CHAPTER 1

Introduction

Ellen Carlson, Sally Cowling and William Mitchell
University of Newcastle

Most central banks now employ inflation targetting and adjust short-term interest rate to ensure that inflation remains within their target range. This approach, common since the 1980s, has been accompanied by tight, passive fiscal policy in the pursuit of budget surpluses. This counter-inflationary policy has been associated with persistently high unemployment in most economies of the Organisation for Economic Co-operation and Development (OECD) and some economists would say that it has caused the chronic lack of jobs. Australia, for instance, did not approach full employment despite the 1990s growth period, and trend unemployment is positive. The low point unemployment rate has ratcheted upwards over successive cycles since 1976. In the last four economic cycles the low point (seasonally adjusted) unemployment rates have been 4.6 per cent (June 1976), 5.5 per cent (June 1981), 5.6 per cent (November 1989) and 6.0 percent in September 2000. The problem of an upward trending unemployment rate is even worse when broader measures of labour underutilisation are considered.

Under neo-liberal policies, unemployment rates in almost all OECD economies have risen and persisted at higher levels since the mid-1970s. The prevailing orthodoxy amongst economists and policy makers sources the persistently high unemployment in institutional arrangements in the labour market, like wage setting mechanisms and trade unions, and/or faulty government welfare policies, which have encouraged people to engage in inefficient search or to embrace welfare dependence. Policy now focusses on overcoming these microeconomic constraints.

In this context, employment policy in Australia has become focussed on active labour market programs with the consequence that the federal

government has effectively abandoned the goal of full employment and instead appears satisfied with pursuing the diminished goal of full employability. The government no longer ensures that employment growth matches labour force growth but focusses, instead, on making individuals 'work ready', should there be jobs available.

The stylised facts of the Australian economy that bear on this problem are: (a) The Australian economy has been demand constrained since 1975 and fails to generate sufficient employment; (b) Unemployment is highly persistent and asymmetric; (c) The cyclical behaviour of short- and long-term unemployment is similar and the latter does threaten a low inflation expansion; (d) Active labour market programs are largely ineffective; (e) Gross flows reveal large inertia in all labour force categories; and (f) Outflow rates are remarkably stable over time but show the expected cyclical behaviour.

What explains the apparent mismatch of policy and the stylised facts? Underpinning the shift from fiscal activism is a belief, held by many economists, that a unique (natural) level of economic activity exists (the so-called Non Accelerating Inflation Rate of Unemployment or NAIRU), which is consistent with low inflation. Policy makers constrain their economies to achieve this (assumed) cyclically invariant benchmark. The NAIRU is not observed and it evades accurate estimation meaning that its use as a policy tool is highly contentious.

The Reserve Bank of Australia admits there are short-term costs of inflation targetting (lost output and rising unemployment) but argues that medium- to long-run real output growth is higher as a result. They say the benefits of low inflation justify the temporary losses. The view that these costs are ephemeral and trivial is one of the most contentious issues in macroeconomics. The history of OECD economies since inflation targetting became the norm does not support the view that a low inflation environment generates sustained low unemployment. Unemployment also behaves asymmetrically rising sharply in downturns and declining slowly as growth resumes. Disinflation thus imposes greater costs than has been previously estimated using linear models, which themselves are prone to inaccuracies, like imprecise NAIRU estimation.

The orthodox NAIRU paradigm appears unable to explain these stylised facts and hence monetary policy that is based on the NAIRU concept is flawed. We argue that a major new effort needs to be made to

restore full employment. Putting this in perspective is the fact that real output growth has to be sustained at around 4.2 per cent for several years before a serious dent in the stockpile of wasted labour resources in Australia will be achieved. Even in the so-called rapid growth period after the early 1990s recession, real output growth only averaged 3.8 percent. Every time output growth falls below that required to match labour force and productivity growth, unemployment spirals sharply upwards again. Something new has to happen in Australian policy circles before we will see a return to full employment.

The chapters in this Volume offer many different insights into the problems already noted. The perspectives therein do not necessarily align with these opening remarks. They were initially presented at the Third Path to Full Employment conference organised by the Centre of Full Employment and Equity at the University of Newcastle in June 2001. They appear in this Volume after a rigorous refereeing, review and editorial process. They represent a mix of theoretical and applied analysis conducted by researchers from diverse backgrounds and with experiences of many different economic structures.

In Chapter 2, Jan Kregel asks whether interventions to boost current employment prospects in the US should be guided by the theories of Keynes, Hayek or Schumpeter. The downturn in the U.S. economy that started in mid-2000 saw many analysts suggest that it would be short-lived and have little impact on employment levels because of the possibility of active fiscal policy created by the substantial US surplus. Kregel argues that this is unlikely to be the case because the downturn was not caused by a Keynesian deficiency of aggregate demand, but rather by a Schumpeter-Hayek process in which excess investments in unprofitable high technology innovations had to end. The appropriate policies are thus different from a typical Keynesian downturn. His analysis is apposite given that the US economy is now struggling to generate any significant employment growth several quarters after the initial downturn, although the events of September 2001 and the increasing evidence of corporate corruption in American business cannot be disregarded.

The following chapter continues the macroeconomic theme and explores the role of aggregate demand, capacity utilisation and investment in shifting the NAIRU to a level compatible with full employment. In Chapter 3, Malcolm Sawyer challenges the orthodox

view of the NAIRU as a supply-side determined equilibrium rate of unemployment. He explicitly rejects the notion that the persistence of high unemployment is a problem of a malfunctioning labour market and as a logical consequence eschews solutions that focus exclusively on reforming that market. The major implications of the supply-side view are that unemployment arises from imperfections in the labour market such as poor incentive structures facing individuals, skill mismatches and excessive regulation, and that aggregate demand plays no essential role in determining such an equilibrium rate of unemployment.

Sawyer begs to differ, positing an alternative conception of the NAIRU in which aggregate demand is important. The NAIRU is framed as a macroeconomic phenomenon with influences from wage determination and from enterprise decisions with respect to price and output. Since price and output decisions depend, *inter alia*, on the level of productive capacity, the equilibrium level of (un)employment is seen to depend on both price and investment decisions. Investment and aggregate demand thus have a key role to play in the determination of the level of economic activity. The chapter argues that the achievement of high levels of employment requires appropriate demand policies to stimulate the necessary investment and to underpin the full employment position. Sawyer acknowledges that policies that seek to restrain inflation through higher levels of unemployment may well cause the NAIRU itself to rise and to bring about higher levels of unemployment. However, the most significant part of his argument is that any inflation barrier against full employment should be viewed in terms of the lack of productive capacity and of aggregate demand as well as the employability of the work force.

Randy Wray, a prominent Post Keynesian monetary theorist, presents an empirically focussed paper in Chapter 4, which examines the evolution of the U.S. economy since the early 1970s and focusses, in particular, on the so-called "Goldilocks economy" enjoyed between 1995 and 2001. Wray seeks to explain the reasons behind the demise of Goldilocks and possible cures that would help to place a floor to the depths of the US downturn. While in the Minsky tradition, Wray chooses in this Chapter to focus on the real economy. He argues that the majority of US economists are looking to the Federal Reserve to cushion the hard landing with monetary policy because they want to preserve fiscal discipline and budget surpluses. He says this represents the "fine art of

backward thinking that you generally find among mainstream economists." In fact, the underlying reasoning in Wray's work is that the primary culprit in the death of Goldilocks is to be found in the growing fiscal surplus. He carefully deconstructs the government budget surpluses to show that the private sector has to have an offsetting deficit. Given that the US was a net importer over this period, the implication is that US households and firms have to continue borrowing at an increasing rate for the government to continue to run surpluses. In the Australian context, this is not often considered when the Federal Treasurer waxes lyrical about the benefits of running budget surpluses. The fact is that surpluses destroy private sector wealth and force that sector to increase its indebtedness to maintain existing spending levels.

Wray asks: Why was aggregate demand growth so high during the Clinton Boom given it was not driven by exports or Keynesian-style government spending? The reason is traced to the unprecedented private sector deficits that emerged in the 1990s, a trend also observed in the Australian economy. In examining the debt-driven spending boom, Wray outlines several institutional changes in financial markets that have made it easier for consumers to borrow. This zeal to borrow has been supplemented by the stock market's irrational exuberance and the wealth effect. The strong growth led the inflation-obsessed Federal Reserve to jack up interest rates and many observers say the monetary policy tightening took the steam out of Goldilocks. Wray instead blames the restrictive fiscal stance while not discounting the solvency problems that the large stocks of household debt pose when interest rates are rising. He says that the only way to avoid a prolonged recession is for a very large, discretionary, fiscal adjustment in the form of tax cuts. While easing interest rates will help reduce debt service burdens, any continued expansion, with tight fiscal policy, has to involve increasing debt ratios. The sums don't add up. He also argues that a discretionary budget deficit now will prevent a hard landing that would probably lead to much larger cyclical deficits in the future if the hard landing is not prevented.

The essential point, which is not often understood by orthodox economists and the policy makers that listen to them, is that a long-term strategy based on the pursuit of budget surpluses is ultimately a deflationary, high unemployment path. Clearly, this is not a path that an efficient economic manager should take, given the costs of unemployment.

In Chapter 5, John Nevile and Peter Kriesler consider the *Tools of choice for fighting recessions*. They begin with the observation that while the majority of economists now look to monetary policy to cure recessions, fifty years ago the majority thought monetary policy was of little use by itself, though it had a role to play as a supporting actor in a drama in which fiscal policy was the star. Nevile and Kriesler argue that the reasons that led economists to downplay monetary policy then are still valid today. The efficacy of monetary policy is seen to depend on fairly high values for the interest elasticity of investment and on price elastic imports and exports. There is strong evidence to suggest that, at least in Australia's case, neither of these is large. The chapter also considers the arguments that have been advanced against the use of fiscal policy over the last thirty years. Crowding out theory, the twin deficits hypothesis and the Ricardian equivalence theorem do not provide a convincing case against the use of fiscal policy to stimulate economic activity during a slump.

However, the authors do not conclude that fiscal policy should be the instrument of choice, but that as many policy instruments as feasible should be used to fight recessions. Nevertheless, fiscal policy should be centre stage as it has a number of advantages over monetary policy in an environment characterised by highly mobile capital and deregulated financial markets. In addition, variations to tax rates and the size and types of expenditure can be used, not only to boost economic activity, but also to achieve social justice and equity aims.

The next section of the Volume focusses on competing explanations for, and policies to address, the persistence of high levels of unemployment in the Australian economy. Chapters 6 and 7 compare two approaches to reducing unemployment, which capture, in many ways, the main divide among economists concerning the scope and nature of interventionist policy. In Chapter 6, Bill Mitchell and Martin Watts lay out the Job Guarantee approach as advocated by the Centre of Full Employment and Equity (CofFEE). In Chapter 7 Michael Keating discusses the economic justifications for the proposals to restore full employment first advanced by Five Economists (of which he was one) in an open letter to the Prime Minister in October 1998. The proposals centred on a relative wage cutting approach to be achieved through a wage-tax trade-off .

While both schemas recognise that the market alone will not deliver full employment, the Job Guarantee approach traces unemployment to deficient aggregate demand. Mitchell and Watts do not consider that traditional Keynesian remedies are suitable with inflationary biases and environmental concerns paramount. Instead they argue for a Job Guarantee in which the public sector resumes the role it played in the post-World War II period of full employment as an employer of the last resort, ready to absorb the flux and uncertainty of the private capitalist production system.

The Job Guarantee requires an endogenous budget deficit, the level of which will be determined by the cycles in private spending. Instead of generating unemployment, the spending gaps are taken up by federal spending. The spending is specific though – the offer of a guaranteed job. Mitchell and Watts thus present a strong argument that the budget deficit should not be seen as a problem but rather it is the solution to persistent unemployment. In this sense, they have much in common with the analyses of Wray and later Forstater.

In contrast, the Five Economists' approach as outlined by Keating considers the problem as being largely on the supply-side and assumes the demand-side will accommodate. It is argued that economic growth alone is unlikely to reduce unemployment below seven percent. A combination of labour market reform to encourage wage restraint and associated welfare reform to reduce welfare dependence and increase incentives is advocated to help increase the amount of employment offered for any given rate of economic growth. Thus the Five Economists advocate a reduction in the rate of wage increases relative to the rate of productivity growth via a four year freeze on award wages. Tax credits would be used to compensate low wage earners in low-income families while lower effective marginal tax rates would improve the incentives for low-income families to pursue employment opportunities. Mitchell and Watts argue that in this sense the proposal is a modern version of the classical wage cutting approach, with some equity insurance being provided by the state and Say's Law ensuring all the demand issues can be assumed away.

In Chapter 8, Bill Mitchell and Joan Muysken conduct an applied analysis of the Australian and Dutch economies to test the recent statements from Franco Modigliani, who argued that unemployment is primarily due to a lack of aggregate demand created by erroneous

macroeconomic policies. Modigliani, the co-founder of the term NAIRU, now suggests that an "objectionable use of the so-called NAIRU approach" has led central banks and treasuries to deliberately deflate their economies. Mitchell and Muysken demonstrate that high real interest rates have undermined the growth of investment, which, in turn, has been a significant determinant of the persistent output gaps in both economies. They show how these gaps have manifested as persistent unemployment. They reject the notion that wage costs have been a major aspect of the failure of the economy to generate enough jobs. They conclude that mass unemployment is a systemic macroeconomic failure driven by a reluctance of governments to use fiscal policy in a correct, counter-cyclical manner. In addition, they highlight the massive cut-backs in public sector employment in Australia as a significant casualty in the paradigm shift towards the pursuit of budget surpluses.

Mathew Forstater builds on the analysis of public service employment programs as developed in the earlier chapter by Mitchell and Watts in a discussion of the relationship between full employment and environmental sustainability. In Chapter 9, Forstater argues that unregulated or poorly regulated capitalist economies are unsatisfactory in macroeconomic terms, as well as being environmentally unsustainable. He argues that the traditional approaches to addressing either unemployment or environmental degradation are insufficient to achieve full employment or environmental sustainability, and often proposals to attain one of these goals appear inconsistent with the other. However, there are a number of ways in which a Public Service Employment (PSE) program (equivalent to the Job Guarantee in Mitchell and Watts) run on the principles of functional finance, may be used to address the effective demand problem while helping to promote environmental sustainability.

As formulated by Abba Lerner, functional finance means that government spending, lending, borrowing, taxing, buying, and selling should be judged only by the effects that such actions have on the economy and society, and not whether they accord with the tenets of 'sound finance.' Wray, Mitchell and Watts, and Forstater share a common view here. No particular relation between, say, government spending and tax revenues, is 'good' or 'bad' in and of itself, independent of the impact the fiscal stance has on the economy and the level of unemployment. Forstater argues that functional finance may be combined with ecological tax reform to reshape market incentive

structures to promote environmental objectives and full employment. In addition, PSE programs may enhance environmental sustainability through the greater flexibility of an economy with a well-managed public service sector and the additional environmental benefits derived from the activities in which public service workers may be engaged.

While Forstater explores the scope for full employment policies which promote environmental sustainability, Sumner Rosen's opening speech to the Conference argues that the realisation of full employment is critical if the working class is to be provided with strong protection against the risk of job loss, employer power in the workplace, the insecurity that arises from rapid, incessant and systemic economic change, technological innovation, and changes in the organisation and geographic distribution of work. The edited transcript of Rosen's speech appears as Chapter 10. Rosen explores the history and prospects for full employment beginning from the proposition that the struggle for full employment in a capitalist market economy like that of the US is at the roots, a question of class. He argues that the single most important period demonstrating the central importance of high employment was the post-war history of the US economy between 1945 and 1970: enlightened and progressive economic policies, supported by effective political organising, generated high levels of employment and rising standards of living for most workers. In contrast, the period that followed the OPEC (Organization of Petroleum Exporting Countries) oil crisis of the 1970s was dominated by policies and economic doctrines that slowed and in many respects reversed the prior progress; union strength weakened and neo-liberal policies acquired dominance intellectually, in politics and government. Rosen concludes by pointing to new efforts to challenge and reverse these trends, which have begun to rebuild the analytic and political base for more effective advocacy of full employment policies.

The next three chapters in the Volume focus on the employability agenda that has reshaped modern welfare states and become the central concern of employment policy over the past fifteen years. The 1994 OECD Jobs study epitomised the full employability concept and has been an important driver of labour market reform. The report argues that persistent unemployment in member countries results from labour market rigidities, which are exacerbated by social protection programs. The policy recommendations flowing from the report centre on active

labour market programs that are targetted to the unemployed or jobless with the aim of enhancing their employability and participation in the world of work.

In Chapter 11, Nancy Rose develops a spectrum of government work programs and examines the extent to which different points on the spectrum reflect the employability agenda. On one end is workfare, in which work that is normally paid a wage is required of welfare (relief) recipients as a condition of receiving aid, and on the other end are fair work programs, that is, direct job creation by the government intended to put the unemployed to work. These programs are elaborated both in terms of their underlying ideologies and theories, and of the three main types of program components: determination of eligibility, payments, and types and locations of the work. Rose describes government work programs and the attempts at implementing permanent job creation programs in the US in order to provide a sense of the scope of the possibilities of fair work programs. Finally, the Job Guarantee or PSE proposal is located along the spectrum, and while Rose is sympathetic to this approach, she raises a number of questions about the potential of such job creation programs to undermine the wage standards prevailing elsewhere in the economy.

Chapters 12 and 13 consider active labour market programs and reforms to the employment assistance system in Australia since the mid 1990s. The *Working Nation* package introduced by the Labor Government in 1994 included individualised case management of the unemployed; direct job creation through New Work Opportunities, and a Job Compact providing a conditional guarantee of paid employment for the long-term unemployed. At the same time, penalties for breaching job search requirements, or failing to accept a reasonable job offer were increased. The election of the Coalition government in 1996 saw *Working Nation* abandoned on cost and efficiency grounds, and substantial cuts to labour market programs. Since then, activity tests applying to unemployment benefit recipients have become increasingly onerous, and sanctions for non-compliance more harsh.

In Chapter 12 Raja Junankar provides an evaluation of the success of the labour market programs of the Coalition government and compares them with outcomes under the Working Nation programs. The relative 'success' of the programs is assessed in terms of the labour market outcomes in aggregate including the behaviour of aggregate

unemployment rates and long-term and very long-term unemployment of males and females. Junankar finds that the Coalition labour market programs are less successful in terms of these measures but argues that a more detailed analysis of longitudinal data is required to provide a definitive assessment.

In Chapter 13, Doug Biddle and John Burgess examine the shift to a contestable market for government-funded employment services in a chapter entitled *The Australian Job Network revolution: rationale, implementation and evolution*. The 1994 OECD Jobs Study suggested that public employment placement services should be supplemented with private providers, including private job placement agencies, so as to enhance the effectiveness of job matching and to improve the job search skills of the unemployed. This proposal was enthusiastically embraced in Australia with the replacement in 1998 of the public employment placement service, the Commonwealth Employment Service, with Centrelink (a one-stop shop for government income support) and the Job Network. This network combines public, private and non-profit provision of employment placement and case management services. The government rewards providers for job, education and training outcomes according to a hierarchy of outcome payments and positive performance assessment.

Biddle and Burgess outline the manner in which the Job Network has developed and the outcomes of the evaluations that have been made of its performance. They also present evidence from independent evaluations of the new arrangements, with an emphasis on the recent Productivity Commission report. They argue that it is also difficult to unambiguously evaluate the new arrangements and compare them with the old. A major problem in this regard is that the Job Network has so far operated in a relatively strong labour market environment and they argue that its real test – a recessed economy - awaits. They are not hopeful of it performing well in this context. While they show that the Job Network has reduced the costs of providing labour market programs and has also performed well in the case of short-term unemployed (matching and placements services), they present convincing evidence to show that the new arrangements have failed the most disadvantaged – the long-term unemployed and those workers in remote areas.

Finally Miriam Altman in Chapter 14 presents an analysis of the problems faced by the South African economy in the quest to reduce the

spiralling unemployment and inequality in the Post-Apartheid era. She locates the source of the problem in the particular way in which South Africa developed into a 'middle-income' country. South Africa is what she calls a 'minerals economy', which means that its development has been driven by the very strong export performance of its capital intensive mining sector. This type of development prevents the more usual phases of development where surplus labour moves from the agricultural sector as mechanisation increases productivity, into a low-wage, labour intensive manufacturing sector financed by foreign investment. The mining development generated wage conditions and massive swings in the terms of trade that militated against the development of the manufacturing sector. The subsequent political instability has exacerbated the problem in attracting foreign investment to create labour intensive employment opportunities. She argues that targetted assistance in labour intensive service sectors is the best hope.

The research presented in the Volume is diverse and many research questions are brought to the fore. It is to be hoped that this research will stimulate debate as well as the development and implementation of alternative policies to those which have resulted in increasing and persistent unemployment in our economies and societies.

CHAPTER 2

Employment prospects in the current downturn: should Keynes, Hayek or Schumpeter be our guide?

Jan A. Kregel
United Nations Conference on Trade and Development

The sharp drop in economic activity in the US economy between the second and third quarter of 2000 raises the question of whether this is the start of a simple cyclical adjustment to excess inventory and capacity buildup that will be quickly reversed by a so-called V shaped recovery, or whether the "new economy" has been a mirage which has now been dissipated with the collapse of the high tech stock bubble and heralds a longer period of adjustment that would produce recession (at least two quarters of negative growth) and prolonged stagnation similar to the 1970s.

Judging current conditions is difficult since the US economy has seldom in the post-war period experienced a similar expansion driven by the private sector expenditures of sufficient strength to create a rising fiscal surplus with a fiscal stance that is structurally in surplus.[1] Probably the only period in which the structural stance of fiscal policy was in surplus, and thus restrictive over an extended period, was as a result of the "bracket creep" that was identified during the last years of the Eisenhower and the early years of the Kennedy administration when the Kennedy tax cut, finally introduced by Johnson, produced a recovery in Gross Domestic Product (GDP) growth and a reduction in the deficit.

One of the distinguishing characteristics of the recent expansion has been the strength of investment expenditures. In the post-war period the US has traditionally lagged behind other developed economies in the share of GDP it commits to investment. This led to the epithet of the US as a "consumer society" that traditionally lived above its means. However, in the 1990s the share of Gross Fixed Domestic Investment to