are partly dependent on faster productivity growth. In short, an improved productivity performance must be seen more as an opportunity to achieve stronger economic growth than as a constraint on growth. The challenge will be to make it happen and not be frightened by it.

3. The Strategy

For a vision to be feasible, it must be based on realistic assumptions; it must be internally consistent, in the sense that the level and mix of aggregate demand must be consistent not only with output growth but with low inflation and external debt stabilisation; and it must be socially acceptable.

The proposed economic strategy concentrates essentially on the role of government, but the challenge of the vision is one for the community as a whole. In particular, workplace attitudes, the quality of management, the willingness of the community to accept structural change, and cultural attitudes to work, saving, risk and innovation will all be important determinants of success or failure.

Nonetheless, governments will have a crucial role to play: in promoting public understanding and awareness of the need for change; in acting as a catalyst for change in certain areas of the private sector such as training and research; in ensuring a stable and positive macroeconomic climate; in ensuring adequate and efficient infrastructure; and above all in creating an incentive structure conducive to investment, efficiency, saving and exports.

The report explores the adequacy of policy in eleven strategic areas and makes a number of recommendations in each of the areas.[2]

Only the major thrust of the strategy is discussed here with special reference to five potential growth constraints: aggregate demand insufficiency; inappropriate mix of demand; rigid labour markets; insensitivity of wages to unemployment; and potential social conflict. The strategy draws on both the libertarian and interventionist schools of economic thought.

3.1 Influencing aggregate demand

Most economists agree that the current high level of unemployment has a large "cyclical" element in it – i.e. it reflects an insufficiency in aggregate demand. Therefore at current very high rates of unemployment, significant reductions can occur without greatly affecting inflation.

Whatever its origin (and there is no doubt that some mismanagement of demand occurred in the years 1988–91), the demand deficiency which exists now is in large part due to conditions in the rest of the world and cannot be addressed unilaterally by Australia. We cannot grow at 4.5 to 5% per annum while the industrial world grows at 1 to 2% and the world as a whole at 2 to 3% – which is what the consensus poll of economists is forecasting for the next year or two.

Up to a point, governments can and should support demand, and those who advocate contractionary fiscal policies at a time of double digit unemployment are putting their faith in psychology and voodoism more than in economics. However, it is likely that in most OECD countries (with Japan a possible exception) the point has already been reached when further stimulus by one country acting alone could be counter-productive. Few governments enjoy complete economic sovereignty in a world of "footloose" international industrial capital and deregulated financial markets. Australian governments have even less economic sovereignty than most.

In one sense Australia has a greater capacity for fiscal stimulus than most other OECD countries, in that the size of its internal public debt is still low by world standards; but this is more than offset by our persistent tendency to run large current account deficits, and our large external debt hangover. If we try to grow much faster than the rest of the world through expansionary fiscal and monetary policies (especially given the present structural imbalance in the composition of demand), our external deficit will grow and this will affect interest rates, business confidence and investment plans, and soon bring the whole process of economic recovery to a halt. This limits our capacity to use the public sector as the catalyst for accelerated growth (except in a limited way in the area of productive, export–oriented infrastructure investment, and even then subject to acceptance by financial markets).

There is reason to feel fairly confident that the developed world will soon shift back into high gear (albeit with Germany and Japan on a slower trend path than in the past); with the developing nations of Asia and South and Central America and Eastern Europe, taken as a whole, providing a strong and growing stimulus to world trade, the medium–term outlook is positive. The timing of the recovery is uncertain however, and it may require more co–operation and coordinated action by the G7 countries to speed the process along.

Once the world economy has moved into a phase of much stronger economic growth, the balance of payments will be less of a constraint on accelerated economic growth in Australia: external demand forces and improved commodity prices will interact with growing business confidence to generate strong demand for Australian goods and services, while providing support for our export income.

In the meantime, the authorities in Australia are trying to insulate the economy to some extent from the worst effects of the world recession – through a budgetary and monetary strategy which is sensitive to the short–term pace of recovery; through maintenance of a flexible exchange rate regime; through a degree of downward flexibility in aggregate real unit labour costs; and through an effective system of prudential regulation and supervision.

As well, governments should be trying to prepare the economy for the world recovery by addressing the problem of structural imbalance in the composition of demand and the labour market. Otherwise concerns about our balance of payments and inflation will prevent us from taking full advantage of the favourable world economic circumstances. This is the main focus of the CEDA report, and it is discussed in the next two sections.

Table 1: An Internally Consistent Vision

	Eight Years to End Decade (2000/1)	
	Business as Usual[4]	CEDA Vision
Real Gross Domestic Product[1]	3.2	4.7
Per Capita GDP[1]	1.9	3.4
Labour Force[1]	1.3	1.6
Employment[1]	1.5	2.4
Productivity p.w.[1]	1.7	2.3
Real Exports[1]	6.0	7.5
Saving/GDP[3]	18.0	22.5
Investment/GDP[3]	21.0[5]	25.5[5]
Unemployment Rate[2]	8.5	5.0
Consumer Prices[1]	3.0	3.0
Current Account Deficit/GDP[3]	3.5	3.5
Net Foreign Debt/GDP[3]	40–45	40–45

1 Average % increase
2 % Workforce End of Period
3 Average % of GDP over Period
4 With no fundamental change in Saving, Investment, Productivity, Export Performance
5 Assumes an improvement of 15% in capital productivity

3.2 Altering the underlying composition of demand

A key factor impeding the achievement of sustained full employment in Australia is that the level of aggregate demand consistent with 4.5 to 5% growth has tended to be inconsistent with external debt stabilisation and low inflation. This has been due to a structural imbalance between saving and investment, and an inadequate export propensity, at high employment levels. As Table 1 shows, the key changes needed are more investment, more saving and more exports relative to GDP.

(a) Investment

Currently, Australia is investing at a rate of about 19% of GDP. It is estimated (Argy 1993) that over the next eight years capital expenditure will need to average 25 to 26% of GDP, subject to what happens to capital efficiency.

A high rate of investment is necessary:

- to ensure there is sufficient productive capacity to sustain the projected output growth;
- to underpin the gains in productivity, competitiveness and exports envisaged in the vision (it would do so through higher growth in capital per worker and through embodied technological progress); and
- to boost aggregate demand for goods and services and labour.

How does the CEDA strategy address the investment constraint? New business investment is a function of real interest rates, the expected rate of return on capital, the level of demand and the state of confidence. The CEDA strategy aims to keep real interest rates low through higher saving, profits healthy through responsible wage policies, and demand buoyant through strong economic growth. Confidence is assisted by low inflation and a stable macroeconomic environment. Most of these conditions are in place now; there are signs of an early recovery in business investment, especially in manufacturing.

If, however, business investment proves timid (e.g. because of world economic uncertainty and surplus capacity in commercial and industrial buildings), the Government might have to intervene on two fronts: it might have to consider further fiscal incentives for investment, especially for plant and machinery expenditure in export–related sectors; and it might have to adopt a more permissive stance on public and private financing of economic infrastructure projects, provided they meet the usual cost–benefit tests and are helpful to our longer–term export drive.

(b) Saving

Saving levels will have to increase in line with capital spending. The Fitzgerald report estimated that Australia's underlying "structural" rate of national saving (i.e. after adjusting for cyclical effects) was around 18% of GDP. Yet the CEDA scenario envisages that a saving rate of some 22 to 23% would be needed to sustain a growth rate of 4.5 to 5% per annum. This high rate of saving is needed to avoid large current account deficits (which are a result of a deficiency of domestic saving relative to investment), and to keep real interest rates down and encourage investment.

The onus to achieve such high rates of saving, will have to fall mainly on governments. There might also be scope for action to encourage private saving, including an education campaign, wider access to superannuation and, if a cost–effective way can be found, more favourable tax treatment of voluntary private saving.

(c) Exports

A policy of higher national saving, to match the growth in investment, will ensure external balance (a current account deficit consistent with debt stabilisation); but it will not ensure strong output and employment growth unless it is also associated with stronger export growth. (Higher saving may boost net exports by putting downward pressure on interest rates and the exchange rate, but there is no guarantee of this).

The income elasticity of imports is very high in Australia – of the order of 1.5 to 1.9 – especially if the mix of spending is skewed towards plant and equipment, as is both likely and desirable in the years ahead. The CEDA vision, therefore puts a lot of stress on strong export growth (both relative to the past and to potential GDP growth) as a means of paying for the imports and at the same time generating demand for domestically produced goods and services and jobs in

Australia. It estimates that exports growth of 7 to 8% per annum is necessary to sustain 4.5 to 5% economic growth. This compares with a trend rate of 5 to 6% per annum (but tending to accelerate).

In the CEDA strategy every instrument of policy – whether it be macroeconomic policy, tax policy, competition policy, education and training, industry or trade policy – is used to skew the incentive structure and the national ethos or culture in favour of exports.

The recent fall in the real exchange rate will help export growth, and if the gains can be sustained in real terms – even at a somewhat higher level than now (reflecting the expected improvement in our terms of trade over the next year or two) – Australia will be in a strong competitive position. In this context, the report argues that macroeconomic policy should be better harmonised with industry policy, and in particular that care be taken, when choosing the monetary/fiscal/wages policy mix, not to skew the exchange rate in an upward direction.

However, we cannot go on relying on currency devaluations and associated reductions in real wages as the principal means of lifting our competitiveness. This is not the way of the future. Instead we should be striving to sustain a strong export growth momentum through relative improvements in productivity and through an improved supply response to any given level of competitiveness. In particular, one cannot stress enough the importance of an improved supply response by Australian industry i.e. through better quality, reliability, speed of response, product innovation, marketing, design, and packaging. As argued in Argy (1993), this offers "an unambiguous win/win situation" (page 38).

This is largely a matter for management (and unions). But governments can facilitate a better supply response in a number of ways: through more efficient public services, especially transport; less obtrusive business regulation; a better flow of trade information, easing entry into markets; and by giving special attention to the constraints on small emerging exporters (such as risk capital and technology access). Most of these policies are either in place or under review.

In addition there is need for a tax structure tilted in favour of exports – greater reliance on value-added taxes; tax incentives for trade-oriented investment in business equipment and machinery and for exports; and a shifting of the tax burden away from business profits towards wealth transfer taxes. This is in addition to general measures to reduce the costs of tax compliance such as rationalisation of the indirect tax system (federal and state) and simplification of tax laws and administration.

Another important issue is the financing of export–related economic infrastructure: much more needs to be done to facilitate private sector financing and, as a last resort, reviewing the scope for public sector financing.

Most importantly, in a competitive world environment where speedy and effective response to emerging export opportunities is critical, there is a need for "greater functional flexibility" at the enterprise level – i.e. greater freedom for individual managers to organise work tasks and hours, and manage their human resources. That is why the report favours an industrial relations system where:

- productivity bargaining is allowed a wide charter (not just over–award bargaining) and is conducted at the enterprise level by single bargaining units, with the ultimate aim of achieving a single award or agreement per enterprise;
- unions are structured in ways which encourage maximum commitment and loyalty to the individual enterprise;
- there are easily enforceable sanctions available for breaches of agreement;
- there is a decent, general safety net which protects workers against all forms of exploitation.

3.3 Dealing with structural imbalance in labour market

The composition of demand is one problem that needs to be fixed. Another is structural imbalance in the labour market. Strong growth is usually associated with rapid structural change and this can lead to a mismatch between supply and demand across regions, competencies and skills. In the later stages of economic recovery and growth, there is a risk, therefore, that structural labour shortages and associated wage pressures and inflation may emerge at a time when the unemployment rate is still relatively high. This may happen if there are impediments to geographical and occupational mobility, delays in job search, wage rigidities, inflexibilities in workplace organisa–

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tion, negative attitudes by employers to the long–term unemployed, and so on.

There is evidence of growing structural imbalance in the labour market – in the unemployment/vacancy relationship but particularly in the incidence of long term unemployment. Hence, the CEDA strategy includes not only policies to strengthen the growth of labour demand but also policies to improve the longer–term workings of our labour market and the unemployment/inflation trade–off. As evident from in Table 1, the aim of the strategy is to achieve a lower unemployment rate than in the "business as usual" scenario, but with the same rate of inflation.

Some of the elements of the policy package are supply–side prescriptions of the kind advocated by market economists (or so–called economic rationalists), including: increased flexibility in the structure of wages; a review of the social security system to reduce disincentives to part–time work; stronger competition policies; and a medium–term credible monetary policy targetted at low inflation.

However, the experience of countries that have adopted such supply–side policies (such as UK and NZ) suggests that they may not do enough to reduce structural unemployment – at least within a reasonable period. Also required are active labour market programs (properly evaluated and where necessary rationalised) which seek to improve the employment prospects of long–term unemployed, shorten the time spent on job search, enhance occupational and geographical mobility, and generally reduce the extent of "mismatch" between demand and supply in the labour market.

In particular there is a need for:

- structural adjustment assistance programs, including training and re–training programs to equip the labour force with the required skills and competencies, and relocation assistance;

- an improved flow and accessibility of labour market information, and more effective job counselling, screening and placement activities, including a review of the operations of the employment services and the potential role of private agencies;

- wage subsidies and other special programs targetted at long–term unemployed;

- regional and community support programs to expand job opportunities in areas of high unemployment, where this can be done cost-effectively;
- action to influence the supply of labour, including measures to facilitate job sharing, permanent part-time work, and more flexible working hours; and an immigration policy more flexible and responsive to labour market conditions.

The strategic package does not include a job levy per se, but it recognises that tax levels will need to be higher than otherwise in order to pay for the labour market programs and to compensate low skilled workers for cuts in their relative market incomes. It canvasses the possibility of temporary tax surcharges and a wealth transfer tax. (It can be argued that those who propose a job levy are starting from the wrong end. They should specify particular expenditures which they see as desirable and then determine the amount of revenue required and how it is to be raised. This is what the CEDA report does.)

Labour market policies are of limited value in an economy that is growing slowly and labour demand is barely keeping pace with labour supply. For example, the direct net job-creating effect of wage subsidies for the long term unemployed, which are financed out of increased income tax revenue, would be small in the short-term: the people who pay the higher taxes might reduce their spending on goods and services less than the Government and the unemployed increase theirs; and there might be a further small capital/labour substitution effect. But these would not amount to much in terms of aggregate employment. Therefore, in a low growth environment, such labour market programs would largely reshuffle jobs around, producing an increase in the ranks of the short-term unemployed roughly equal to the decrease in the numbers of long-term unemployed.

There would also be some dead-weight costs from the tax increases and the administration of the wage subsidies. It is likely, moreover, that the long term unemployed would have a lower initial marginal productivity than the workers they displace. So there would not be any economic gains. Even the social benefits of labour market programs would not be very large in such an environment: they would

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allow some redistribution of the burden of unemployment but that is all.

But the economic and social implications of labour market programs are much more positive *in an environment of strong and vigorous GDP growth with falling unemployment* (as envisaged in the CEDA vision). In such an environment, programs such as wage subsidies and training programs for the long–term unemployed and a more effective employment counselling and placement service would:

- better prepare the long–term unemployed for the demands of the labour market and, more generally, improve structural efficiency in the labour market; the effect of that would be a better trade–off between unemployment and inflation in the Australian economy, and a greater capacity to sustain high economic growth for a longer periods; and
- lead to a socially desirable redistribution of incomes from well–paid employed workers to the long–term unemployed, who otherwise run the risk of becoming increasingly viewed as unemployable.

In brief, labour market programs are best viewed as complementary to high growth policies of the kind discussed earlier (in particular export, investment and productivity policies) rather than as substitutes for such policies.

3.4. Ensuring responsible aggregate wage outcomes

Another factor which can impede full realisation of our productive potential and achievement of full employment is the behaviour of aggregate wages.

What kind of wage behaviour would be most positive for employment?

First, *real* unit labour costs (RULC) should be as *sensitive* as possible to *levels* of unemployment; so when (as now and in the next few years) unemployment is at high levels, RULC would decline (to encourage a substitution of labour for capital, lift profits and hence the incentive to invest, and make Australia more competitive). This can be called "real macro–wage flexibility".

Secondly, *nominal* wages should be as *insensitive* as possible to *declines* in unemployment; so when in the later stages of economic recovery the labour market starts to strengthen, nominal unit labour costs do not rise much (this is to improve the trade–off between unemployment and inflation and allow strong growth to be sustained without inflationary pressures). For want of a better term, we call that "nominal wage restraint".

Thirdly, wage *differentials* should be as responsive as possible to relative demand and supply and relative marginal productivity of different groups of workers (so as to enhance the employability of say, unskilled and long term unemployed without necessarily displacing other workers to the same degree; to encourage acquisition of skills; and to assist functional flexibility at the enterprise level). This can be called "structural wage flexibility".

The CEDA report accepts that all three forms of wage "flexibility" are desirable from an unemployment viewpoint and they have a place in any long term strategy targetted at unemployment. The third type – structural wage flexibility – was mentioned in the previous section as a means of achieving improved labour market efficiency. Here we focus on the other two dimensions of flexibility.

First, real macro–wage flexibility. Although RULC is not high in historical terms, especially if adjustment is made for cyclical influences[3] the CEDA report accepts that a decrease in RULC in the early years of the scenario would facilitate the transition to high growth. However, it only argues for a "modest" decline, and this is now likely to happen anyway as a consequence of the recent depreciation of the exchange rate. It does not argue for big real wage cuts – for two reasons: practicability and effectiveness.

Leaving aside the possibility of further depreciations of the dollar (with continued nominal wage restraint), it is not clear how a substantial cut in RULC can be engineered. Radical deregulation of the labour market can influence the *structure* of nominal and real wages but the impact on *RULC* depends on what happens (i) to prices, and (ii) to average productivity. If product markets are competitive then nominal wage cuts should be followed by price cuts; other than in the short term (when there might be lags in adjustment), deregulation may not have much effect on aggregate real wages – unless it entails a marked curtailment of union power but an unchanged degree of monopoly power in product markets (which is not what the libertarians advocate).

Downward wage flexibility may also affect productivity. On the one hand, it would make it easier for employers to take on workers with relatively low marginal productivity; on the other, it might, as ILO evidence suggests (Sengenberger 1990), have adverse effects on employee attitudes to efficiency and technological change and blunt the incentive to greater efficiency and competitiveness. If so, the fall in average real wages might be matched, at least in part, by lower average productivity, with little net impact on RULC.

In any case, there is much social resistance to the notion of totally deregulated labour markets. While many economists argue that social objectives are better pursued through the tax/transfer system, this is easier said than done and the community is rightly sceptical. Moreover tax/transfer measures are not cost–less: there are consequences for economic incentives (in the case of personal or corporate income tax) or for inflation and equity (in the case of indirect tax increases).

And even if real unit labour cost cuts could be achieved by policy intervention (whether through deregulation or some other means), the benefits for employment should not be exaggerated. The overwhelming view of economists (see Valentine 1993) is that there is a relationship between real wage levels and unemployment, and this is built into most macroeconomic models of the economy (Brooker 1993). However, cross–country and other studies are ambiguous on the size and scale of this relationship (Castles, CEDA 1992; OECD 1993; Quiggin 1993); and the lags are unpredictable: in fact, the studies suggest that employment responds only slowly to real wage cuts (OECD 1993). The UK and NZ experience with deregulated labour markets and unemployment is a salutary one.

In short, further reductions in real unit labour costs would be hard to achieve and the gains for employment might be only small and slow to materialise. The recent cuts in real wages should be locked in, but the argument for more "action" on real wages has little practical policy relevance.

In addition to real macro–wage restraint, we mentioned earlier the need for *nominal wage restraint*. The main concern here is to ensure that nominal wages do not respond upwards as soon as improvements in unemployment begin to appear. The issues here are of much more practical policy relevance.

Ideally, "aggregate nominal wage outcomes should be relatively insensitive to a fall in unemployment, which means that in the middle years of the scenario, productivity gains should be reflected at least as much in lower prices as in higher remuneration for workers and management" (Argy 1993 p.66). One way this can be achieved is through credible anti-inflationary monetary policies and policies to strengthen competition in domestic product markets. These form part of the CEDA strategy.

But it may not be enough. Until a full enterprise-based system is in place, including enterprise-based unions, the IRC should have an overall monitoring and policing role on wage outcomes, especially in those sectors of the economy where there is scope for abuse of market power by employers and unions. In short it suggests that a "public interest test" be applied to certain enterprise agreements – both union and non-union.

4. Minimising social conflict

The final impediment to the achievement of full productive potential is social conflict.

This is an impediment in three senses: it saps the time and energy of our political, business, union and community leaders; it leads to obstructive, delaying tactics whenever reforms are considered; and it makes sustainability of the reforms more uncertain.

It is clear that, *in the absence of some offsetting action to redistribute costs and benefits*, the package of economic reforms proposed (designed to lift saving, investment, exports, efficiency and enhance labour market flexibility) would hurt many significant groups in our society and cause social disruption. This is true for example of proposals for restraints on recurrent forms of government spending; low levels of business taxation; the pricing of public services on a user cost basis; increased exposure to foreign competition (predominantly affecting unskilled workers, including migrant workers); a more flexible wage structure; and increased reliance on indirect taxes.

These reforms are necessary to generate stronger job growth (especially for unskilled workers), so many of the existing poor would benefit; and they have the potential to make every one better off in the long run.

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However, if nothing were done to address the short–term distributional effects of these policies, the benefits might be very lop–sided and biased against low paid workers. These distributional effects would reinforce trends arising from other developments such as: financial market deregulation (which has greatly enhanced the influence of financial markets in determining not only overall fiscal outcomes but the structure of the budget); technological change, which has tended to be biased against unskilled workers (OECD); and increased international capital mobility (with multinationals free to relocate wherever they get the best terms). We could end up with fewer unemployed but more working poor. Since many of the low paid workers are already poor and disadvantaged and their needs are relatively great, there could be no guarantee that the total happiness or well–being of Australians would increase. In any case, a vision which breaches the values and sense of fair play of many Australians will generate resistance and obstruction, and would be very difficult to implement.

It is not good enough to argue that in the long term "every one benefits" from economic reform and improved productivity, so we should leave it to the market to sort out winners and losers. The risks of relying on such a "trickle down" approach are borne out by the experience of the Thatcher years in the UK 1979–91, when the top 10% of households improved their standard of living by 62% but the poorest 10% suffered an absolute decline in real incomes of 14% (based on Department of Social Security estimates reported in Sun–Herald 20/10/93).

For all these reasons, the CEDA strategy strives to ensure that the short–term costs and sustained benefits are shared equitably across the whole community – without unduly inhibiting the dynamics of economic growth, but of course, it is neither practicable nor sensible to demand full compensation every time an efficiency–promoting economic reform package involves losers as well as winners. Any economic strategy must compromise on distribution if it is going to have anything useful to say on structural economic reform.

The CEDA long term package of economic reform adopted the following set of principles or guidelines:

(i) minimise disturbances to distribution by proposing reforms in tandem – as an integrated package;

(ii) where distribution is disturbed by the reform package, seek to neutralise any adverse effects on the lowest income quintile but ignore other distributional effects – e.g. any redistribution between the top and middle quintiles; and

(iii) pursue redistribution goals mainly through the tax/transfer system and labour market programs, and environmental goals mainly through market–based instruments such as green taxes.

Here and there, the CEDA report also chooses reform options which (relative to first best options) involve some sacrifice of efficiency, but only provided the efficiency costs were considered small relative to the equity gains.

No doubt there are other ways of dealing with distributional effects which are equally defensible, but what is not defensible is to simply ignore these effects altogether. Had the CEDA strategy focussed only on reforms which improved efficiency and growth, it would have been just another academic exercise, unrelated to the real concerns of the community, politicians and policy advisers.

The CEDA strategy seeks to ensure that the adjustment costs are not all borne by the relatively poor, such as unskilled low–paid workers. For example, it acknowledges the need to:

- minimise cuts in socially sensitive public expenditures;
- maintain a progressive income tax system, with greater use of tax rebates or cash payments for low income families – a form of negative income tax system;
- target the relatively well–off in any new revenue measures, such as surcharges on high income earners, and wealth transfer taxes;
- include measures such as wage subsidies, labour market adjustment programs, regional support policies and the like, which are of special value to poor workers but which may have some efficiency costs;
- opt for less radical industrial relations reforms than some might like to see on purely efficiency grounds.

5. Conclusions

The most effective and equitable way to deal with the present high levels of unemployment is to provide the foundations for much stronger economic growth over the next few years.

In the rest of this decade, the productive resources and skills should be available to sustain economic growth of 4.5 to 5% per annum (subject to adequate investment). Such a growth rate can halve the unemployment rate by the turn of the century. The challenge will be to take advantage of this unique opportunity without stumbling into balance of payments or domestic inflationary crises in the process, and without dissipating our skills and energies in debilitating social conflict.

This requires, apart from a benign world economic environment and a sound macroeconomic management framework:

- an incentive, institutional and policy structure that is skewed in favour of exports, productive (especially export-related) investment, and saving;
- a more structurally efficient and flexible labour market;
- a policy and institutional mechanism which facilitates responsible aggregate wage outcomes, and in particular aggregate outcomes which are sensitive to the rate of unemployment; and
- an acceptance that growth is only sustainable if the short-term costs of structural reform are borne equitably.

Any long-term economic strategy must try to address these potential growth constraints. The CEDA strategy is simply one modest attempt to do so.

Currently CEDA is working on the next phase of the project – clarification and refinement of the policy messages, and presentation of specific recommendations.

Notes

1. The final report is Argy (1993).
2. The detailed conclusions and recommendations are set out in Argy (1993). The eleven areas are: Macroeconomic policy, industrial relations, the unemployment/inflation trade-off, the tax structure,

competition policy, education and training, industry policy and competitiveness, size and effectiveness of government, business regulation, economic infrastructure, and trade policy.

3. However, as Valentine (1993) has pointed out, the relative stability or slight decline in RULC is partly the result of higher unemployment, which in turn could be the response of employers to high wages. It is also; interesting to note that real unit labour costs have not shown the same decline in Australia over the 1980's as in many other OECD countries, and this may partly explain the sharper increase in unemployment in Australia over that period. In other words, it can be argued that, whether or not real unit labour costs are high historically they may be too high in relation to the current high level of unemployment and in that sense slowing down the pace of adjustment to full employment.

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