

# Full employment abandoned

## The macroeconomic story

William F. Mitchell

### ◀ WHAT HAPPENED UNDER LABOR...

- Labor initially adopted an expansionary approach to budgetary policy, but this lasted only for a short period, after the 'trilogy' promises which signalled the start of reductions in public spending
- income was redistributed from labour to capital under the Accord, through real wage restraint, while the social wage was delivered through tax cuts
- external issues were dealt with through the use variously, of wage restraint, reliance on currency devaluations, interest rate increases and reductions in the budget deficit
- monetary policy was effected through interest rate adjustments rather than by targeting the money supply, and was used for different purposes (to fight inflation and to reduce the current account deficit) at the same time, with very damaging results

### ▶ WHAT LABOR SHOULD DO NEXT TIME...

- introduce a 'buffer stock employment' scheme where the public sector brings the unemployed into paid labour in labour-intensive service industries at award rates, and supplies training as necessary
- terminate the protocol on monetary policy between the government and the Reserve Bank
- keep interest rates as low as possible
- make greater use of fiscal policy — including the tax system — as an instrument of macroeconomic management

## Introduction

In 1983, when Labor won government, unemployment ran at 9 per cent, inflation was at 11 per cent, and Australia's net foreign liabilities were 28 per cent of national income.

In 1996, when Labor lost office, unemployment was still at 9 per cent, inflation was down to 4 per cent, and Australia's net foreign liabilities were up to 59 per cent of national income.

Inflation: under control. Unemployment and the current account: out of control.

These are the three, hard facts about Australia and Labor's economic policy over 13 years. They say a lot about what the Australian Labor government stood for after 30 years of economic expansion following the Second World War.

Labor's legacy — high unemployment and one of the worst situations of external imbalance in the developed world — raises questions over what Labor did in government and what kind of economic policy the party must try to craft to promote social justice through prosperity and wealth.

In telling the story of macroeconomic policy under Labor, this chapter will contest the widely applauded outcome of low inflation, with policy makers being resigned to high levels of unemployment. The analysis is therefore at odds with the parameters of much public debate in Australia.

## Labor's macroeconomic policies: a potted history

Labor's failure to fix Australia's employment and external problems while driving inflation to negligible levels lies in its choice of economic policies through four stages of the economic cycle following Labor's election near the end of a recession in early 1983.

An inspired start, in the form of an expansionary budgetary position and the Prices and Incomes Accord, soon lapsed into a hotch-potch of Treasury-inspired half measures: cuts to government spending, income and company tax, and tariffs. Joined to these cuts were: the rapid deregulation of the financial markets, the drive to defeat inflation, measures to address the balance of payments, and signing up to the trade agenda of the world's richest countries.

Surprisingly, Labor's primary power base, the trade unions, tolerated this new direction. Yet a major drawback with the economic strategy was the lack of any mechanism to ensure that the profits generated from wage restraint and tax cuts were channelled into productive investment. The resources released by the Accord, instead of laying the foundation for structural change and longer-term prosperity, were dissipated in the post-financial deregulation debacle of asset price inflation, takeovers and large executive remuneration packages. The corporate borrowing binge that followed financial deregulation led to an asset boom which was largely responsible for the doubling in the ratio of external debt to GDP.

Excess borrowing loaded debt onto previously sound companies. This provoked an inflation in share prices and then an inflation in property prices. As in the 1970s, the boom-bust cycle in asset prices was the precursor to recession.

Advocates of financial deregulation promised greater competition, more services, lower prices, and the balance of payments aligning with that of other countries. Only the second materialised

during the first ten years of deregulation. Over that decade, deregulation precipitated a high external debt ratio, which led to an increase in real interest rates, which in turn choked off private investment in productive capital.

The failure of business to channel the massive redistribution in income from wages to profits into real productive capacity was a serious reflection of Labor's weak grasp on the economy. It also showed the corporate sector in a poor light. Business groups argued trenchantly that Australia's major problem was the rigidity in the labour market, meaning — in effect — high wages. Yet the Accord cut real wages and bolstered profit margins. The problem was that the rise in external debt did not support the development of productive capacity, especially in export industries.

Employment grew strongly in the period from 1983-89, in large part because of the increase in consumer spending made possible by the greater availability of credit following financial deregulation, and enhanced export performance following the currency devaluation of the mid-1980s. But all that came to an end in 1990, when high interest rates and a giant budget surplus delivered the worst economic downturn for 60 years. The high unemployment that accompanied the recession was caused in two ways.

First, it directly followed the high real and nominal interest rates that the government deliberately engineered to restrain the economy, as the balance of payments became unmanageable. Second, the high interest rate policy itself was the product of a confused macroeconomic policy position that bedevilled the government throughout the 1980s: were high interest rates supposed to improve the balance of payments or to fight inflation?

The government failed to maintain consistent policies in other areas: their microeconomic industry policy, for example, designed to make industry competitive in value-added export markets was substantially negated by the excessively high interest rates used to control the inflation rate and/or the level of imports (depending on who you spoke to). The high interest rates pushed the exchange rate

higher as capital inflow surged into interest-bearing financial assets and negated the competitive gains that had been made. They also further encouraged foreign borrowing.

Following the recession, the government never really regained control of the economy. The 1990s period of the Labor government, including Keating's four and a half years as leader, was really an exercise in fire-fighting. Any coherence in their early position was destroyed in the period from 1987 to 1990 by their confused policy stance.

We shall look in more detail at the policies which led to lost opportunities in Labor's term: budgetary, wages, external and monetary policy, and outline options to renew Australia's opportunities for growth and prosperity.

## • The budgetary stance: expansion arrested •

Labor's 1983 election victory held great promise on the economic policy front. The Hawke government abandoned the monetarist 'fight inflation first' strategy from the Fraser years in favour of a Keynesian strategy, aimed at using public spending to reduce unemployment.

Figure 1 shows the expansion in government spending in the first two years of the Hawke government. In 1982, federal government spending was around 26 per cent of GDP (this ratio is a useful measure of the size of government within the economy and a rough measure of the stance of fiscal policy). In 1985, government spending rose to 30 per cent of GDP on the back of a sharp rise in the federal budget deficit, a change of 4 per cent. Private investment and consumption also accelerated reflecting the new period of growth. The GDP growth rate was sufficient to make inroads in the high unemployment rate (see figure 2).

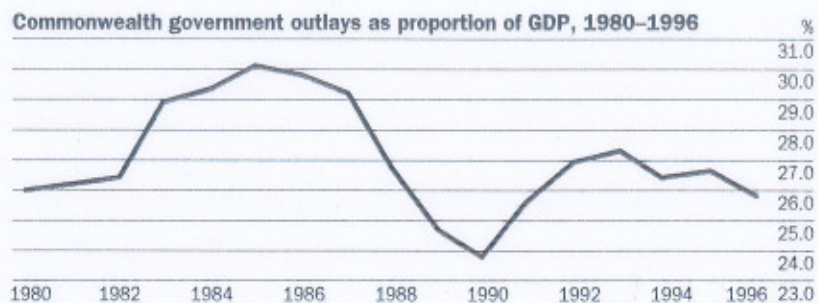


Figure 1

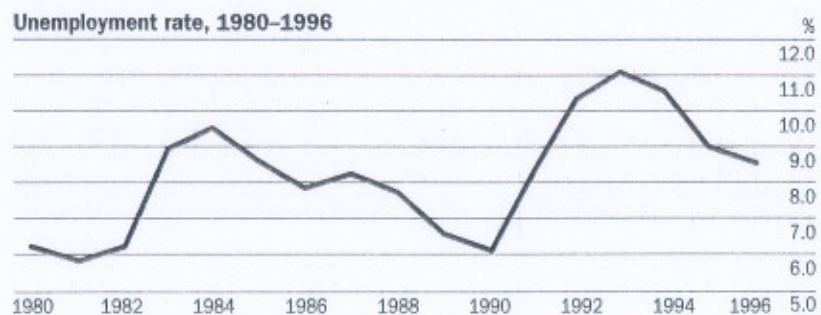


Figure 2

As early as December 1984 however, the government's expansionary phase halted, and Labor committed itself during the December election campaign to three fiscal promises which became known as the trilogy. These were:

1. Government outlays as a proportion of GDP would not increase in 1985-86 and over the life of the Parliament.
2. Tax revenue as a proportion of GDP would not increase in 1985-86 and over the life of the Parliament.
3. The Budget deficit would be reduced in money terms in 1985-86 and reduced as a proportion of GDP over the life of the Parliament.

The trilogy ended the short-lived period of fiscal activism aimed

at reducing unemployment. The deficit-cutting obsession propagated by the financial markets and Treasury economists had taken hold of the government, although the trilogy didn't please this constituency because outlays were not cut quickly enough.

Despite the 1985-86 budget being mildly expansionary, the five budgets between 1984-85 and 1989-90 were on the whole contractionary, a process started with the trilogy promises.

The deficit rose in 1991-92, largely due to tax cuts and increases in payments for unemployment benefits. Only modest new spending measures were made.

In 1993-94, Labor finally adopted an easier fiscal policy, primarily to fund its welcome, if overdue, job and training programs (Working Nation). The latter was a supply-side response to a primarily demand-side problem, but it had mild demand-inducing effects.

#### LABOR'S APPROACH TO BUDGETARY POLICY

- on gaining government, Labor successfully adopted an expansionary approach to budget management, as a means of reducing unemployment
- however, the so-called 'trilogy' of late 1984 marked the end of Labor's expansionary approach, with substantial reductions in outlays for the next five years
- outlays increased mildly after the 1990-91 recession, though not to the levels of the mid 1980s

## Wages and the Accord: belt-tightening and overhang

The National Economic Summit held soon after the election delivered a so-called consensual approach to macroeconomic policy, including wages policy. The agreement reached at the Summit restored national wage fixation under the Accord, which included a strategy to initially cut real wages to restore profit margins and thus encourage investment.

An important adjunct of the agreement was that it also defined an active macroeconomic role for the government in sharp contrast to the monetarist Fraser years. Part of this intervention was to create services which would boost the 'social wage', an explicit recognition that the government would pay some of the real income back to workers that they lost in their wage restraint.

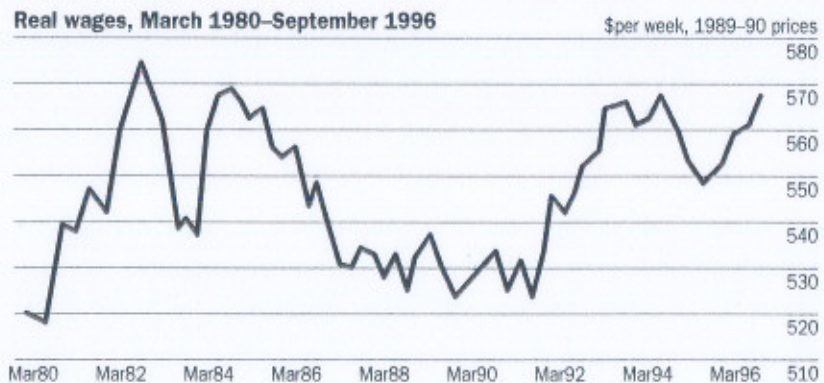


Figure 3

Figure 3 shows that the redistribution of income towards business worked as planned in the early Accord years. The reduction in real wages was unprecedented and saw the wage share in national income go from 63.3 per cent in March 1983 to 59.4 per cent a

year later, dropping to 56.4 per cent in June 1989 and remaining at around 56 per cent until the present day.

The 'real wage overhang' debate dominated labour market discourse in the 1970s. The debate centred in essence on whether growth in real wages in excess of labour productivity (the overhang) caused rising unemployment or whether it was due to a deficiency in aggregate demand. The debate polarised the economics profession into two groups. The prevailing Treasury view that influenced Labor was that the overhang had to be eliminated before private investment could grow and employment rise.

The Accord was conceived as part of the overhang logic and clearly aimed to redistribute factor shares of labour and capital so that they would return to 1960s levels. Many economists regarded the 1960s period of low inflation, unemployment and steady GDP growth as the benchmark for economic well being, despite the fact that supply conditions in the world economy, principally as a result of the oil shocks, had changed irrevocably.

Correlation between employment growth and falling wage shares during the early years of the Labor government gave strength to the real wage overhang arguments. However, the picture is far from straightforward. Real wages fell over most of the Accord period while productivity largely increased. Combined, the result has been a declining wage share. Employment change has exhibited three phases: strong growth, a sharp decline, and then some growth again. Further, the cycles in investment and private consumption spending have closely matched the phases of employment growth.

The clear indication from the data is that employment growth responds to boosts in aggregate demand stimulated by public and/or private expenditure, and, that there is no unambiguous relationship between employment growth and wage movements. The Labor government chose to ignore the former and focus on the latter and this laid the foundation for the rising unemployment that ultimately saw its political demise. It also ensured that many Australians faced a hostile labour market and an existence underpinned by household

poverty and unemployment and economic insecurity.

### LABOR'S APPROACH TO WAGES POLICY

- Labor negotiated an Accord which restored national wage fixation, and cut real wages in exchange for the provision of services which made up the 'social wage'
- the Accord was conceived on the logic of the 'real wage overhang' debate of the 1970s, which said that growth in real wages in excess of labour productivity growth caused rising unemployment
- the redistribution of income from labour to business was substantial, with the wages share decreasing from around 63 per cent in 1983 to around 57 per cent from 1989 onwards
- the relationship between real wages and unemployment is very ambiguous

### Imbalance of payments: the J-curve

Between March 1985 and March 1987 — and due to events beyond the government's control — the terms of trade (basically the price paid for our exports) fell by around 14 per cent. The terms of trade decline and a persistent current account deficit led to a staggering 37 per cent fall in the trade-weighted index (the exchange rate) between the beginning of 1985 and the middle of 1986, leading to a dramatic fall in the value of the Australian dollar. The terms of trade drop was the cause of a sharp slowdown in economic growth.

The Australian dollar had floated since 1983 — a key plank in the deregulation effort. The Reserve Bank began to defend the \$A against its drop in the foreign exchange market in 1985 and 1986, while the government sought to maximise the competitive advan-

tage derived from this depreciation. With inflation still persisting at high levels despite the wage moderation, they feared that the imported price rises accompanying the exchange rate depreciation would destroy the Accord and set in process a renewed wage-price spiral. Accordingly, the government and unions agreed to discount the next round of wage rises to counter the decline in the terms of trade. In September 1985, Accord Mark II replaced the original two-year agreement based on full indexation. It provided for a once-off 2 per cent 'terms of trade' discount (nominal wage increases 2 per cent below the CPI rise) in return for income tax cuts. This was a signal that indexation would be abandoned in favour of productivity-based increases.

The cumulative depreciation in the \$A in 1985 and 1986 improved Australia's competitive position significantly. The hope was that the relative price swing in favour of our trading sector would lead to a growth in exports and a fall in imports. The celebrated J-curve rhetoric, which simply says that things have to get worse before they can get better, emerged in this period.

However, the Accord partners were soon challenged by a further sharp export price fall that showed that the external problems had to be translated into lower living standards. The problem was to work out who was going to bear the cuts and in what proportion. As it turned out, workers wore the biggest losses during this period. The stage was also set for the next attack on workers' conditions — the soon to be introduced enterprise bargaining phase.

The government implemented the changes to the wage setting Accord with a so-called gradualist approach. By trying to secure export led growth while constraining domestic demand, the government aimed to deliver a current account adjustment over a 4-year period. This was in contrast to the free market zealots who wanted a rapid deflationary strategy with rising unemployment to curb wage demands and domestic growth.

The J-curve worked as predicted in 1985 and 1986. Initially, there was a deterioration in the nominal trade balance, followed by

positive volume effects in 1986. Real merchandise trade went into surplus in the second half of 1986 and the current account deficit fell by around 2 per cent over the two-year period to 1987-88.

But conditions worsened. A steady appreciation in the exchange rate interrupted the adjustment process. This was exacerbated by the blowout in imports in 1987 and 1988, which was in turn stimulated by the loose monetary policy following the share market problems in 1987.

The J-curve got lost in the confusion of policy. The reaction by the government was probably the worst possible. Keating allowed the Reserve Bank to push up short-term interest rates to arrest the growth in the domestic economy (while pretending he was not). But this pushed the exchange rate up further which undermined the underlying balance of payments position. The overvalued exchange rate destroyed the competitive gains made following the 1985 depreciation.

Real interest rates went through the roof, domestic investment dived and the hoped for, and vital, export improvement failed to materialise as the economy quickly headed towards recession.

## The twin deficits obsession

Labor adopted a new element — called the twin deficits hypothesis (TDH) — to justify the move to fiscal restrictiveness that was the ultimate expression of the supremacy of the rationalist thinking to which it had become captive. It was imported from the Thatcher and Reagan regimes who used it as a justification for their public sector cutting.

The argument centred on the amount of funds available for lending in the economy — or as economists say — the amount of loanable funds. The hypothesis played on the analogy of the household. A household that spends more than it earns has to borrow or run down its financial assets. Economists call this the net increase in

financial liabilities. The alternative also holds — a household earning more than it spends will acquire financial assets or pay back debts.

Each sector in the economy can be analysed in the same way. The private household sector supplies loanable funds when it saves; the private business sector demands loanable funds when it invests; the public sector demands loanable funds when it runs a budget deficit; and the external sector (overseas transactors) supply loanable funds to us when we run a current account deficit (we spend more than we earn in relation to this sector).

As one sector's demand for loanable funds have to equal another sector's supply, it becomes true — as an accounting definition — that the current account deficit plus saving always equals investment plus the government budget deficit. The TDH makes this accounting statement into a theory by adopting some unrealistic assumptions. First, private saving and investment were assumed to be invariant to the budget deficit. Second, the gap between saving and investment was assumed to be constant or zero. Third, the current account deficit was assumed to act passively, merely accommodating the need for a supply of loanable funds (external debt).

It is obvious that under these assumptions any increase in the budget deficit will increase the current account deficit dollar for dollar, and to improve the current account deficit it is necessary to effect a prior cut in the budget deficit. In the spending-earning analogy, the current account deficit reflects the economy spending more than it earns: the culprit was seen to be the public sector because of its deficits.

The problem with the twin deficits hypothesis is that it contradicts the empirical facts. The private sector saving-investment relationship is far from stable. Much of the rise in the current account deficit in the 1980s can be attributed to the private sector's borrowing surges. Further, a fall in the budget deficit, in times of weak private sector demand, will depress economic activity and reduce private sector saving. The other major failing of the TDH is

that it asserts that causality runs from the budget deficit to the current account deficit. However, for a small open economy like Australia the causality can easily run the other way. A fall in export revenue (via a terms of trade decline) can reduce GDP and increase the budget deficit via rising unemployment benefit outlays and falling tax revenue.

The TDH was discredited when unprecedented fiscal restrictiveness which led to budget surpluses in the late 1980s was still accompanied by sustained increases in the current account deficit. After this, the rationale for budgetary tight-fistedness (to which Labor was seemingly wedded) centred on boosting national savings. The argument was a close cousin of the TDH, and has also been used by the coalition government. By containing public expenditure, the government claimed it would reduce its call on domestic savings and improve the current account. In the 1990 budget speech, Keating emphatically declared that "fiscal policy must remain the principle instrument of adjustment in the savings balance between our savings and those we rely upon from abroad". Incomprehensibly, this didn't stop the government promising tax cuts in its 1992 One Nation statement.

The savings argument conveniently bypasses the fact that household savings — traditionally a major contributor to total savings — have plummeted. The real wage declines which were the result of the Accord played a significant part in the decline in household savings, and the budgetary restrictiveness further exacerbated this, so that the effect of cutting public spending on savings is ambiguous at best, but most likely to be negative.

In any case, savings are simply residual income after consumption, so that the problem can more usefully be cast as an income problem rather than a savings problem. Boosting national income through increasing public spending is more likely to improve the savings situation than boosting public savings through cutting public spending.

Nonetheless, the Labor government had ready-made — if fun-

damentally flawed — rationales for keeping public spending dampened, and this it did from the mid-1980s onwards, as a deliberate policy action.

### LABOR'S APPROACH TO EXTERNAL POLICY

- Labor's initial response to external policy challenges was to discount wages rises, to prevent a wage-price spiral from developing and upward pressures on costs from undermining the competitive gains flowing from the currency depreciation
- the J-curve, which states the trade account will worsen, but later improve following a currency depreciation, worked as predicted in the mid-1980s
- in the late 1980s, interest rate increases were used to dampen import growth, but in fact worked to worsen the balance of payments owing to the currency appreciations which they caused
- later in Labor's term, reductions in the budget deficit were used as a means of reducing Australia's liabilities, though this relied on unrealistic assumptions

### The interest rate asphyxiation

The Labor government's worst mistakes were made in the conduct of monetary policy. Financial deregulation had made it impossible to target the money supply and left the rate of interest as the only real way in which monetary policy could be used. On this front, the government left it too late to raise interest rates and kept them too high for too long.



## Deregulation

The period 1983 to 1988 was one of far-reaching financial deregulation. The largest changes occurred in the 1983-84 period which saw the full float of the dollar (as the Reserve Bank abandoned attempts to sterilise the heavy capital inflow in the first months of the Hawke government). All exchange controls were abandoned in late 1983, and all controls on bank deposits were abandoned in August 1984. Foreign banks were invited to enter in early 1985 and interest rates deregulated in 1986. The last of the big changes saw the Prime Asset Ratio introduced in 1985 to replace the Liquid assets and Government Securities ratio, and then the Statutory Reserve Deposit (SRD) ratio which was a primary prudential control instrument.

In earlier periods it was possible to gauge the conduct of monetary policy by the growth in the money supply (measured as M3 — currency plus bank deposits of the private non-bank sector) compared to the growth in real GDP and the inflation rate. A large increase in the annual M3 growth rate signalled a loosening in monetary policy and vice versa. However, during 1984 it became clear that the relationship between M3 and GDP was no longer stable. In January 1985, monetary targeting was abandoned in place of the so-called checklist approach.

Deregulation certainly made the conduct of monetary policy more difficult and also fuelled the excessive credit expansion (and asset inflation) in the second half of the 1980s.

## The movement of interest

Prior to the 1970s, real interest rates averaged around 2 per cent. Following the OPEC oil shocks in 1974, real interest rates became negative because nominal rates could not adjust quickly enough to the surge in inflation. Significantly, real interest rates rose sharply during the 1980s.

Monetary policy was loosened after 1986 and led to a sharp rise in investment spending. The problem however, in relying on monetary policy to control the economic cycle is that the effects are indirect and subject to unknown lags. At the time the Reserve Bank was easing interest rates, the terms of trade recovered substantially. The export expansion complemented the investment surge and the strong GDP growth not only reduced the unemployment rate to around 6 per cent but also worsened the already parlous current account. The current account deficits became the political and economic issue of the second half of the 1980s for the government. The reason it assumed a central importance lies in the accompanying rise in external debt (figure 4).

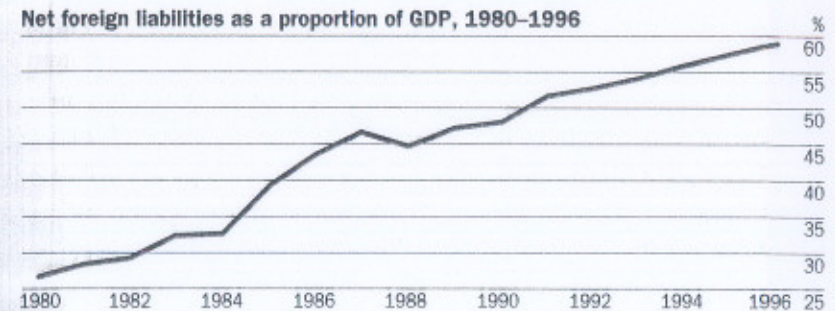


Figure 4

By 1988, the balance of trade was deteriorating because import growth was so strong. The inflation rate was also persistently high, partly due to the asset boom, and, partly due to the fact that business took full advantage of the wage restraint by pocketing larger margins.

It was in the late 1980s that Labor's most serious mistakes were made. Cash rates, which effectively set the interest rates paid by business and households, increased from just below 9 per cent in December 1987 to more than 17 per cent by January 1989 as a means of stabilising the exchange rate by encouraging capital inflow.

This was consistent with the Reserve Bank's narrow anti-inflationary objective. The government, however, saw the high rates as a vehicle to slow down demand, and hence import growth. The lack of clarity between the two bodies with respect to monetary policy was an important reason for the rates staying too high for too long. As the high interest rates choked off new investment projects, the GDP growth rate became negative (that is, the level of output actually fell).

### LABOR'S APPROACH TO MONETARY POLICY

- financial deregulation meant that monetary policy had to be effected through interest rates rather than by targeting the money supply
- monetary policy was eased after 1986, but massively tightened in the late 1980s, so that cash rates moved to more than 17 per cent
- different justifications were put forward by different bodies for the high interest rates: to dampen inflation by stabilising the exchange rate, or to reduce demand for imports
- this lack of clarity was an important reason for interest rates staying too high for too long

### A mild recovery

The recovery was prompted by two events, one external and one policy-induced. First, export growth was very strong on the back of a world recovery and so net exports helped economic growth. Second, reduced interest rates gave some boost to consumption spending but private capital formation continued to decline. The lower interest rates were due to the freeing up of monetary policy in 1990 — belated but beneficial. Fiscal policy remained con-

strained with outlays growing modestly as a percentage of GDP and only really starting to play a part in the recovery after more than 2 years of high unemployment (see figure 5).

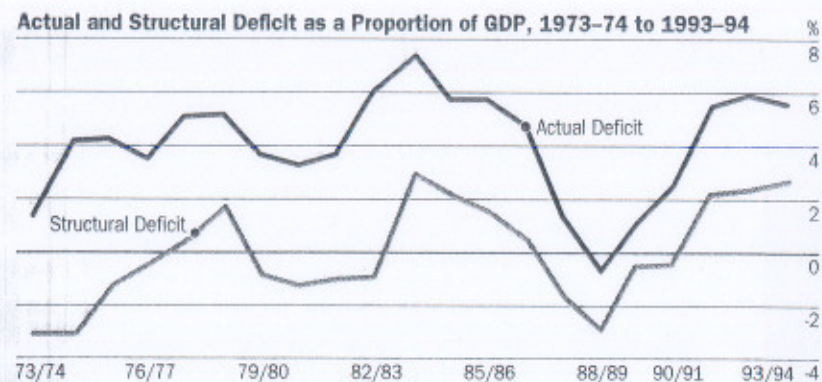


Figure 5

There is no defensible reason for the government's three-year wait to go for fiscal expansion. The budget of 1992-93 was of similar shape to that of 1991-92. All through this period, the government was firmly captive of the balanced-budget lobby, and ignored evidence from the last recession in the early 1980s that unambiguously showed that the countries who used expansionary fiscal policy with large budget deficits experienced the strongest employment growth compared to those who adopted less expansionary policies.

From 1993, with strengthening investment and private consumption, employment prospects improved, although with a disturbing lack of new full-time jobs.

The evidence for the entire period of the Labor government suggests that demand conditions and employment growth are strongly related. However, they do not provide any unambiguous relation between real wage movements, real unit labour costs and employment.

The twin deficits hypothesis and the national savings policy were

the principle reason for the limp fiscal policy during the recession. But this does not mean that expansionary fiscal policy was not the correct response in the recession. Even if there was a critical balance of payments situation there could have been stimulus given through increased government expenditure and taxation without reducing savings.

The rationalist straitjacket prevented the government from increasing taxation. The tax take in the federal budget as a proportion of GDP fell from 27.8 per cent in 1986-87 to 23.5 per cent in 1993-94, although there were some cyclical elements in that decline. The successive reductions in taxation over the period of growth were inconsistent with the government's savings-gap rhetoric. It would have been more responsible to increase taxes systematically as the economy was growing and to maintain some public spending, particularly in capital infrastructure.

## Labor's performance: the policy confusion

Early in its term, the Hawke government fell captive of the economic rationalist approach documented so well by Michael Pusey. The result was a reliance on a narrow set of blunt policy instruments. In particular, the government cut off its fiscal policy options through repeated expenditure cuts and tax relief to companies and higher income earners.

In the end Labor had one major tool of economic policy: interest rates. Use of high real interest rates failed to achieve all but one goal: low inflation. Yet due to the pervasiveness of rationalist thinking in the senior levels of the federal bureaucracy and the private sector 'think tanks' the government was unable to see its predicament because of its policy blindspots. By the time the recession hit

in 1990, economic rationalism became too much for its traditional supporters who began to desert Labor.

## Interest rates: 'soft landing' on a scorched earth

The extraordinarily restrictive assumptions used to justify policy options (in particular the twin deficits and national savings policies) and the bluntness of the policy instruments were the most striking aspects of this period. The consequences of the government's narrow strategy were severe. It was obvious, as much then as now, that reliance on high interest rates to subdue activity would make economic management difficult. By the time the government and Reserve Bank realised that their policy was working, high rates had eroded demand. Instead of inducing a 'soft landing', the policy resulted in a 'scorched earth', where unemployment nearly doubled and business investment fell to nothing but the minimum needed to replace worn out equipment. There was next to no investment in new projects or new capacity.

## The fiscal fix

Analysts wonder why the government was so reluctant to use fiscal policy (taxing and spending) to achieve its aims. There are two ways of looking at the conduct of fiscal policy in the latter years of the 1980s. One approach is to argue that the government had to rely on interest rates to restrain the economy because previous spending cuts had left very little 'fat' in the public sector. Any further pruning would have affected the viability of programs.

Or it could also be argued that the government blurred the distinction between fiscal policy and wages policy. When introducing the Accord, Labor said it would reward wage restraint through additional government spending to maintain the standard of living of workers. The emphasis was on the real 'social wage' rather than the

narrower concept of take-home pay. The idea was that universal health cover and other social benefits would reduce the cost of living and therefore free income for consumption and saving. The social wage concept implied more public spending, not less.

In the end, the government muddled both its social wage and wage restraint objectives as it tried to deliver the social wage through lower taxes, notably through a series of wage-tax trade-offs and national wage case decisions. The consequences were significant.

First, by reducing the revenue base, pressure grew for further spending restraint. This took place amid an ideological attack on public spending, which also had a powerful influence on budgetary policy.

Second, the concern about the expansionary consequences of the tax cuts (as they lifted take home pay during the boom) placed more pressure on monetary policy to restrain growth.

Finally, the tax cut amounted to a crude industry policy in the sense that the loss to the budget provided subsidies to the private sector in an indiscriminate way. Ironically in view of the rationale for tariff reduction, inefficient industries were given incentives to stay in operation at the expense of the national economy.

Had the government not tied its fiscal policy down, it could have ensured a softer landing by progressively inflating the economy, as the effects of the tight monetary policy became evident. However, this could only have occurred if wages policy had been more independent of tax and spending policies. Had the private sector borne more of the costs of employment, rather than the national budget, Labor could have expected more rapid adjustment and higher productivity growth.

This period illustrates the flaw of having monetary policy conducted by the RBA independently of the federal government. Treasury claimed the increase in real interest rates in 1988-89 was to fight the current account deficit. The RBA said it was to fight inflation. At any rate, the high, sustained interest rates demolished the disposable incomes of too many households, arrested the cash

flow of too many businesses, and with a drop in confidence and investment, were largely responsible for the sharp decline in the economy in early 1990.

The 1980s and the 1990s have shown that the rationalist approach can not generate sustained full employment and satisfactorily address other policy imperatives such as the current account deficit. Some will say that the Labor government did not go far enough and avoided labour market deregulation. It is hard to argue, however, that labour costs were a constraint on employers given the large shifts in national income shares that occurred. There is nothing to suggest that further deregulation would have reduced unemployment to low levels.

The Labor government failed to use enough policy instruments, with sufficient flexibility, to achieve clearly formed objectives. By following the rationalist approach, it lost the potential to be creative and to respond to changes in the economy. Economic rationalism did not deliver sustainable improvements to the economy and ultimately forced the government into an excessive reliance on monetary policy, with destructive outcomes.

#### **LABOR'S MACROECONOMIC POLICY BLINDSPOTS**

- **Labor only left itself one policy instrument to use for a number of objectives — high interest rates — because it cut off its budgetary policy options**
- **interest rates are a blunt policy instrument which are indirect, have substantial and negative side-effects, and are subject to unknown lags**
- **use of tax cuts to deliver social wage outcomes under the Accord increased pressure for spending cuts and reduced budgetary flexibility**
- **the tax cuts amounted to a crude industry policy in as much as inefficient firms were effectively given a subsidy and allowed to stay in operation**

- having monetary policy conducted independently of the government can lead to economic mismanagement

## A model of full employment and price stability

The amazing aspect of Labor's time in office was the growing acceptance of high and persistent levels of unemployment. To regain its traditional support and to point the nation in a more humane direction, the next Labor government must develop a model of full employment that does not violate price stability. This section outlines the core elements of such a model.

### Buffer stock employment

One of the most promising avenues in this regard is this: that the government act as a buffer stock employer (BSE), absorbing the unemployed into paid employment. The government could eliminate involuntary unemployment and maintain price stability by restraining the price paid for these 'buffer stock' employees.

The buffer stock wage would not interfere with the labour market because it would be close to the minimum wage. The BSE proposal would automatically increase government employment and spending as jobs were lost in the private sector, and decrease government jobs and spending as the private sector expanded.

It can be shown through technical analysis that any rise in the budget deficit is not likely to cause any problems for the fully employed economy. Foreign capital markets judge the economy by what it can deliver by way of investment opportunities. The fully employed economy with lower crime rates and increased purchasing power is likely to be an appealing prospect even if the budget

deficit is higher.

The buffer stock would vary with economic activity. When the economy is buoyant, there would be a net transfer of employees to the private sector in search of the higher paying positions and vice versa. The scheme differs from the Howard government's 'work for the dole' scheme because it would encompass all unemployed workers, pay award wages, and also set a constraint on the price level.

Critics might ask the question: where is the work? There are a large number of service jobs that could provide immediate benefits to the society if filled by BSE workers. These include urban renewal projects and other environmental and construction schemes (reafforestation, sand dune stabilisation, river valley erosion control and the like), personal assistance to pensioners, assistance in community sports schemes, and many more. When the One Nation statement was proposed in 1991-92 the local government sector submitted lists of community-based projects that might be funded by public sector job creation schemes. There were more than enough meaningful projects that could engage BSE workers in both urban and rural areas.

Labour-intensive service areas are ideal candidates for employing buffer stock workers. Moreover, many of these areas are under the direct control of government because they are provided by government — health, education and community services. These industries also have the highest total impact on the economy through their flow-on effects (see the box 'Employment Multipliers').

Opponents of the scheme have argued that substantial numbers of the current unemployment are unskilled persons who are not able to perform any task without retraining. The argument, however, is often accompanied by solutions such as minimum wage cuts, which allegedly would provide the incentive to employers to take these unskilled workers on. The argument is specious: its not possible to have it both ways. Either the workers are unskilled and require extensive re-training, or there are circumstances where they can work if offered an opportunity. There is no evidence that reduc-

ing minimum wages increases total employment. There is strong evidence that employers lower hiring standards and provide required training with employment opportunities as the labour market tightens.

### EMPLOYMENT MULTIPLIERS\*

Government administration	30
Education	38
Health	32
Community Services	37
all-industry average	21

\* Australia 1993-4. Multipliers give an indication of the impact on the whole economy through inter-industry linkages caused by a change in demand for a given industry's output. The higher the multiplier, the greater the economy-wide impact of a change in demand.

Under the BSE scheme the work would be relatively unskilled and service-oriented. The wages to be paid are at the low end of the wage structure, but workers would be paid the award wage appropriate to the skill of the job being performed. Where training is required, the BSE scheme would provide integration with public sector training schemes and at least give the trainees guarantees of employment after the training period, a security that does not accompany current training schemes.

### The cost of full employment

What would this cost? Using ABS data, we can make the following calculations. Assuming that full employment would coincide with a low unemployment rate (two per cent) to account for people changing jobs, the BSE scheme would lead to around 625,000 people gaining public sector employment (in June 1997). At the minimum level of \$360 per week, on-costs of 20 per cent, an aver-

age income tax rate of 25 per cent, and an average unemployment benefit payment of \$160 per week, the extra employment would cost the government in net terms around \$6.4 billion over a year. Assuming an average productivity level, the extra outlays would result in a lower budget deficit as a proportion of GDP. The \$6.4 billion, which would be the maximum estimated extra outlay, is approximately 1.2 per cent of current GDP, a relatively small fiscal cost.

More importantly, the costs to the government are an over-estimate because they ignore the extra expenditure effects that arise as the buffer stock employees increase their incomes and raise their consumption, generating flow-on tax revenues. Over a year, this spending would create extra employment in the private sector, reduce the buffer stock employment levels, and increase tax revenue and reduce outlays.

But perhaps a better way of showing that the relative costs of this scheme would be small is to focus on the costs of not doing it. At average productivity levels, the cost to Australia in foregone production of having unemployment above 2 per cent is a staggering \$18 million dollars every day of the year at current unemployment rates. These daily losses are permanent. We never get back the goods and services that were not produced. As a result of this lost production the government also foregoes tax revenues. Taxes amount to about 25 per cent of GDP. The lost taxes amount to around \$7.5 billion per year. Looking at it this way suggests that the BSE proposal is a very cheap option indeed.

But there are other costs involved in not reducing unemployment to minimal levels. High unemployment places increased costs on the health system, and is associated with increased family breakdown and higher crime rates. While difficult to give 'back-of-the-envelope' estimates, it is likely that these costs are substantial.

The only contentious issue is whether the increased spending would lead to an exchange rate depreciation via the current

account as imports rose. If this challenged price stability then a firm incomes policy would be required. However the scheme itself would not force up labour costs. Additionally, the depreciation would enhance the international competitiveness of local industry, so inducing further increases in output and employment.

As has been seen, the link between government deficits and the current account is weak, so that Australia's external balance would not be prejudiced. Fears of a capital flight are also misplaced: capital is attracted to growth and high returns, which the BSE would be enhancing.

### Administrative costs

Opponents of public sector work initiatives always point to the hidden costs of administration. While there would be administrative costs, there is no reason for these to be any higher than the administrative costs associated with high unemployment (which extend well beyond the costs of running the unemployment benefits system). The administrative costs of running the health system, the judicial system and the family court system would all be lower under the BSE proposal.

The BSE is an innovative, workable, demand-side response to a demand-side problem. It is a potent way for government to address the most pressing economic and social issue of our time.

### Conclusion

There are a few clear conclusions that can be drawn about the Hawke-Keating years, which are instructive for future Labor governments.

### The light hand of monetary policy

First, using monetary policy to target both the inflation rate and the current account deficit is completely untenable. The high real interest rates of the late 1980s certainly slowed investment spending and hence the economy, but also pushed the exchange rate higher than it should have been and had a negative impact on exports and import-competing industries, thereby working against the external account.

Second, any future Labor government should not rely on monetary policy to stabilise the business cycle. Such a policy is far too blunt to be of use. Labor should pledge to terminate the protocol on monetary policy reached between the coalition and the Reserve Bank. Monetary policy should be made by the government, and accountable to parliament.

Most importantly, interest rates should be kept as low as possible. With a floating currency, jacking up interest rates is a sure-fire way to suck in portfolio capital from overseas, leading to an increase in interest payable on foreign debt (and hence balance of payments difficulties) and an exchange rate appreciation (with a concomitant loss of competitiveness for locally based industries which are exposed to international competition).

### The bold hand of tax policy

Labor has to break the entrenched view that tax rises are politically impossible. To manage the business cycle a government has to be able to use all its fiscal and monetary instruments. It would have been better to use fiscal policy, whose impact is much easier to predict, and looser monetary policy in the late 1980s.

### Wages

This chapter did not consider wages policy in great detail. However,

it is clear that if the Labor government had avoided absorbing wage rises via tax cuts, the fiscal position would have been more flexible and the structural adjustment process more rapid. Another lesson is that wage-tax trade-offs are clumsy vehicles with undesirable budgetary effects. Wages policy should not function as a defacto industry policy, rewarding inefficient firms: mechanisms must be put in place to ensure that gains from wage restraint are ploughed back into productivity-enhancing investment.

### A place for the public sector

The next Labor government will also have to use the public sector more creatively as an employer. The private sector has shown comprehensively that it cannot fully employ the available labour force and increasingly prefers to casualise the job opportunities that it provides. As the preceding section on restoring full employment shows, there are many functions that can be served by public sector employment schemes.

The major change that Labor has to make is to jettison the baggage that to be a good economic manager requires rigid adherence to advice from the Treasury department and the private capital market players. These groups reflect narrow sectoral interests. They are interests that are at odds with the general welfare of the population.

Rationalist policies did not work to enhance the prosperity of the nation as a whole. The Labor government embraced them out of insecurity with its past, lack of clarity, and uncertainty and hesitation in a rapidly changing environment. Labor can put workable policies in place which reflect a clear vision of growth in which all can share. Economic success and electoral victory would then surely go hand-in hand.

### POLICIES FOR THE NEXT LABOR GOVERNMENT

- **introduce a 'buffer stock employment' scheme where the public sector brings the unemployed into paid labour in labour-intensive service industries at award rates, and supplies training as necessary**
- **terminate the protocol on monetary policy between the government and the Reserve Bank**
- **keep interest rates as low as possible**
- **make greater use of fiscal policy — including the tax system — as an instrument of macroeconomic management**

### Sources

The statistics referred to in this chapter and used for the graphs are sourced from the Australian Bureau of Statistics 1350.0 and 5209.0, OECD *Economic Outlook* no. 62 and various issues of *The Reserve Bank Bulletin*. The different purposes for which monetary policy was used is examined in Milbourne, Ross 'Money and Finance', in Stephen Grenville (ed.), *The Australian Macroeconomy in the 1980s*, (Reserve Bank of Australia) pp. 222-288., 1990. The buffer stock employer scheme is outlined in more detail in William F Mitchell 'Inflation and Unemployment: A Demand Story', presented to European Unemployment Conference, sponsored by the European Commission, at the European University Institute, Florence, November 21-22, 1996. Some fiscal policy observations and the structural deficit graph are sourced from Nevile, John 'Fiscal Policy in Australia', in Peter Kriesler (ed.), *The Australian Economy*, Allen and Unwin, pp. 101-118, 1995. Michael Pusey's discussion of economic rationalism is found in his *Economic Rationalism in Canberra*, Cambridge University Press, 1991.