Strong On Policy Suggestions, But Weak On Analytical Framework: A Review Of The Green Paper On Restoring Full Employment

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Abstract

The Green Paper makes the fundamental point that rapid economic growth of around 4 to 5 percent a year is necessary to substantially reduce unemployment, but even 5 percent growth will not greatly reduce the numbers of long-term unemployed. Policies targeted specifically at this group are also necessary. Its analysis of the policies conducive to rapid economic growth and its arguments that things like more rapid productivity growth and reductions in the participation rate have little effect on unemployment in the medium to long run are supported by simulations of the Murphy model which assumes the results that the Green Paper argues that it demonstrates. On the other hand, the Green Paper is rich in policy suggestions to reduce long-term unemployment and to improve the working of the labour market. The Job Compact is central but improvements to social security and education and training are also important.

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1. Introduction

The Green Paper, **Restoring Full Employment**[1] begins with an unequivocal statement on the importance of its subject matter. It declares that

> "the nation's number one priority is to find jobs for unemployed Australians,...[that] the loss of production through unemployment is the single greatest source of inefficiency in our economy [and that] unemployment is also the most important cause of inequality and alienation for individuals families and communities." (p.1)

All three things need to be said, and to be remembered by all who discuss economic policy in Australia. The Green Paper starts at the right point.

It then goes on in the first chapter to describe not only the labour market as it is at present, but also how it has changed over the last fifteen to twenty years. It brings out many well known facts such as the increasing participation of women in the labour market, the fact that unemployment is neither gender, nor age, nor race neutral, bearing more heavily on men, on young people, on migrants from non–English speaking countries and on Aboriginal and Torres Strait Islander peoples. It also points to less well known facts, for example that older men as well as teenagers are being squeezed out of the labour market, that there has been a switch from part–time to full–time jobs by women in the 25–34 age group and that the Community Development Employment Scheme has been successful in reducing unemployment rates among Aboriginal and Torres Strait Islander people.

Drawing on this descriptive material the Green Paper identifies correctly the two steps necessary to restore full employment, namely substantially increasing the rate of growth (to between 4.5 and 5 percent a year according to Green Paper estimates) and also implementing specific government policies to reduce the number of long term unemployed. The first chapter also draws on the survey of labour market trends to point out the importance of entry level education and training in reducing teenage unemployment and the need to reform the social security system to bring it into line with the labour market of the 1990s where the increased participation of women and the growth of part–time and casual employment have

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undermined the assumptions on which the social security system is based.

After such a good start it is disappointing that the Green Paper sidesteps the next logical point: the size and nature of the cost to the rest of us of taking the steps necessary to provide jobs for the unemployed and restore full employment. The Green Paper challenges all Australians with the questions:

> "Do we want to change or are we prepared to live with high unemployment? In other words how important to you is sharing the burden – a "fair go for all"? (p.15)

But, because it does not indicate the cost to the rest of us of giving the unemployed a "fair go", it removes the bite from the question.

The last chapter of the Green Paper does have a section of a bit over half a page entitled "Costs of Proposals". This, however, deals with the budgetary costs of proposals to expand labour market programs so that the ranks of the long term unemployed are reduced, of the proposals to reform the social security system and of other minor proposals. The total cost is estimated to be from 1.6 to 2 billion a year in 1993–94 dollars. The Green Paper discusses ways of meeting these costs, including a job levy. It does not point out that if the economy grew at the faster rate advocated by the Green Paper the extra revenue generated would soon amount to more than 2 billion dollars a year. Thus, a reader with enough economic knowledge to realize this will be led to the conclusion that restoring full employment is costless, because the more rapid economic growth, which is part of doing this, in the words of the Green Paper itself

> "increases the scope for fiscal flexibility while still maintaining the Government's medium term budget targets and can provide a substantial fillup to living standards benefiting both the unemployed and the wider community." (p.70)

If this were the whole story, no–one would hesitate to answer yes to the question "do we want change to restore full employment?" But faster economic growth itself imposes costs in terms of foregone consumption in the early years. These costs are not impossibly large and do not last forever, but they do exist and will impose a short to medium term burden on those who are employed or self employed or are living comfortably off investment income. Because it provides no analytical framework to support its discussion of faster economic

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growth, the Green Paper is able to ignore the short to medium term costs of faster growth.

These issues are discussed in the next section, and section 3 is an attempt to provide the analytical framework missing in the Green Paper. Section 4 reviews the Green Paper discussion on other matters, namely education and training, measures to cut substantially the number of long–term unemployed and the reform of the social security system. Then the threads are drawn together in section 5.

2. The Green Paper Discussion of Economic Growth

The second chapter in the Green Paper, on economic growth is by far the weakest chapter in the whole discussion paper. It is here that the lack of any analytical framework about how the economy works at a Macro level vitiates the discussion. The chapter begins well by pointing out that Australia is an open economy in an international economic system which has become increasingly integrated following improvements in transport and even more in communications. As the Green Paper points out, in this environment "no country can directly manage its exchange rate for long" (p.44) But the Green Paper never considers the implications of world–wide integrated financial capital markets and floating exchange rates for its policy prescriptions on how to increase the rate of economic growth in Australia. The Green Paper argues strongly for micro–economic reform and productivity growth so that the Australian economy will be more competitive and export more. But why will increased productivity in Australia not lead to a rise in the exchange rate so that our competitiveness is unchanged? The Green Paper does not even consider this question.

The nearest the Green Paper comes to providing an analytical framework to support the discussion of economic growth is to refer readers to the appendix which describes simulations made using the Murphy model. But in the Appendix the Murphy model simulations are used in ways that are misleading, at the best. The model is used to answer questions, which, because of its nature, it cannot answer. For example the Green Paper argues strongly that inflation reduces total output and hours of employment available to be shared. This may or may not be correct. The effect of inflation on the rate of economic growth is a matter of some controversy in the literature.[2] The evidence in the Appendix showing that reducing inflation reduces unemployment is completely valueless. The simulations in the Appendix show the effects on unemployment of each of three changes. These are (1) reduced wage inflation, i.e. the non accelerating inflation rate of unemployment (NAIRU) is reduced by two percentage points (2) higher productivity growth and (3) a reduction in participation rates. Each change is considered separately. The simulations show that reducing the NAIRU by 2 percentage points reduces unemployment by 2 percentage points after 8 years have elapsed, but that the other two changes have very little lasting effect on unemployment. This is not surprising. As the Green Paper acknowledges the Murphy model is "neo–classical in the long term." (p. 210) That is, it is constructed so that unemployment is forced to return to the NAIRU in the longer run whatever the shock that is assumed. Reducing the NAIRU by 2 percentage points must reduce unemployment by close to 2 percentage points after eight years. Since the other two assumed shocks do not affect the NAIRU they can not affect the level of unemployment in the long run. The results in the Appendix of the Green Paper tell us that the model performs to produce the results that were built into it by assumption. The assumptions may be correct but it is misleading, to say the least, to use the simulations to support the hypothesis embodied in the assumptions.

One final point on the Appendix. In Chapter 2 the Green Paper argues that the modelling results in the Appendix show that

> "it should be possible to increase the average rate of economic growth achievable over the remainder of this decade to between 4 and 5 percent." (p.70)

However, the Appendix omits reporting this. No figures for the effect on the rate of output growth are given for any of the three policy simulations or for the scenario's produced by combining policy changes.

While the Green Paper produces little worthwhile analysis to support its policy proposals designed to increase the growth rate this does not mean its proposals themselves are not worthwhile. It means they must be discussed and supported by analytical arguments other than the simulations in the Appendix. The Green Paper's prescrip–

tions to secure economic growth are "a concerted effort...to increase productivity growth and reduce capacity bottlenecks and other inflationary pressures." (p.70) Great emphasis is placed on restraining inflation. "A large part of the benefit of higher productivity growth comes from reducing inflationary pressures" (p.51), but as already pointed out, no valid evidence is given on the controversial question of whether low inflation does increase the rate of economic growth. The Green Paper also points out that more rapid economic growth will require Australia "to achieve the investment necessary to sustain expansion without excessive resort of foreign borrowing." (p.49) However, it does not discuss this issue as it says that it has already been addressed in Dr Fitzgerald's **Report to the Treasurer on National Savings** (1993) and in the **National Fiscal Outlook Report** to the 1993 Premiers' Conference. Unfortunately this not only means ignoring the major cost of economic growth, the consumption foregone to enable the necessary investment to take place, but also means that the valid arguments why rapid productivity growth may be helpful for employment generating economic growth are not put forward.

3. An Analytical Framework for Discussing Increased Economic Growth in Australia

There is universal agreement that raising the level of economic growth form 3.5 percent to (say) 4.75 percent will require an increase in the rate of growth of the capital. There is agreement among almost all economists responsible for policy advice and many academics that the increase in investment required cannot simply be financed by borrowing from abroad but must be financed largely by increased domestic savings. The basic argument is simple. Australia already has a large foreign debt, and the amount we are already borrowing from abroad is a high proportion of our GDP. If we continue to borrow increasing amounts from abroad (i.e. if the current account deficit increases continuously as a proportion of GDP) sooner or later foreigners will wonder if we will be able to service the debt and will cease lending to Australia. This will precipitate a massive devaluation of the Australian dollar on foreign exchange markets and hence large falls in real consumption and a rapid, painful structural adjust–

ment. It is better to reduce consumption a little now and to have slower structural adjustment. Therefore, along with the Green Paper, I will assume that more rapid economic growth should not be allowed to increase the current account deficit as a proportion of GDP.

If the current account deficit is an important target of economic policy, how can its size be influenced? Will micro–economic reform, which makes export and import competing industries more productive increase exports, reduce imports and thus reduce the current account deficit, or will more competitive industries in Australia merely lead to an appreciation of the exchange rate leaving the current account deficit unchanged? Some discussion of what determines a floating exchange rate in the modern world is required.
Let us start with the social accounting identity

$$GDP = C + I + X - M$$

where C is public and private consumption, I public and private investment, X exports and M imports

plus the definition

$$DS = GDP - C$$

where DS is domestic savings.

From equations (1) and (2) it follows that

$$I - DS = M - X$$

or the savings gap equals the trade gap.

This must be true, as social accounting identity *ex post*, or after the event. But what if it is not true *ex ante*, if the trade gap which would result from the plans of participants in the economy does not equal the savings gap which would result from those plans? Will the trade gap change or will the savings gap adjust. This depends critically on the exchange rate regime. The savings gap represents a net supply of foreign exchange as foreigners lend to us and results in an inflow of foreign exchange on the capital account to pay for the surplus of imports over exports. The trade gap represents an outflow of foreign exchange on the current account to pay for the surplus of imports over exports. Thus, *ceteris paribus*, given a floating exchange rate regime, if *ex ante* the savings gap is greater than the trade gap, one would expect the exchange rate to appreciate which would tend to increase imports and discourage exports increasing the trade gap to match the savings gap. Conversely, if the trade gap is greater than the savings gap one would expect the exchange rate to depreciate reducing the trade gap. Thus, in a country like Australia, which has a floating exchange rate, one would expect the savings gap to be the dominant one. No doubt both gaps may change, but there is a market mechanism in existence to ensure that it is mainly the trade gap that changes to bring about equality between the trade gap and the savings gap. Thus, if we want to contain the size of the current account deficit it is the relationship between savings and investment that is important, not how productive are our import competing and export industries, though of course productive industries are important for other reasons.

How much extra investment, and therefore how much extra domestic savings will be required to realise the rate of economic growth in Australia from 3.5 to 4.75 percent? From 1982–83 to 1991–92 the ratio of gross fixed investment to GDP averaged 23.2 percent, consumption of fixed capital averaged 15.45 percent leaving net investment in fixed capital 7.77 percent of GDP. GDP increased by 3.32 percent a year over this period giving an incremental capital–output ratio of 2.34. This suggests that the ratio of fixed investment to GDP and hence the savings ratio must increase by 3 percentage points. About another 0.1 percentage point must be added to the savings ratio to allow for the extra investment in stocks and a little more extra investment and savings may be needed, compared to the 1980s, if there is a faster pace of micro–economic reform and structural adjustment. Clearly, one should not put any weight on the last decimal place in the above required increase in the savings ratio, but the conclusions set out in the next paragraph hold for any required increase in the savings ratio between 3 and 3.5 percentage points.

Given the calculations in the previous paragraph, if the rate of economic growth in Australia is to be increased from 3.5 to 4.75 percent without increasing the ratio of the current account deficit to GDP, total consumption will have to be below the level it would have reached at the lower growth rate for 3 years. By the fourth year the higher rate of growth will mean that total consumption is slightly higher when growth is 4.75 percent despite the higher savings ratio. However, there will be a substantial increase in the consumption of those who become employed at the higher growth rate, but not at the lower one, so that it will be 5 years before the employed, the self–employed and those living off investment income have on average as high a level of consumption at the higher growth rate. After the fifth year all Australians are better off, though it takes another 2 or 3 years before the subsequent extra consumption in the higher growth rate path is greater than the consumption foregone in the earlier years.

Thus, the true cost of having "a fair go for all" and restoring full employment is less consumption for the majority of Australians for four years. The required reduction in consumption is about 3.5 percent in the first year, it steadily diminishes and only lasts four years. The real challenge is whether comfortably off Australians are prepared to accept this relatively minor sacrifice.

The above analysis also shows what can and cannot be achieved by "a concerted effort to increase productivity growth" or micro–economic reform. Increased productivity growth will increase eco–nomic growth and improve living standards on average, if and only if the resulting increase in output per person employed is not offset by increased unemployment. Increased employment, rather than unemployment, will occur when the productivity growth increases the rate of economic growth by more than the increase in productivity growth itself. Given that the binding constraint on economic growth is the current account deficit, which is largely determined by the savings investment gap, productivity growth can actually reduce unemployment to the extent that it reduces the marginal capital output ratio or makes new or existing capital more productive without making any existing capital obsolete.

The analysis also shows what, if anything can be achieved by working shorter hours, job sharing and reducing the participation rate. Unless reduced work is accompanied by reduced consumption of those working less it will not enable more people to be employed. If it is it will enable some of those presently unemployed or not in the labour force to be drawn into employment, but all the benefits of higher living standards that come in the long run with increased economic growth will be lost. If people want to work less hours a week despite the proportionately lower income this should be made easier to achieve. If they do not, advocating reduced average work–ing hours is a council of despair.

Unfortunately, the analysis sketched out in this section is of no more help than the Green Paper in resolving the question of the effects of inflation on economic growth. However, there are other reasons for making very low inflation a goal of economic policy. The simplest is that most people dislike even moderate inflation.

4. Labour Market Issues

Most of the chapters in the Green Paper are concerned not with the macro issues of economic growth, but with micro issues of improving efficiency in the labour market and getting the long term unemployed into productive jobs. The first of these micro chapters is concerned with eduction and training and looks at ways to

> "increase opportunities for adults to train and retrain, with flexible arrangements to meet their needs and the needs of their employers;
>
> expand education and training opportunities for young people seek–ing to enter the workforce;
>
> improve the links between industry and the education and training system so that the skills which people learn are those needed and valued in their workplace;
>
> consider some form of trainee wage for long–term unemployed people; and
>
> make sure that adults with a limited education are confident about going back to learn, so that they are able to take their place as valuable members of the workforce." (p.92)

While some of the measures proposed would involve additional costs to governments and private sector industry, the Green Paper believes that the resulting investment in workforce skills will be more than justified in terms of increasing economic growth and living standards and reducing the numbers of long–term unemployed (p. 92).

The Green Paper then turns to labour market programs. After reviewing labour market programs in Australia over the last two decades, it points out that there are now more people being helped than ever before, but still two–thirds of the long–term unemployed received no special assistance last year and "for many there is no end in sight to their unemployment" (p. 120). Therefore the number of places in the various programs must be increased, but also these programs need to be better linked to the needs of both job–seekers and employers. The Green Paper suggests that this be done through a social contract to help all long–term unemployed find jobs, a contract which the Green Paper calls a Job Compact.

> "The Committee's considered view is that over and above the growth imperative, a major community effort will be needed to get long–term unemployed people back to work soon. A clear commitment should be made to this obligation on the understanding that all sections of the community will need to play a part: governments, employers, trade unions, community organisations, those already in employment and not least, long–term unemployed people.
>
> A Job Compact would give new meaning and genuine effect to the principles of entitlement and obligation. As a result some changes in the roles and responsibilities of both the Government and long–term unemployed people, as well as employers and other groups, would be needed.
>
> More specifically the Job Compact draws on the concept of obligation. From the time of registration, those in receipt of unemployment allowances are currently obliged to meet an activity test, the successor of the work test. They must seek work actively, accept reasonable offers of training and other labour market programs provided through the CES, and accept suitable jobs which become available." (p.123)

The Job Compact is not just a contract to help long–term unemployed find jobs. It also places obligations on the unemployed to "seek work actively, accept reasonable offers of training and other labour market programs provided through the CES and accept suitable jobs which become available." (p.123) The Government is not only obligated to provide increasing assistance to help unemployed into jobs as their length of unemployment increases but also to provide income support for them while unemployed (p. 124). After people had been unemployed for more than a certain period (very long in the phasing in period but eventually 12 months) they would receive a job offer either in the public service or at a subsidized wage in the private sector. The job would be guaranteed for at least 6 months, or better for 9 months when this became financially feasible. In addition to existing programs such as Jobstart, NEIS and Jobskills a new program christened Extra Work Options would be created. These would provide opportunities for work in community service, environmental work, and part–time work because of child minding commitments. The Green Paper lists a number of possible projects but says this is only a small selection of possibilities. The list comprises:

"regionally based environmental servicing: to reverse environmental degradation through repair and regeneration projects;

ecotourism;

redevelopment and maintenance of community recreation facilities;

mature–age traineeships with public sector employers;

providing care for the aged and unwell, eg. supplementing Home and Community Care (HACC) activities through cleaning, gardening, shopping services, etc;

tourist information assistance including training and employment as 'tourist ambassadors';

constructing community infrastructure through State and local governments;

community development projects similar to CDEP for Aboriginals and Torres Strait Islanders, particularly in more remote locations; and

opportunities in the cultural industry and leisure sector." (pp. 131–2)

Thus the Job Compact would not only build on existing programs but would include policies at a local level which would provide community benefits, promote community involvement and meet local needs and plans for regional development, as well as help the long–term unemployed back into the mainstream of society (p. 136).

The last topic tackled by the Green Paper is reforming social security to bring it into line with current labour market characteristics. Four particular problems are identified.

"the social security income test discourages unemployed people from seeking and accepting part–time and casual job opportunities as there is a large range of income over which unemployment payments are withdrawn on the basis of one dollar for every dollar of earned in income;

the treatment of married couples as a joint income unit comprising a main job seeker and a dependent spouse does not encourage both spouses to seek and obtain employment;

the partner in a single income married couple may have little incentive to get a low paid full–time job; and

the nature of the social security system, including its benefits and targeting of payments, can potentially constrain the choice of parents balancing work and family responsibilities." (p.183)

The first three of these problems relate to poverty traps. If social security benefits are withdrawn, as earned income increases, at such

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a rapid rate that one is no better off or even worse off by working one is literally caught in a poverty trap. Even if the improvement in income is positive but slight, this may still be regarded as a poverty trap. There is no correct answer to the question of whether to withdraw benefits quickly, so as to keep the range within which a poverty trap operates relatively small or to withdraw them slowly – so that the incentive to find work is greater even though the range over which the poverty trap works to some extent is increased. However, most agree that withdrawal rates of 100 percent are usually undesirable, and the Green Paper notes, that an important principle is "to seek to provide a financial return for every dollar earned". (p. 184)

The first problem listed is the classic poverty trap situation. The Green Paper points out that there is a long weekly employed income range ($85 to $242) in which there is a 100 percent withdrawal rate of social security benefits. (p. 186) There is probably a net cost of working to the benefit recipient because other benefits may also be lost (e.g. rent rebates from State Housing Authorities) and there may be work related expenses. The Green Paper addresses this by replacing the 50 percent and 100 percent existing benefit withdrawal rates by a standard 65 percent rate which commences at a $15 a week lower income than the present 50 percent rate. Thus the range over which benefits are withdrawn both starts earlier and finishes later.

This has two unfortunate results. First, Social Security payments are lower and the poverty trap greater for income support recipients who earn between $30 and $130 a week. It is a retrograde step to help pay for a "reform" by penalizing those already very badly off, and it is undesirable to have a strong poverty tax barrier at such a low level of earnings as $30 a week.

Secondly, the 65 percent withdrawal rate is still too high. Many people will face an effective 100 percent (or more) poverty trap over just as large an earned income range or even a larger one. For example most public housing tenants pay between 20 and 25 percent of their before tax income in rent giving them an effective marginal tax rate of 85 to 90 percent if social security benefits are being withdrawn at a rate of 65 percent. In addition there are work related expenses, for which the Green Paper quotes a figure of 20 percent. (p.171) It is likely that they will be worse off working over the whole range in which social security benefits are withdrawn.

The second and third problems listed by the Green Paper both relate to the treatment of married couples and may be considered together. The social security arrangements are generally based on the assumption that the typical family comprises a breadwinner, a dependent spouse plus perhaps dependent children. With the increased participation of women in the labour force this is no longer the case, at least where the wife is younger than 40 – older women's participation may still reflect the attitudes of the 50s and 60s. The Green Paper therefore suggests that "married women below, say, 40 years at the date of implementation could be required to qualify for unemployment payment in their own right." (p. 187) However, one spouse in a family with dependent children "would be exempt from the requirement to look actively for work in recognition of their child case responsibilities" (p. 188) and would be eligible for a new parenting allowance.

As well as having the obligation to actively look for work both spouses would have the right to their own unemployment benefits, though at half the married rate not the single rate. However, for financial reasons the Green Paper baulks at paying unemployment benefits to people whose spouses have incomes high enough to support them in very frugal comfort and suggests that once a person's income exceeds $235 a week for every dollar above that figure their spouses social security entitlement be reduced by 65 cents.

Apart from this, the withdrawal arrangements for each spouse's separate social security entitlement mirror those for single people and the strictures made of those arrangements also hold in the case of married people. But the principle of treating at least very low income married couples as two individuals for social security purposes, as all couples are for income tax purposes, is welcome.

The really new initiative is the parenting allowance. This would be the same as the level of unemployment benefit for spouses looking for work and would be subject to the same withdrawal rates – including those applying where the spouses income is over $235 a week. The only difference is that someone receiving a parenting allowance does not have to look for work. The age of the youngest child at which the allowance ceases to be paid is a matter of judgement. The Green Paper suggests, howbeit tentatively,

> "that the parenting allowance could be available where there are children aged under 12 years of age. For those with children aged

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between 12 and 16 years, they could be required to look only for part–time work to receive income support as unemployed. When the parent's youngest child is getting towards the stage when they will no longer attract parenting allowance, special labour market assistance is envisaged so the parent can be prepared to re–enter the labour market if they choose." (p.192)

5. Conclusion

The Green Paper is correct in arguing that more rapid economic growth is essential if unemployment is to be halved by the end of the decade. However, because it does not produce a logical case to support its statement that reducing the participation rate will have little effect on unemployment, it will not convince those who believe that worksharing is the answer to the current high unemployment rate. This is a pity. On the other hand its proposals to improve the working of the labour market and to get the long–term unemployed back into jobs are generally soundly based, imaginative and worthy of more than discussion, though further discussion will improve the details of some proposals.

Notes

1. Committee on Employment Opportunities, **Restoring Full Employment: A Discussion Paper**, Australian Government Publishing Service, Canberra, 1993. All page references in the text are to this publication.
2. See, for example, Kyriakopoulos (1991), McTaggart (1992) and Nevile (1990).

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