Langmore and Quiggin on Full Employment in the Nineties

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John Langmore and John Quiggin have produced an ambitious and optimistic book[1]. It is ambitious because it aims to provide not only analysis of the causes of Australia's current high level of unemployment, but also a detailed and comprehensive prescription for the cure. It is optimistic that, with the adoption of its policy recommendations, a "return to genuine full employment" (taken to be around 3% frictional unemployment) "might be achieved within ten years" (P141).

The book is also optimistic about the practicality and acceptability of its policy prescriptions in the current political climate: "A reaction against the more extreme and naive assertions about the purity and perfection of markets has begun" (P237); "There has been a reaction against the preoccupation with inflation, a reaction against the neglect of employment and equity, and against the exclusion of important human concerns from policy making" (P41). At the end of 1993, with Australian unemployment starting to creep down below 10% and inflation at an annual rate of around 2%, the political rhetoric accompanying the release of the Green Paper (*Restoring Full Employment* 1993) might have justified such optimism. However, over 1994, as the economy struggled to achieve the increase in the GDP growth rate necessary for any significant reduction in the unemployment rate, monetary policy was progressively tightened with three successive increases in the official cash rate. Although with modest optimism, the Green Paper saw sustainable growth of 5–6 percent as achievable, the release of

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the September quarter National Accounts, provisionally estimating a year-on-year GDP increase of 6.4% (with inflation still running at an annual rate of about 2%, and unemployment at 9.1%) was greeted with great alarm by official and private commentators, dire warnings of the risk of an inflationary surge from the emerging "boom", and confident expectations in financial markets that further significant monetary policy tightening was imminent. The GDP growth rates seen as necessary and reasonable in the Green Paper, were now seen as dangerously high. At the end of 1994 it seemed that there had been no great shift in the balance of policy priorities between unemployment and inflation – the authors of this book and others seeking a more interventionist full employment orientated national economic policy, still have a substantial selling job to do.

The authors themselves are an economically-literate parliamentarian and a politically-interested academic economist. The style of the text ebbs and flows with alternating currents of social and political philosophy, economic analysis, statistical evidence, sociological comment, and political polemic. This makes for interesting and thought-provoking reading.

The book is clearly divided into two parts: Part I (analytical) and Part II (prescriptive).

Part I provides analysis of the nature and dimensions of the unemployment crisis in Australia. The first two chapters of this part deal with the individual and national costs, both economic and social, of high unemployment. Part I concludes with two chapters setting out the authors' interpretation of the history of the unemployment crisis and its causes. In their view the recent recession is "the product of contractionary policies and the collapse of the asset price boom generated by financial deregulation" (P95), with a longer term underlying cause of rising unemployment traced to technological, organisational and structural changes in the traditional sectors of mining, agriculture and manufacturing (and more recently in administration) which act to reduce the demand for labour associated with any given level of activity. Since explaining the past is something economists do most (if not best), many professional readers will no doubt have different interpretations of recent unemployment history and emphasise different causal factors and mechanisms – but the arguments here are persuasively put. The level of analysis makes it easily accessible to non-specialists, but those seeking more rigourous analysis of critical empirical relationships will find some disappointments.

For example, although the authors (rightly, in my view) emphasis depressed aggregate economic activity, and hence depressed "derived" demand for labour, they feel obliged to devote much discussion to the neoclassical view that unemployment is a result of the general level of real wages being above its "equilibrium" market-clearing level. In this discussion they cite estimates from a Reserve Bank study of the relationship between real wage levels and employment growth (Russell and Tease 1988) which imply that a ten per cent reduction in real wages would eventually result in a five per cent increase in employment. They then go on to state (P50): "However, analysis of the Russell Tease model using more recent data shows that the estimated effect of real wage variations is greatly outweighed by the effect of changes in total output." There is no explanation provided of the methodology of this "analysis", nor is any reference citation for this given. There is an important issue here and it deserves better treatment. There are important causal relationships between the general level of real wages and aggregate demand (and hence employment). The authors consider the effects of changes in the level of real wages on consumption demand but neglect the more significant causal relationship running from real wages, to the profit share/wage share distribution of aggregate income, to investment demand. There is some econometric evidence that rises in real wages relative to productivity, consequent shifts against the profit share, and resulting collapses in corporate real investment, were the dominant factors in the Australian recessions of both 1975 and 1981/82. The evidence also suggests that the relationship between the profit share and aggregate investment, because it depends on current profitability being sufficient to make an adequate contribution to the financing of firms' desired investment plans, is not symmetric. While rises in real wages which squeeze the profit share will depress investment demand, falls in real wages relative to productivity, which restore the profit share (as occurred in the late 1970s and again in the mid 1980s), do not necessarily provide the incentive for a matching recovery in investment demand.(for a summary of the argument and the evidence see Stegman 1994).

Part I also includes a chapter on "Economic Rationalism and Economic Fundamentalism". The policy errors (sins of omission and commission) responsible for the current crisis are in general seen as the result of dogmatic adherence to "Economic Fundamentalism" – an ideology characterised by uncritical faith in the supremacy of market solutions, and a narrow perspective on policy goals which places allocative efficiency above all else. The deregulation of the financial sector, policies of privatisation and deregulation in other sectors, "the current wave of microeconomic reforms", and the acceptance of contractionary macroeconomic policies, are all seen as "motivated primarily by fundamentalist ideology" (P40). The authors argue that the dominance of this narrow theoretical perspective in policy advice (particularly in the Treasury and the Industry Commission) has resulted in the neglect of the role of public policy instruments in improving economic

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outcomes, and the undervaluing of goals such as equity, social cohesion, and environmental security. This chapter's criticisms of neoclassical economic orthodoxy, and the condemnations of its effects on Australian policy advice, are in similar vein to those recently presented in Pusey(1991) and Toohey(1994).

The authors begin the prescriptive Part II by setting out the value system for social policy, within which full employment can be achieved. What they seek is nothing less than a "secure, free, just, and creative society", for which, as they convincingly argue, a high level of employment is an important requirement. This is high-minded, normative stuff, and contrasts with the alleged value-free, "positive" objectives in orthodox economic analysis.

The authors descend to more practical analysis in the ensuing three chapters. The first sets out their proposed National Economic Policy Program, the next two provide detailed discussion of tax policy and labour market programs respectively.

The National Economy Policy Program consists of the following major elements:

- a pro-growth macroeconomic policy orientation;
- substantial expansion of community and public services employment;
- increased bond-financed public infrastructure expenditure;
- an expansion of labour market programs to provide a job guarantee for the long-term unemployed;
- an Accord-based wages policy which "retains sufficient central direction" (P140) to prevent wage based inflation;
- tax reforms to increase progressivity, remove regressive tax concessions, and provide the funding for expanded public sector employment (including the so-called 'jobs levy').

The level of detail in the explanation and justification for each of these elements varies. While tax policy and labour market programs are given a chapter each, other elements get less consideration.

Monetary policy and wages policy are two areas where this reader was left unconvinced by both the analysis of recent developments in Part I and the prescriptions in Part II.

With regard to monetary policy and the financial system, the authors continually refer to deregulation of the financial system as a "mistake" – a policy failure. It is true that deregulation was "sold" on the basis of alleged efficiency gains through competition (often based on naive market models which seem to make no recognition of the enormous technological and institutional developments in domestic and international financial operations). But the political proponents of deregulation were making a virtue out of necessity – politicians and senior public servants are loath to admit impotence. The process of deregulation – the removal of capital controls and the floating of the exchange rate, the removal of a raft of controls on banking sector operations – inevitably occurred because the financial sector environment had so changed, that existing controls had become impossible to implement or incapable of achieving their purpose. Here is surely a case where events were bigger than men.

While the authors acknowledge that "it would have been difficult for the government to entirely resist the pressures for deregulation because it was a global trend", they claim "there were choices" (P69). While they catalogue the detrimental results of deregulation – the increasing emphasis on short term goals to the detriment of long term investment, the explosion of finance for speculative asset accumulation, the dominance of short term capital flows in determining the market value of the exchange rate – they are not forthcoming on what alternative policy choices should have been made.

Neither do the authors provide adequate explanation or analysis of their prescriptions for monetary policy and the financial system. They state that the main aim must be "to return the financial system to the role of the servant, rather than the master of the real economy" (P119), but it is not made clear how this is to be done . At one stage they seem to argue that we would be better off if all forms of government guarantees explicit or implicit are withdrawn from deposit-taking financial institutions, since "the main regulation required for such institutions is consumer protection" through "appropriate warnings" of risk (P120). This is surely wrong. The crucial requirement of an efficient credit system of transactions settlement is a high level of general and continuing public confidence – a level that only some form of perceived government support can provide. The authors are apparently in favour of government guarantees and supervision somewhere in the system however, "there should be no possibility of state-level intervention to rescue ... financial institutions (which) choose to operate outside the controls imposed on publicly guaranteed banks" (P120). In the next paragraph they baldly assert "with the reintroduction of an appropriate system of prudential regulation and the availability of controls on the direction and volume of lending the Reserve bank would be in a better position to operate an appropriate interest rate policy". There is no explanation of what the appropriate regulations and controls might be, or how they would operate. The proposed appropriate interest rate policy is to maintain the real interest rate at around "three to four percent". There is little argument and no evidence given in support of this proposition.

The targeting of monetary policy on the "real" rather than nominal level of interest rates is puzzling in a book so critical of neoclassical theory and concepts. The credit squeeze of 1974 is cited to "indicate the absolute necessity of avoiding ...very high real interest rates" (P120), despite the fact that measures of the real interest rate for this period were negative! Even more puzzling is the immediately following assertion that "Given a sustainable setting of the real interest rate, and the avoidance of cost-push pressures in wages and prices, the maintenance of a low and stable rate of inflation should follow almost automatically."

With regard to inflation and wages policy, there is insufficient emphasis given to the role of the Accord in the mid 1980s in allowing the pursuit of pro-growth, employment generating policies – by dealing with the "inflation constraint" on growth (but not, alas, the 'balance of payments' constraint). This, in turn, means insufficient consideration of the implications of the developments in the wages system over the last decade: the shift in priorities from the macroeconomic goal of inflation control to the microeconomic goals of labour market efficiency and flexibility. The current system of "enterprise bargaining", lacking any formal influence on the growth in aggregate wages outcome, leaves monetary policy as the main weapon in the anti-inflationary armoury. This means relying on high interest rates and thus on restricting real investment and growth in activity and employment, in order to "discipline" wage demands. The authors do not explain how "sufficient central direction" is to be restored to the wages system, in order to control wage-inflation in circumstances where robust growth in aggregate activity provides the inevitable skill shortages in sectors of the labour market. They largely rely on the goodwill and unselfishness of the unions, particularly the public sector unions (P140), who are expected to refrain from opportunistically exploiting expansionary macroeconomic policy by a wages push.

The chapters on Tax Policy and Labour Market Programs provide the kind of practical detail that is lacking for other elements of the National Program.

While the Tax Summit and GST debates have resulted in much cynicism about hypothetical tax arithmetic, the estimates and calculations presented in this book at least represent careful thought about the implications of tax proposals and the necessary "responsible attitude" to government deficits.

The Labour Market Programs are also presented in some detail. In general, the proposals here are the targeted employment subsidy and training schemes recommended by the Green Paper (1993), with the important addition of a major program of expanded public sector employment.

In Chapter 11 the authors recognise that Australia's prospects for the domestic growth rates necessary to reduce unemployment depend on the international economic environment, and our capacity to cope with external shocks. The style and tone of this chapter is one of high-minded optimism, as suggested by its title: "One Inseparable Humanity – A Global Employment Strategy". More cynical readers will be less optimistic about achieving co-ordinated and consistent multi-national policies – the sort of policies needed to provide high world growth rates, an equitable international distribution of the benefits of this growth, and some order and control to international financial capital flows and speculation.

The remaining chapters ('Green Jobs', 'Humanising Work', 'Political Will') are more polemic and persuasion than analysis, but the arguments are interesting and worthy of further debate.

It is easy to be cynically critical of an optimistically presented program, especially when (as here) there is an honest attempt to lay the details bare. Although there is much to doubt and disagree with in the authors' policy prescriptions, they are to be congratulated for their positive approach. It is to be hoped that this book will be widely read and therefore play a role in keeping the problem of unemployment at the highest priority, and in stimulating further work on modifications and alternatives to the elements of their program. Otherwise we run the dangers of becoming accustomed to high unemployment, of strangling the emergence of any hint of robust economic growth for fear of inflation, of relying on the chanted mantra of "more flexible labour markets and greater efficiency through market forces", and of accepting the level of unemployment "ground out" by the market system as "natural" (to use Friedman's expression).

Notes

1. Langmore, J. and Quiggin, J, *Work For All: Full Employment in the Nineties,* Melbourne University Press, 1994.

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