ANNEXURE B

A Plan to Cut Unemployment in Australia: An Elaboration on the 'Five Economists' Letter to the Prime Minister, 28th October 1998[1]

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1.1 Introduction

In October 1998, I was one of five economists who wrote a letter to the Prime Minister, suggesting a plan to reduce unemployment to around five to five and a half per cent. The other four were John Freebairn, Ross Garnaut, Michael Keating and Chris Richardson. The contents of the letter are reproduced as an attachment to this article.

In the letter we suggested that continued economic growth could reduce unemployment to around 7 per cent, but for it to go much lower required a range of polices to improve the operation of the labour market. Specifically we proposed:

1. replacing Living Wage adjustments, for the time being, with tax credits for low wage earners in low income families, (to be done in a way that reduces effective marginal tax rates for low income families);
2. a long-term commitment to further reduce effective marginal tax rates by moving towards a negative income tax system;
3. a systematic approach to labour market programs;
4. up-grading the education and training systems over the longer-term.

In this article I seek to elaborate on the contents of the letter by further discussing each of the four policy developments proposed above, in sections 2 to 5 in turn. It must be stressed that what follows is my own discussion of the "five economists plan". While there is substantial agreement amongst the five about the kind of policy mix required, and I believe that the other four would concur with the thrust of what I have to say in this article, it is my own perspective on the plan that is being presented. Having said that, I am drawing on a number of ideas and suggestions of others in the group, as well as my own.

1.2 The Proposed Wage-Tax Trade-Off

1.2.1 The Importance of Wage Costs

Continued strong economic growth could make further in-roads into the unemployment rate. Our letter suggests that such growth could get unemployment down to around 7 per cent or even, perhaps a little lower. Estimates of the non-accelerating inflation rate of economic growth (NAIRU) vary, but it is thought to be around 7 to 7.5 per cent (see for example Debelle and Vickery 1998). It seems very unlikely, therefore, that

[1] This paper is extracted from the *Mercer-Melbourne Institute Quarterly Bulletin of Economics Trends*, 1'99.

economic growth alone could get unemployment much below 7 per cent without causing accelerating inflation.

Thus to get a sustainable reduction in unemployment down to around 5 to 5.5 per cent requires some structural change to the labour market. Specifically, it will be necessary for the rate of growth of labour costs to be lower, for any given rate of productivity growth. There is widespread evidence to support this proposition, and there would be widespread, if not universal, agreement that if this could be achieved, a sustainable cut in unemployment would result.

This raises the question of how much the rate of growth of labour costs needs to be reduced. The evidence that we reported in our letter to the Prime Minister came from a Reserve Bank study by Debelle and Vickery (1998). Their empirical study of the Australian labour market led them to conclude that if the rate of growth of wages could be reduced by 2 percentage points for one year, this could reduce the unemployment by one percentage point.

The forces underlying this finding are essentially two-fold. First, a lower real wage leads to higher labour demand. The elasticity of labour demand in their study was of the order of –0.4. That is, for a 10 per cent higher real wage employment would be lower by 4 per cent. This elasticity is a bit lower than that found in a number of other Australian studies.

Secondly, with lower growth in wage costs, the Reserve Bank can respond with a more expansionary monetary policy without risking accelerating inflation. Thus there is an indirect effect of wage costs on labour demand though stronger growth in the economy, resulting from its effect on monetary policy.

This raises the question of how we could achieve lower growth in real wages, of the order of say 2 to 4 per cent, in order to reduce the unemployment rate by about 1 to 2 percentage points below the rate that could be achieved just through strong economic growth. The suggestion of the "five economists" is a kind of wage-tax trade-off. We proposed replacing living wage increases by tax credits for low wage earners in low income families.

1.2.2 The Use of Tax Credits

Earned income tax credits apply in the US and over the last decade the Clinton administration has progressively increased the value of such tax credits as a tax-free supplement to low wage earners in low income families. The size of the credits depend on the number of children and the level of family income. Initially the tax credits increase proportionally with income then plateau, and are then tapered out. This reduces effective marginal tax rates at low levels of family income, but increases them further up the income distribution, when the tax credits are tapered out. These principles also applied to the earned income tax credits proposed by the Labor Party at the last federal election.

What the five economists proposed in our letter to the Prime Minister differed from the US system in two main respects. First, the provision of

the tax credits was proposed to be an alternative to living wage increases. Second, it was proposed to be integrated into the tax/transfer system in such a way as to reduce effective marginal tax rates for low-income families, but not to increase effective marginal tax rates for any families.

One of the five economists, Michael Keating, has converted this principle into a specific proposal. Under this proposal a tax-free tax credit of the order of 2 per cent would be paid as a supplement to the wage of low wage earners in low-income families, as an alternative to a Living Wage increase. After a certain level of income is reached the tax credit would be tapered out, but in combination with the tapering of other family payments in such a way as to not increase effective marginal tax rates. As an example, Keating has pointed out that this would amount to an increase in disposable income of a little over $10 per week tax-free for a low paid employee earning two thirds of average male ordinary time earnings. To produce an equivalent increase in income for someone in the withdrawal range for family payment in the current tax/transfer system would require a wage increase of as much as $70 per week. This is nearly three times the $27 per week that the ACTU is requesting in its Living Wage claim.

Our letter also made the point that recent research by Sue Richardson and Ann Harding (1998) has highlighted how those people receiving low wage rates are well spread throughout the distribution of family incomes. This makes Living Wage adjustments a very blunt equity device. The proposed earned income tax credits would compensate low-income families whose members are in relatively low wage jobs. This difference, combined with the fact the tax credits would be more valuable to low-income families than living wage increases, makes our proposal one that is very strong on equity grounds.

1.2.3 The Effect on Real Wages and Employment

What then would be the effect of our proposal on the average level of real wages? In our letter we suggested that it would reduce the growth of average real wages by about 3 to 4 per cent, over a four-year period. This was based on the assumption that the proportion of wage earners who depend upon safety net adjustments for their wage to increase, was greater than 30 per cent. We further assumed that the inflation rate would be in the Reserve Bank's target range, say around 2 to 2.5 per cent, over a four-year period. Thus if not for the proposed wage/tax trade-off, low wage earners could reasonably expect living wage increases of the order of 2.5 per cent per year. This means that over a four-year period the wage/tax trade-off would reduce the growth in real awards by about 10 to 12 per cent. Taking into account the wage levels of workers depending on awards (which are relatively low), that these workers represented about 30 per cent of all workers, that some might get some over award increases, but that there would likely be some flow-on effects to other workers, we estimated that the effect on real wages on average would be of the order of 3 to 4 per cent.

This estimate has been criticised by the ACTU, who point to the Industrial Relations Commission's judgment that the Living Wage increase in 1998

would increase the average wage level by an estimated 0.44 per cent. If Living Wage increases over a four-year period were of this order of magnitude, the effect on average real wages would be of the order of 1.5 to 2 per cent rather than our estimated 3 to 4 per cent.

There are reasons, however, to believe that the ACTU's estimate is on the low side. First, the Industrial Relations Commission's judgement about the effect of the last Living Wage increase on the national wage bill was based upon the Government's lower bound estimates in their submission. It is not clear why the lower bound estimate should be preferred over the upper bound estimate. Second, the ACTU's estimate does not allow for flow-on effects of award wage increases to enterprise bargains. It must be remembered that any given percentage flow-on effect has a higher impact on the national wage bill than the same percentage wage increase for an award-wage worker. Third our judgement about the effect over a four-year period was based upon the assumption that the inflation rate would hit the Reserve Bank's target range. This would mean a higher inflation rate than we have seen for the past two years. Thus while the 1998 Living Wage increase was substantial, it was awarded in a lower inflation environment.

While there are reasons why the ACTU's figure may be an underestimate ours may be an overestimate. However, even real wage restraint more in line with the ACTU's assessment could produce excellent inroads into the unemployment rate.

Subsequently, one us, Chris Richardson, has applied macroeconometric modelling to our proposed wage tax trade off, using the Access Economics Model. This work is outlined in a recent Business Council of Australia report (1999). This suggests real wage restraint of 1.5% over three years (more in line with the ACTU's estimates than our own), combined with tax credits, could cut unemployment by a full percentage point.

Further, Richardson's modelling revealed that tax credits would not place a heavy burden on the Commonwealth Budget. That is because the extra growth in jobs would add to tax collections, as well as saving on unemployment benefits and labour market programs. At the same time lower inflation would save the Government money (as much spending is indexed to growth in prices and wages, such as the age pension). In fact, Access Economics estimates that ten years down the track the policy package would be boosting the Federal Budget bottom line, rather than drawing upon it.

1.2.4 Average and Relative Wages both to be Affected

The primary focus of our letter, as far as wages were concerned, was to reduce the growth in the average real wage in order to reduce aggregate unemployment. The reduction in the real wage costs of low skilled workers and the associated reduction in their relative wage, however, is also seen as an advantage for the current unemployed who are disproportionately found amongst the low skilled. This is because such a reduction in the wage levels of less skilled workers would tend to lead to a substitution of low skilled labour for capital, as well as an expansion of output and employment of workers in general. It would also tend to lead

to some degree of substitution of low skilled workers for higher skilled workers, although the general increase in employment and output would probably at least neutralise such a negative impact on higher skilled employment.

Hamermesh (1993) provides the most comprehensive review of empirical evidence from around the world about the responsiveness of the demand for different types of labour to changes in their own wage. This analysis reveals that the responsiveness of labour demand to changes in wages is higher for less skilled than for higher skilled workers, further strengthening the case for our proposal.

Even if it were possible to restrain the real wages of high skilled and high paid workers, it is very doubtful that this would be as beneficial for low skilled members of the unemployed. It would tend to lead to an even stronger growth in demand for high skilled labour than is currently the case, having a limited impact on the unskilled unemployed. As a caveat to this, it should be noted that to the extent that it reduced average real wages it could benefit some low skilled employees if they were employed as "complements" to high skilled workers, and could also lead to some people with lower skills or experience being promoted.

The main problem with seeking to constrain the real wage of high skilled workers however, is that this would be operating to a significant extent (though not necessarily in all cases) against market forces. Labour economists have observed a general tendency for the demand for high skilled labour to grow strongly and the demand for low skilled labour to weaken. Unless the supply of high skilled labour grows correspondingly quickly and the supply of low skilled labour declines correspondingly quickly, this tends to widen the distribution of earnings. Attempts to counter this artificially would tend to lead to skill shortages, and reduce the incentive for individuals to invest in education and training. Even if wage restraint of high wage employees were implemented for a short period, it would be unlikely to be sustainable.

1.2.5 Labour Supply Benefits of the Tax Credits

Quite apart from the benefit of raising the demand for labour due to lower wage growth, while improving the living standards of low income families containing low wage earners, another important benefit of the plan is to reduce the effective marginal tax rates facing low income families, especially where an unemployed person is deciding whether to enter employment.

This issue of the high effective marginal tax rates facing low income families has been a major problem of the tax transfer system in recent times (see for example Dawkins et al, 1998 and Beer, 1998). For many low income families such effective marginal tax rates have been greater than 80 per cent, for some over 100 per cent. This results from a combination of income tax paid on additional income, and the withdrawal of social security benefits.

The Coalition Government's tax reform package includes some changes that reduce this problem somewhat (for a discussion of them see Dawkins

and Johnson, 1998). By reducing the number of family benefits from twelve to three and by reducing taper rates applied to their withdrawal, effective marginal tax rates for low income families will be reduced to about 60 per cent for many, while remaining higher for some.

As outlined earlier the type of tax credits proposed by Michael Keating (as developed with Simon Lambert), would further reduce effective marginal tax rates for many low income families, and not increase them for any. They would be particularly beneficial for the incentives faced by an unemployed person in a low income family deciding whether to enter employment. Thus in addition to creating more jobs, it raises the probability that the unemployed will go out of their way to secure jobs.

1.3 Long Term Commitment to Reducing Effective Marginal Tax Rates

As a radical solution to the problem of high effective marginal tax rates, Dawkins and Freebairn (1997) recommended part or all of social security benefits be replaced by a tax credit system, which is a version of what is sometimes called "negative income taxation". A full "basic income flat-tax system" is the most radical version of this and would reduce effective marginal tax rates considerably for low income families and increase the incentive to work. The main problem with this radical proposal is that if it were introduced in one go, it would probably need a flat tax rate in excess of 50 per cent (if it was to be revenue neutral in its effect), which would become the effective marginal tax rate for everyone (Dawkins et al, 1998). This would reduce the effective marginal tax rate for many low and middle income families but increase it for those on high incomes. In time, it is likely that the behavioural benefits from such a system would increase the tax base and allow a reduction in the tax rates. It seems likely that such a radical reform, with an apparently high tax rate and significant numbers of winners and losers may not be politically feasible in the short term. It appears more likely that we could move in this direction gradually, in such a way that when it is finally achieved, it could be achieved at a significantly lower tax rate (Garnaut, 1998).

Thus the kind of reform of family payments in the Coalition Government's tax reform package, supplemented by the use of tax credits for low wage earners as proposed by the five economists, would represent two significant steps in the reduction of effective marginal tax rates, and in moving towards a negative income tax system.

1.4 A Systematic Approach to Labour Market Programs

Our letter to the Prime Minister also proposed a systematic approach to labour market programs. Whatever else is done, it seems likely that labour market programs are here for some time to come, and have their part to play in helping especially the long-term unemployed to get a foothold in the labour market. The role of such programs should include, for example, job search assistance and wage subsidies for the long-term unemployed, to be integrated with welfare reform and reinforced by availability to work and job search tests and re-employment bonuses. In the Policy Watch section of this issue of the *Mercer-Melbourne Institute Quarterly Bulletin of*

Economic Trends, Don Harding and Joanne Loundes make a constructive contribution to policy discussion in this area. They suggest that the operation of the job network could be improved by restructuring unemployment benefits so as to increase the incentives to search for jobs, to obtain skills and to seek employment.

After a major investment in labour market programs by Labor under its Working Nation policy, the new Coalition government made major cuts in such expenditure in 1996. It has subsequently, however, put substantial amounts of additional funding into labour market programs such as under the work for the dole scheme, and its recent additional funding to the Job Network. Policy discussions within the Coalition also indicate that they are considering additional funding for work for the dole programs.

It is to be hoped that with accumulating evidence about the operation and successes and failures of labour market programs in Australia and internationally, that a systematic approach can be applied to such programs over the next few years. I would strongly recommend the discussion of labour market programs by John Martin of the OECD, who has summarised the ingredients that he would suggest in such a systematic approach. These ingredients include the following:

i. integrate the referral to active programs closely with benefit and placement work;

ii. 'profile' new benefit claimants to identify those at risk of becoming long-term unemployed; provide the latter immediately with counselling and job-search assistance;

iii. make passive income support as "active" as possible by using instruments like re-employment bonuses, in-work benefits etc.;

iv. enforce availability to work and job search tests;

v. make continued receipt of income support conditional on agreeing to participate in active programs after a certain minimum duration of unemployment spell;

vi. ensure that participants in training and public sector employment programs continue to be available for work and actively seek jobs;

vii. explore ways of making the public employment service more effective by giving greater play to the role of market signals (Martin, 1998).

The tendency for governments to chop and change labour market programs is of concern. It would be good if the kind of research evidence referred to by Martin could underpin an ongoing systematic approach to labour market programs, subject to rigorous evaluations and amendments in the light of such evaluation.

1.5 Upgrading of Education and Training over the Long-Term

We noted earlier that the main problem with seeking to constrain the real wage of high skilled workers rather than low skilled workers, is that this

would be operating, to a significant extent, (though not necessarily in all cases) against market forces.

In the short run, getting less skilled labour into work is a priority. In the long run, the best response to strong growth in demand for high skilled labour and weak demand for low skilled labour is to expand the amount of high skilled labour through education and training, and try to substantially reduce the amount of unskilled labour. This is a major challenge that is not going to be met easily.

Just as active labour market programs rather than passive welfare is an important ingredient of policy, it is appropriate for government to look at its support for individuals over their life cycle as an investment in their labour market performance, as far as that is possible. Thus the idea that income transfers might be used for human capital investment, recognising the life cycle dynamics of successful labour market participation and the likely need for lifelong learning, should be incorporated into an integrated policy regime. The idea of "flexible learning accounts" to support lifelong learning, proposed by a number of British academics, and also canvassed in the recent West Report on higher education, (West 1998) as well as in Mark Latham's book, *Civilising Global Capital*, is well worth examining.

Thus, as well as education and training being an important issue for efficiency outcomes, these services remain important for equity as well. Educationalists have been frustrated by the limited effect of public education on social mobility in the Twentieth Century and it is a challenge for those designing and implementing educational policy in the Twenty-first to see if they can make greater strides in this area. There is growing evidence that it is at the pre-school and primary school level that resources need to be devoted to give children from disadvantaged families and areas, a chance of getting ahead.

7. Conclusions

Unemployment is Australia's major economic and social problem. Sustained economic growth is opening up the possibility that we could reduce the unemployment rate down to around 7 per cent over the next few years.

At least one economist, John Edwards (1999), is arguing that economic growth may be sufficient on its own to reduce unemployment to 5 per cent. Research by Pitchford and Dungey (1998) lends some support to this idea as well. It would be nice to think that Edwards is right about this. It may be that the level of unemployment that can be reached without accelerating inflation has been reduced by microeconomic reforms and associated productivity effects of the last decade. But it is risky to rely on growth alone. As yet economic research is not strong enough to confirm his hypothesis. Further, even if a level of unemployment below 7 per cent (without accelerating inflation) were achievable without lower real wage growth, as Dungey and Pitchford (1998) accept, with lower real wage growth it would be more easily achievable. If these researchers are right, we may not need as much wage restraint to get to 5 per cent as the five economists estimated!

There is strong research evidence that dampening wage growth can help cut unemployment. Increasing work incentives at the same time should also help. Part of the reason is that policies of this kind will help us to achieve the kind of sustained economic growth that John Edwards desires. Thus the "five economists" have argued that in addition to growth, there needs to be a change in the way that the labour market works. Lower real wage growth is required to generate more jobs for a given economic growth rate, combined with reforms to social security and a systematic approach to labour market programs, to increase work incentives and assist the unemployed in obtaining jobs, along with the continual upgrading of the education and training system over the longer term.

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1.7 Text of Letter to the Prime Minister, 28th October 1998

Dear Prime Minister

This letter offers some ideas for policies that could complement your tax reform package, to help in substantially reducing unemployment over the next few years. We believe that the continued steadiness of fiscal and monetary policy of recent times and the continuation of microeconomic reform, of which tax reform forms part, are both important elements in a set of policies to reduce unemployment. Our specific additional proposal is to link industrial relations reform with reform of the tax and welfare system. This would complement your present policies and significantly enhance the chances of achieving large reductions in unemployment.

The growth in jobs necessary to substantially reduce unemployment will require higher economic growth and lower growth in wage costs. Tax reform will lead to a more robust economy and improve the chances of realising higher economic growth. Evidence suggests, however, that enhanced economic growth alone will not be sufficient to reduce unemployment much below 7 per cent in the long-run. Economic growth will need to be complemented by policies directed at improving the relationship between growth and unemployment, involving a linking of your industrial relations and tax and welfare reforms. The linkage would include an attempt to achieve a lower growth in real labour costs, alongside an integrated approach to reforming the social security system and labour market programs. The proposed reforms to family payments in your tax package are a solid start in the area of social security reform.

Recent research at the Reserve Bank of Australia, by Debelle and Vickery, suggests that a two per cent fall in the growth of real wages, for one year, could lead to a permanent reduction of unemployment of about one percentage point. Lower growth in wage costs leads directly to a higher demand for labour. It also results in lower inflationary pressure and enables the Reserve Bank to conduct a more expansionary monetary policy.

In the mid-1980s wage restraint made a big dent in unemployment. The more decentralised and deregulated wage setting system now, however, requires a different approach from that adopted under the Accord. We suggest that the Commonwealth Government should mount an argument in the Industrial Relations Commission for the replacement of Living Wage adjustments, at least for the time being, with compensation for those on low wages in low income families by providing tax credits to boost their incomes. This would be both more equitable and better for labour market efficiency than the established approach of relying on award wage interventions to secure equity. Unlike the Accord, there would be no expectation that unions or employees would be restrained from negotiating over-award increases.

While the number of employees who depend on award variations for wage increases has decreased substantially, it is still around 30 to 40 per cent, and many enterprise agreements are also affected by awards. If the

"award wages safety net" were frozen for four years, this would reduce the growth in real award wages by about 10 to 12 per cent, due to inflation. Allowing for the coverage of awards and for the possibility of over award increases, this should reduce the average growth in real wages by about 3 to 4 per cent. Based on Debelle and Vickery's estimates, this should reduce the level of unemployment by 1.5 to 2 percentage points below the level that would otherwise be attainable, to about 5 to 5.5 per cent.

Earnings would be suppressed more for low skilled than for high skilled workers. It is likely that lower growth in wages for the low skilled will be more helpful than lower growth in wages of the high skilled, as the unemployed are disproportionately low skilled.

Why would this approach also be better for equity? First there is the reduction of unemployment. Second, the use of the tax-transfer system to improve the income for low-income families, which include wage earners, would be better than Living Wage adjustments. Recent research by Sue Richardson and Ann Harding has highlighted how those people receiving low wage rates are well spread throughout the distribution of family incomes. This makes Living Wage adjustments a very blunt equity device. Indeed, the proposed tax credits would be more valuable to many such low-income families than "Living Wage adjustments". For many low wage earners in low-income families, especially those with children, an increase in their wage has little effect on their net income after the effect on tax and sccial security entitlements. This proposal would improve the position of low-income families on low wages, in the spirit of the famous Harvester decision. This should prove to be a powerful argument in the Industrial Relations Commission.

Recent research at the OECD shows that no single policy can be expected to solve the unemployment problem. A range of polices will be required, acting on both the demand for and the supply of labour. As well as tax reform and the award rates freeze, this should include the upgrading of the education and training systems and a systematic approach to labour market programs. Instruments such as re-employment bonuses as well as the tax credits would increase the incentive for people to move from welfare to work. The tax credits should form part of a rationalisation of our complicated tax and social security system and a move towards a negative income tax system. Michael Keating has recently shown how such tax credits and your proposed rationalisation of family payments could be consolidated to achieve even lower effective marginal tax rates.

The government will need to commit funds to the "welfare to work" policies including tax credits and labour market programs. We believe, however that the costs would be quite modest, especially if compared with the medium to long-run benefits. In the long run, the result of reaching around 5 to 5.5 per cent unemployment would mean substantial savings in unemployment benefits. There would be an added tax revenue dividend from these policies helping to maintain solid ongoing economic growth, and very importantly an equity dividend from the lower unemployment and enhanced assistance to low income families.

We hope that you find these suggestions helpful and would be very pleased to meet with you or any members of your government to discuss the proposals in more detail.

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