

# A Longer Run Perspective on Australian Unemployment

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## Introduction

Most Australians regard the current level of unemployment as undesirable. It delivers personal hardship to most of the unemployed and their families and is slowly changing the nature of our society in undesirable ways. Poor and depressed neighbourhoods are growing in our cities. One third of our children live in families with no employed adult. An increasing proportion of people of working age appears to be increasingly welfare dependent. Unemployment has been at unacceptable levels for at least 25 years and it is probably Australia's most serious economic and social problem.

Why then has the unemployment problem been so difficult to solve? As is to be expected, given our long-standing failure, the answer includes inadequacies of economic theory and economic policies, but also extends into the nature of our society and its changing ability to marshal political support for policies which may be more effective. Achieving an unemployment solution has become as much a political as an economic task. How then should the discussion proceed? It is not possible to cover fully the subtleties of the interactions between politics and economic policies. Therefore, most of the emphasis will be on the economics of the unemployment problem, with occasional detours into some of the political difficulties we face.

There is another choice to be made. Unemployment is primarily a macro phenomenon and its causes lie predominantly in the macro economy. So where should we focus? Is the source of our unemployment inadequate saving, inadequate investment, restrictive monetary policy and so on, or does the cause lie elsewhere? Indeed, is there one cause? We cannot explore all these possible relationships so, along with most economists, we have put most of our emphasis on the labour market, although it is not at all clear that this is the source of the unemployment problem<sup>1</sup>. It may well be that unemployment is a symptom of problems that lie elsewhere in the economy. All aspects of the economy are linked together and it is always a matter of judgement what to include in the discussion and what to exclude.

To begin, we adopt an historical approach. Understanding our history throws light on the current policy debate, provides some indication of the likely success of different labour market policies and helps us to understand the changing political environment. Importantly, it teaches us to be sceptical of instant and easy solutions.

Not every economist would accept that history matters for understanding the economics of the policy solutions for unemployment. Many might argue, for example, that if unemployment is judged to be too high – whatever the cause and whatever the history that

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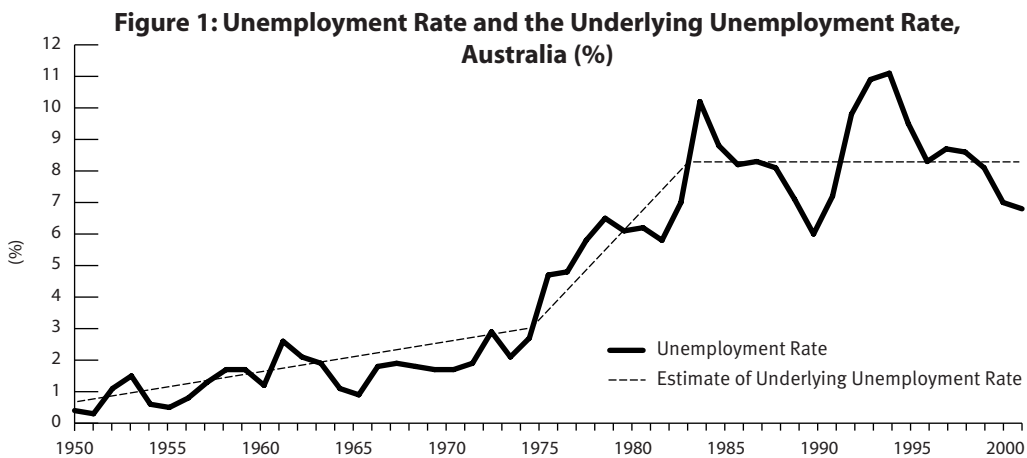
<sup>1</sup> *This chapter discusses only a few of the important issues. The reader might like to consult the following surveys, Anh T. Le and Paul W. Miller (2000), which primarily adopts a micro approach to unemployment, and the papers collected in Debelle, G. and Borland, J. (1998), which largely take a macro approach.*

led to this situation – there is always the same solution. Real wages must be reduced to create more jobs and lower labour supply. This is the unemployment solution taught in first year micro economics, with its emphasis on demand and supply of labour and an equilibrating wage. But history provides us with some indication as to whether real wages are the source of the unemployment problem and some indication of how easy it is to bring about real wage changes in the Australian labour market.

Other economists might argue that history was once relevant for understanding the level of unemployment, and for providing the experience necessary to design appropriate unemployment policies, but that now the past is no longer a good guide. They believe that there is a new information economy rapidly evolving and the labour market is changing so much in response to new technologies that an analysis of the past has little policy relevance. Although it is true that the economy is changing, we believe that an historical approach is necessary to identify the extent of the changes in the labour market and to assess their relevance.

Once an historical approach is adopted, it appears sensible to think of unemployment as consisting of two parts: a cyclical component, which is the unemployment response to the economic business cycle; and an underlying, or long run unemployment rate around which the unemployment cycle is imposed. It is a crucial judgement as to whether it is sensible to divide unemployment into these two categories and whether the factors that contribute to each part of unemployment are different. For example, it is clear that monetary policy affects the unemployment cycle but most economists would not accept that monetary policy affects the underlying unemployment rate<sup>2</sup>.

It is useful then to begin with Figure 1, which plots the Australian unemployment rate over the period 1950 to 2000. We divide unemployment into three historical periods indicated by the three straight lines, which are our estimates of the underlying unemployment rate. This historical conceptualisation – three unemployment periods and unemployment having two components – is important. It plays a major part in determining the way in which the unemployment problem is viewed, the way in which evidence is marshalled to support particular policies and the interpretation of just what went wrong.



Source:

<sup>2</sup> The underlying rate of unemployment is often referred to as the natural rate of unemployment.

The first unemployment period is from 1950 to the early to mid 1970s. This period is characterised by a low underlying unemployment rate. In the environment of the 1950s, 1960s and early 1970s, the underlying rate of unemployment was so low, and the upward trend so slight, that the underlying rate of unemployment was ignored. Policy makers directed their attention to managing unemployment and the macro economic cycle as though they were the same phenomenon. When unemployment was too high, monetary policy was loosened and the settings of fiscal policy placed in expansion mode. When unemployment was too low, monetary and fiscal policy were tightened. Unemployment policy seemed to fit very comfortably with the application of Keynesian demand side economic theory. Any unemployment problem was viewed as a cyclical problem.

The second unemployment period extends from the mid 1970s to the early 1980s, when unemployment increased from around 2 per cent to around 7 per cent. The dominant contributor to the increase in unemployment to a new level appears to be the underlying rate of unemployment. The policy emphasis therefore shifted away from demand side management and cyclical unemployment to a concern about the determinants of the underlying rate of unemployment. A new range of questions, not related to demand management and the unemployment cycle, moved onto the policy agenda.

The third unemployment period is from around the early 1980s to today. The unemployment cycle and the underlying unemployment rate pose a larger policy and social problem than in any other period over the last 50 years. The underlying rate of unemployment has remained on the very high plateau that was reached in the early 1980s and cyclical unemployment variations have been very much larger, relative to the movements of unemployment during the 1950s and 1960s. The increase in the unemployment rate in the early 1980s and 1990s recession was around 6 percentage points. During the 1950s and 1960s, the largest cyclical increase in the unemployment rate was around 2 percentage points.

The interpretation of the unemployment history presented in Figure 1 suggests four important issues to be addressed, each of which is the subject of the subsequent sections of this chapter.

The first section discusses changes in the underlying rate of unemployment. Why did the base rate of unemployment increase from one level to another over the 1975 to the early 1980s period and why has it remained at high levels? Can we learn anything about good unemployment policy for today from these experiences?

The second section continues the focus on the underlying rate of unemployment and assesses the unemployment response to the new policies of labour market deregulation that have been introduced over the last decade. The third section looks briefly at new policy ideas to reduce unemployment. These new ideas include wage reductions for the low paid and adopting a much tougher attitude towards income support for those not employed.

The fourth section moves the focus to the unemployment cycle, comments briefly on the current unemployment situation and the prospects for a major recession in the near future, while the final section offers concluding comments.

## **Why Has the Underlying Unemployment Rate Increased So Much?**

One way of explaining changes in the underlying unemployment rate is to focus on the basic theoretical model of the relationship between average real wages, average labour productivity and the level of employment. At any point of time – given technology, the capital stock and the supply of labour – there is an average real wage and associated average labour productivity which will generate full employment. An efficient labour market will produce this real wage. If the real wage is maintained above this level there will be unemployment. Consider a number of examples of the way in which this model works.

If the economy is at full employment, there is a balance between real wages and labour productivity. Then, if real wages increase suddenly, without an increase in labour productivity, firm profitability will fall. Firms will be paying more per worker (real wages have increased) without receiving additional output per worker (labour productivity has not changed). In response, firms will attempt to offset their profitability decline. In a competitive environment, firms will reduce employment to increase labour productivity and restore the balance between average real wages and labour productivity. In this way, the profit fall is reversed and unemployment increases as employment falls.

In an efficient labour market, the additional unemployment generated by the sudden real wage increase creates pressures to reduce the real wage as workers compete for the reduced number of jobs. In response, real wages begin to move back to their original level and employment increases in response to the real wage reductions until the economy is back to full employment.

If the labour market is not efficient, the real wage may not respond quickly to unemployment and remain above the full employment level. Under these circumstances, labour productivity will adjust to the new real wage but the new balance between real wages and labour productivity will not occur at full employment. At any particular time, with a given technology, capital stock and labour supply, there is one real wage and associated labour productivity that is consistent with full employment.

During the 1950s and 1960s, the underlying rate of unemployment was consistent with full employment and the balance between real wages and average labour productivity was maintained. Real wages and average labour productivity increased at the same rate in response to technological change, labour supply and capital accumulation. The Australian labour market, with strong unions and a centralised wage fixing system, operated as though it was efficient. Indeed, along with a number of European economies, the labour market appeared to be more efficient than that of the US where the underlying unemployment rate was much higher<sup>3</sup>.

Then, during the early 1970s, something happened to the efficiency of the Australian labour market. There were two distinct aspects of this reduction in efficiency. Firstly, real wage increases suddenly accelerated above the average rate of increase of the previous two decades without an accompanying increase in the underlying rate of technological change. The increase in real wages created a real wage-labour productivity imbalance. As a result,

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<sup>3</sup> See the comments in Gregory, Klug and Martin (1999).

there was a 'real wage overhang', i.e. the real wage level by 1975 exceeded the level of labour productivity that would prevail at full employment. In response to this imbalance, firms reduced employment and increased labour productivity as less labour was applied to the existing capital stock. This process continued until labour productivity and real wages were once again in balance. However, the new balance was at a higher rate of unemployment. Secondly, it was widely believed that the labour market would not reverse the real wage increase. Real wages would not be sufficiently responsive to the increase in unemployment.

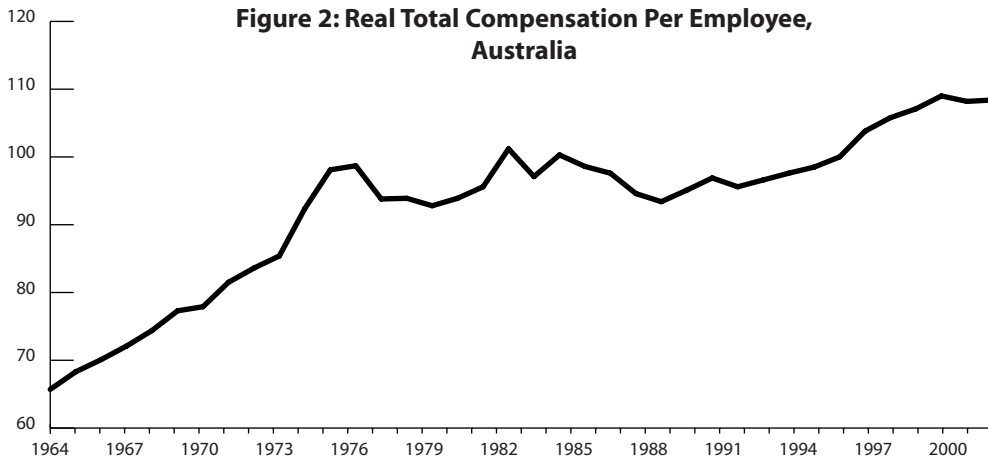
The 'real wage overhang' theory led to a clear-cut policy solution. To restore full employment, average real wages should be reduced or maintained at their current level to allow the rate of technical progress that would normally occur to increase labour productivity. Technological change, unmatched by real wage increases, would create another imbalance between labour productivity and real wages as the labour demand curve moved to the right. This would create further employment to close the gap. The response to the 'real wage overhang' could be reversed and the underlying unemployment rate could return to its previous level. Any further real wage increases should be avoided until unemployment fell to acceptable levels.

The 'real wage overhang' theory has its counterpart, in one form or another, in all macro and micro economic textbooks and, as a result, was widely accepted by economists. It quickly became conventional wisdom among governments and provided the stimulus for the real wage indexation policies from April 1975 onwards. These policies were to protect employees against real wage falls and, in this way, encourage unions not to seek further real wage increases. Later, the focus on real wage moderation, was adopted as the centre piece of the Accord by the Australian Labour Party. Therefore, all major political parties more or less accepted that excessive real wage increases were the source of the unemployment problem and that there should be some form of intervention into the labour market to improve its efficiency. Most important commentators and policy advisers, such as the Treasury, the Reserve Bank of Australia and the OECD, also believed that real wage constancy for a substantial period of time, or real wage reductions, were a necessary condition for unemployment reductions.

In retrospect, this emphasis on the real wage increase as the sole explanation of the increase in the underlying unemployment rate now seems inadequate. A number of puzzles have emerged which are important for the development of current policy. These puzzles go straight to the central issue of the diagnosis that the excessive real wage increases were the cause of the subdued employment growth, and the recommended policy solution that real wages should not increase until full employment is restored.

## **Were Large Real Wage Increases the Primary Cause of the Increase in the Underlying Unemployment Rate?**

Figure 2 presents the real wage index from 1964 to 2000, with 1995=100. Real wage changes seem to divide into four different periods: 1964 to 1973, steady real wage increases; 1973 to 1975, acceleration of the rate of growth of real wages; 1976 to 1995, more or less real wage constancy; and 1995 onwards, when average real wages increased at a rate similar to that of the 1950s and 1960s.



Source

There does not seem to be much disagreement that the exceptional real wage increases of the 1973 to 1975 period posed a problem for the macro economy. But the first puzzle is that the real wage increases do not seem sufficiently large, relative to past increases, to have brought about such a significant increase in the underlying rate of unemployment. On the basis of past trends, it should have taken only three years of real wage constancy for the trend rate of technical change to increase labour productivity and restore the real wage-labour productivity balance compatible with full employment. Indeed, by 1977, real wages were back on trend. Yet, despite real wage moderation, unemployment continued to increase and 25 years later, unemployment has not returned to pre-1975 levels.

The second puzzle is that although average real wages hardly increased at all for 15 years after 1975, unemployment has remained high. For example, by 1990, real wages were about 30 per cent below a trend projection based on the 1950s and 1960s data and yet there was no evidence that the underlying rate of unemployment had fallen in response? Why was real wage moderation so ineffective as an unemployment solution?

These puzzles can be explained, within the spirit of the 'real wage overhang' theory, if the macro rate of technological change had slowed dramatically sometime from the early 1970s, in much the same way as technological change and the rate of growth of labour productivity had slowed in the US. A slower rate of technological change would produce a slower rate of growth of labour productivity consistent with full employment. Consequently, to maintain the balance between real wages and labour productivity at full employment, the economy would have needed to generate a much lower rate of real wage increases during the early 1970s than in the past. However, the opposite occurred and real wage increases accelerated.

If there was a slower rate of technological change during the 1970s and 1980s, this considerably alters conventional historical analysis and our assessment of the correct policy response at this time. Even if there had been no acceleration in the growth rate of real wages, the slow down in the rate of technological change would have created a significant unemployment problem. The past trend of real wages, if it was to continue into the future, would not have been consistent with full employment. The difficulty, therefore, becomes not so much the exceptional real wage increase but the inability of the Australian labour

market to recognise a productivity slow down and quickly produce a slower rate of real wage increase in response. This shift in emphasis, towards a change in the rate of technological change as an explanation of the large increase in unemployment, is not trivial. It begins to explain why the high underlying unemployment rate has persisted until today.

The emphasis on the slow down in the rate of technological change suggests that the 1970 to 1975 real wage increase was more serious than was thought at the time. The acceleration of real wages should not have been judged relative to past real wage trends but judged relative to the rate of growth of labour productivity that was consistent with full employment. Because the rate of growth of full employment labour productivity slowed so much in advance of the large real wage increase, the real wage overhang was very substantial. Hence, the increase in unemployment was considerable.

The slow down in the rate of technological change and, hence, the growth rate of the underlying full employment labour productivity, meant that it would take much longer to remove the real wage overhang. As an extreme example, if the rate of growth of the full employment level of labour productivity was zero from 1970 onwards, the 'real wage overhang' could not be removed by keeping the real wage constant and waiting for technology to increase labour productivity to remove the gap. Removal of the real wage overhang would require a real wage reduction.

In retrospect, this suggests that intervention into the labour market should have attempted to achieve a reversal of the real wage increase rather than real wage indexation. For a number of reasons this would not have been easy to achieve. Firstly, about one third of the real wage increase took the form of establishing equal pay for women. In the political climate of the times, this could not have been openly rolled back. Secondly, the real wage effect on unemployment seemed manageable with the passage of three or four years. Finally, there were so many other changes occurring at the time, such as the manufacturing sector response to tariff reductions and the large exchange rate appreciations, that made it difficult to completely accept the real wage increase was so important.

## **The New Labour Market Policy and Its Impact on the Underlying Unemployment Rate.**

When the Labour Party was elected in 1983, the Accord – an agreement between the Labour Party and the Australian Council of Trade Unions – was a central part of economic policy. The Accord was set up to help avoid another real wage increase when unemployment fell during the recovery from the 1982-83 recession. The Accord process, with its emphasis on centralised wage fixing and real wage maintenance, carried within it political tensions that increased through time and eventually led to its abandonment. Centralised wage fixing effectively robbed union officials of one of their most important functions, fighting for wage increases for their members. As a result, the trade union movement became increasingly disillusioned with the Accord. Gradually, policy began to dismantle the centralised wage fixing system. This began under the Labour Government at the beginning of the 1990s and has been extended during the Liberal and National Coalition government. The emphasis of the new policy has been to shift wage bargaining to the enterprise level, weakening the role of trade unions and deregulating the labour market.

This process of deregulating the labour market has effectively removed centralised control of average wage outcomes. Consequently, if real wages and full employment labour productivity are out of balance, and there is a need for moderation of average wage increases, there are no direct policy instruments that government can bring to bear on the problem. The centralised wage fixing system, which was the widely accepted instrument to bring about the policy solution advocated during the 1970s and 1980s, has been abandoned.

The new policy for the labour market is based on two important propositions. Firstly, there is a strong belief among many policy advisers that any real wage-labour productivity imbalance should be corrected by the free workings of the labour market. In an efficient and well working labour market, any real wage-labour productivity imbalance will be a transitory problem. If real wages are too high and unemployment is created, then, in an efficient labour market, the unemployed will exert pressure for the real wage to fall and restore full employment. If the labour market is unable to produce full employment, further labour market deregulation is required to increase efficiency. Full employment is now seen as a problem of the institutional design of labour markets rather than a problem of demand management.

Secondly, the new labour market policy in the early years placed considerable emphasis on enterprise bargaining as a method by which firms and unions could increase labour productivity and increase the firms ability to pay wage increases. A policy of enterprise bargaining, weaker trade unions and deregulation of the labour market was seen as a way to increase the rate of technological change.

How is the labour market performing under its new institutional structure? Is it moving towards producing real wage outcomes compatible with full employment? Is employment increasing and unemployment falling as a result of the new labour market flexibility?

### **Average real wages**

It is apparent from Figure 2 that after the break down of the Accord, and as the new labour market policy has become increasingly effective, average real wages have begun to increase quite quickly. Over the last five years, real wages have increased by an average of 2 per cent per annum. Indeed, all of the real wage increase since 1980 has occurred in the last five years. The labour productivity growth rate has also accelerated since the 1991-1993 recession and real wage and labour productivity increases have moved in a parallel fashion. The increased rate of growth of real wages and labour productivity, viewed in isolation, are good outcomes. Employees are now better off than before. However, there is a problem.

The market generated real wage increases are occurring despite very high unemployment rates. But a major objective of the policy to change labour market institutions was to moderate real wage increases so that the underlying unemployment rate could fall. But this has not occurred. With respect to the real wage-unemployment nexus, the labour market has not increased its efficiency. At this point of time nothing seems to have changed and underlying unemployment remains high.

It is interesting to note that the current real wage acceleration, at a time of high unemployment, is not being discussed in the same manner as the real wage increases of the 1970s. Indeed, it is common to hear politicians and policy commentators endorse the current real wage increases as a good thing and evidence of success of the new policy stance.

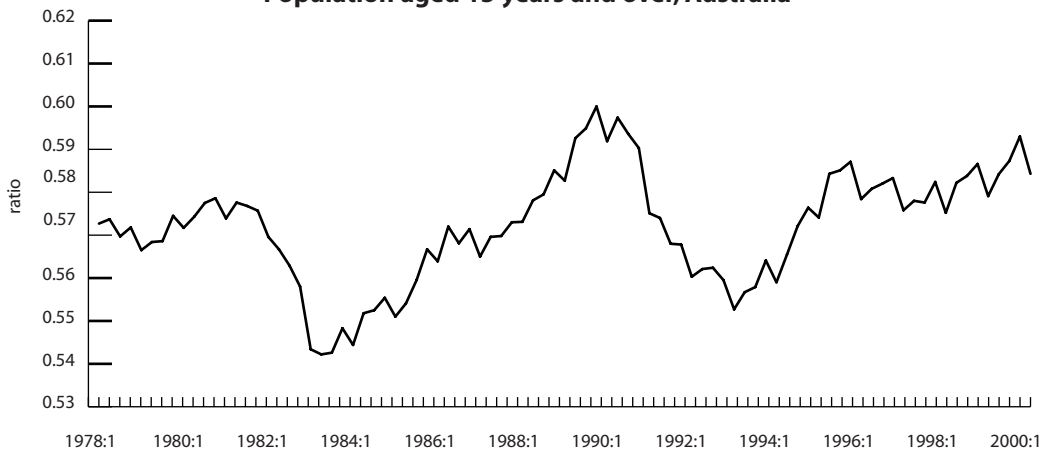
Policy advisers and commentators are not stressing that perhaps the labour market has become less efficient under the new institutional framework, because high rates of unemployment are no longer controlling the rate of increase of real wages. The central idea that average real wage moderation is a precondition for employment growth, and that there should be policies that directly impinge on real wage increases, has been largely abandoned.

If we accept the theory of the real wage-unemployment nexus, which was the centre-piece of Australian policy for so long, how can the current outcome be regarded as satisfactory? Perhaps there is evidence that the new labour market structure is producing higher employment growth so that the current high rate of unemployment is just a transitory phenomenon?

### Employment and unemployment

Figure 3 presents the history of the employment-population ratio over the last two and a half decades. It is apparent that the employment response to the new labour market policy is disappointing. After an initial rebound from the 1991–1993 recession, similar to the rebound from the 1982 recession, the rate of employment growth has slowed. Indeed, relative to the working age population, there has been no significant employment growth since 1995. The increase in the rate of technological change is being directed towards labour productivity and real wage increases rather than additional jobs.

**Figure 3: Employed Persons as a Proportion of the Population aged 15 years and over, Australia**

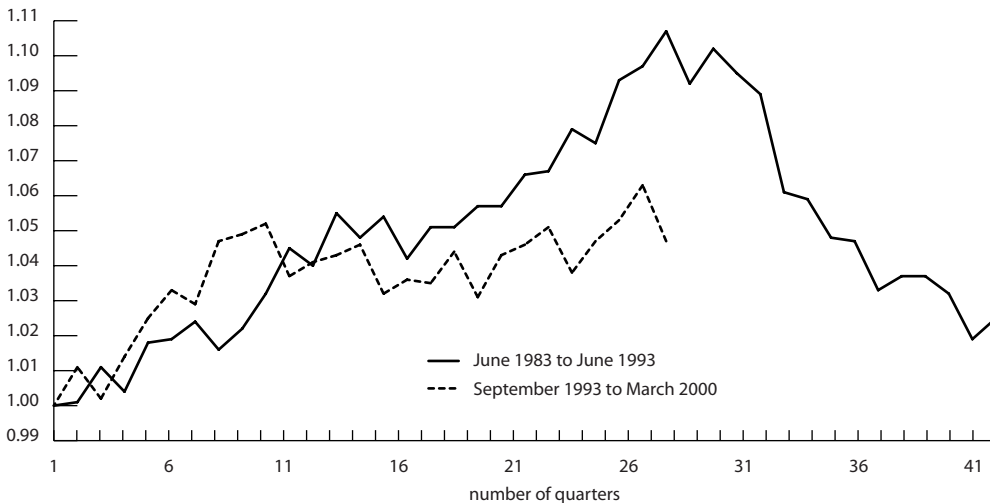


Source

The disappointing employment outcome can be made clearer by plotting the employment-population ratio over the two periods of different labour market institutional structures, the centralised wage fixing period (the Accord) and the recent period of encouraging enterprise bargaining, weakening trade unions and labour market deregulation. We date the first period from June 1983, the trough of the recession, and the second period from September 1993, also a trough of a recession (Figure 4). The employment-population ratio at each starting point is set at 1.0 so we can directly compare the employment growth of the two periods.

During the first four years of the recovery from each recession the pattern of employment growth has been similar, although marginally stronger during the Accord period. However, from the four year mark after the trough of the recessions, employment growth during the Accord period was much stronger. Since 1995, the Australian labour market has been experiencing something similar to a jobless growth, once allowance is made for increases in the population. The contrast between the late 1980s and the late 1990s is very clear. Six and half years after the troughs of the recessions, the Accord period had generated more additional jobs than the new labour market regime. Figure 4 extends the Accord period into the large recession of 1991 to 1993. It is apparent that, even if a decline in employment is avoided over the next 12 to 18 months, the new institutional structure will not have managed to generate as many jobs as the previous period unless there is an upturn in employment growth.

**Figure 4: Post Recession Employment History**  
**Employed Persons as a Proportion of Population aged 15 years and older, Index**



Note: June 1983=1.00, Sept 1993=1.00

Source

These employment facts make the current policy dilemma clear. The job creation ability of the current policy and institutional structure of the labour market does not appear superior to the employment creating ability of the centralised wage fixing system during the Accord period. Indeed, to date, it might be argued that, with regard to employment generation, the new system has failed. From the viewpoint of the unemployed, the new labour market is generating the wrong wage-employment outcomes. The new labour market is delivering the gains from a faster rate of technological change to those that are employed, rather than creating new jobs for the unemployed. This has always been seen as a key problem that is likely to be encountered in deregulating European/Australian type labour markets. Without a framework for real-wage intervention, it appears to be difficult to bring real wages and labour productivity back into balance at full employment after the system is subject to an adverse shock.

What can be done? In principle, and within the context of this discussion, there are two possible responses; a move back towards centralized wage fixing or a further move towards labour market deregulation in the hope that this will provide more real wage moderation.

In practice, either of these possible policy responses will be difficult. After so much dismantling of the old system, and in an environment where unions are weaker, it would be difficult to reverse current policy and move back to a more effective centralised wage fixing system. Union influence is not as great as before and trade unions may no longer be able to exercise significant control over wage outcomes.

A move towards further labour market deregulation may also fail to moderate average real wage growth. After all, it has failed to do so to date. Are there any other ideas that might work? The following section of the chapter discusses two approaches which could be considered.

## **New Ideas and Policies to Reduce Unemployment**

### **Reducing relative real wage of the low paid**

One possible way out of this dilemma has been suggested by a group of five economists<sup>4</sup>. They argue that wages matter but it is relative wages, rather than average wages, that are important. The argument is that unemployment is not so much the outcome of the average wage-full employment labour productivity link that we stressed earlier, but a response to the wage prevailing in labour markets where there is significant unemployment. Hence, it is the average wage of the young and the unskilled that is too high relative to their productivity. The real wage-unemployment focus has shifted towards micro markets.

The ‘five economists’ believe that the centralised wage system still has a role to play in bringing about a fall in wages of the low paid and those groups experiencing high rates of unemployment. Within the current pay setting framework, the low paid who fail to gain wage increases in the market place can still access across-the-board safety net wage increases through the Industrial Relations Commission. The ‘five economists’ argue that this access should cease and that wage increases should be denied to the low paid. If the low paid fail to obtain safety net wage increases, the increase in the average wage will be less and, hence, there will be two sources of employment stimulus, a reduction in relative wages of the low paid and a lower rate of average wage increases.

Would such a policy work? How large a real wage reduction do they envisage for the low paid? The ‘five economists’ have suggested that a reduction of 5 per cent may be sufficient. One way to develop a feel for the likely success of the suggested policy is to look at what has been happening to the wages of the low paid.

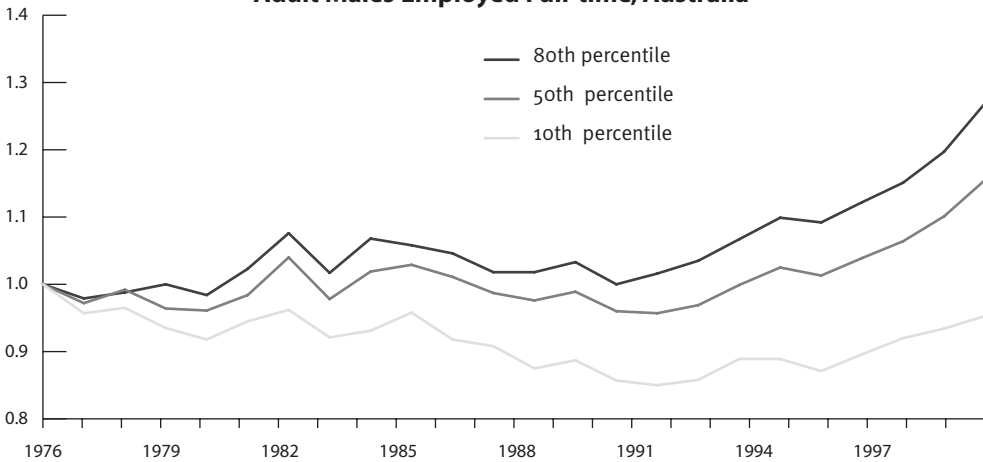
Figures 5 and 6 plot earnings from full time work at the 80th, 50th and 10th percentile of the male and female earnings distributions respectively. Over the period of high unemployment, the dispersion of earnings from full time employment has widened significantly for men and women, both before and after the Accord period. Since 1975, there has been a 5 per cent reduction in real earnings from full time work for men at the 10th

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<sup>4</sup> *The five economists are Professor P. Dawkins, Professor J. Freebairn, Professor R. Garnaut, Dr M. Keating and Dr C. Richardson. The basic ideas can be found in Dawkins and Freebairn (1997).*

percentile and an increase of 20 per cent at the 80th percentile. For women, real earnings at the 10th percentile have remained constant while real wages at the 80th percentile have increased by 25 per cent. At this point, would a further 5 per cent reduction of real wages at the bottom of the distribution be successful as a job creating strategy? It appears unlikely. After all, relative to median earnings from full time work, earnings at the 10th percentile have fallen by about 15 per cent. If the policy recommended by the ‘five economists’ is to work it seems that a very large real wage fall is needed. A 5 per cent wage reduction would only put real wages back to the level of the 1991 recession, when the unemployment rate was 11 per cent.

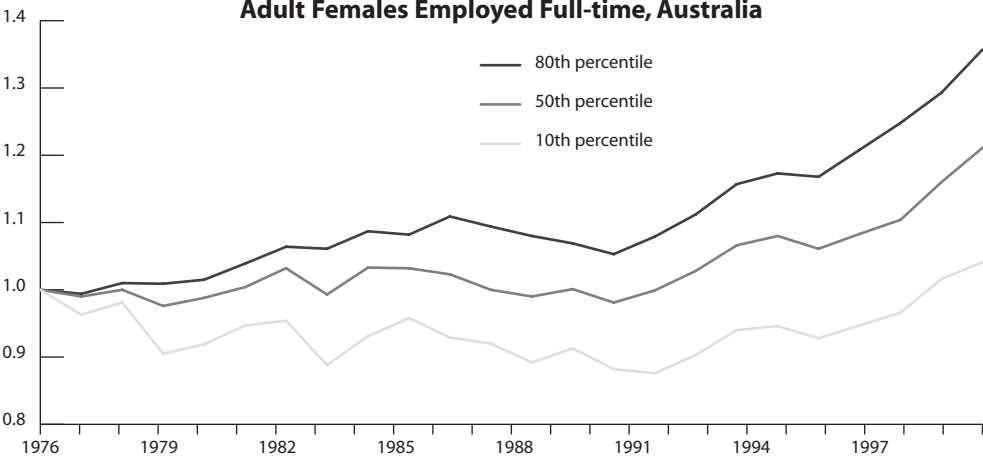
**Figure 5: Index of Real Weekly Earnings, Adult Males Employed Full-time, Australia**



Note: 1976=1.0

Source:

**Figure 6: Index of Real Weekly Earnings, Adult Females Employed Full-time, Australia**



Note: 1976=1.0

Source:

There is one further difficulty associated with this policy. The 'five economists' advocated that the government offset the real wage reduction with a tax concession to preserve the income of the low paid. Of course, the larger the real wage reduction, the larger the tax concession. Therefore, a large real wage reduction would most likely translate into a real income fall for the low paid, as government is unlikely to provide all the subsidy needed to replace the wage reduction.

## **Changes in labour supply**

The second set of ideas that may lead to a reduction in the unemployment rate focus on the supply side of the labour market. There are two separate approaches here.

Firstly, a preliminary glance at the employment history over the last two decades indicates that supply side adjustments and supply side policy have been important in reducing the level of unemployment, particularly in the full-time labour market. For example, all the reduction in male unemployment since 1975 has been a supply side response. The full-time employment-population ratio has fallen by 12 percentage points and yet the unemployment-population ratio has only increased by 2 percentage points. This supply side adjustment has taken the form of increased school retention, increased attendance at institutions of higher learning, increased rates of early retirement for the older male age groups, and increased use of invalid pensions. For women, increased attendance at education institutions and diversion into part-time jobs has been important. The full-time employment-population ratio for women today is much the same as in 1966. Each of these supply side adjustments has involved increased government expenditure and it now appears that they have run their course. It is difficult to see government financed supply reductions being an important influence in the future, except for the encouragement of women to stay at home to look after young children.

Although supply side responses have reduced unemployment, the failure of employment to grow quickly, and the increasing fiscal cost associated with supply reducing policies, is leading to a change in the supply side emphasis. The new emphasis is proceeding in the opposite direction to reducing supply. Over a number of years the government has been attempting to build political support for the argument that the high level of unemployment is the result of social security recipients not accepting jobs and preferring to remain on benefits. The idea is that increased use of social security payments for income support is acting to reduce the effective labour supply and is weakening labour market pressure for real wage reductions. In this way the supply side of the labour market might be thought responsible for the lack of employment growth.

The increased attention directed towards social security recipients leads to a number of policy changes. Firstly, policy has begun to make access to social security income support more difficult. Many asset and income tests are now more stringent, while longer waiting times have been introduced before individuals can gain access to particular programs.

Secondly, policy is now placing more emphasis on the welfare to work transition. One aspect of this policy has been to increase the degree of individual case management and to attempt to tailor the social security system more closely to the job finding needs of each individual. As part of this policy, job finding agencies have been privatised, and training and job placement activities subject to tender.

Thirdly, more financial assistance is now being offered to the low paid to accept jobs and to remain in employment. As low wages fall, in relative terms, the incentive structure is changing to make welfare support more attractive relative to low paid employment. To offset this, government is increasing the rewards from employment by allowing some individuals to keep some welfare income support while in low paying jobs. There is considerable interest in extending de facto wage subsidies to the working poor. These schemes might be loosely described by the political slogan – “making work pay”.

The logical extension of this policy is to reduce the level of income support for those on social security income and to place a cap on the period of time that an individual can access benefits. Some hints that the government is considering moving in these directions is contained in the recent discussion paper used to launch the current review of the welfare system.

Although a welfare system obviously weakens the incentive to accept just any job, there is no substantial evidence in Australia that the welfare system has been responsible for the increase in the underlying unemployment rate. The increase in the underlying rate of unemployment is confined to a very short period of time, from 1975 to 1983. The loss of jobs seems quite clearly to be a demand side phenomenon. However, if the welfare system was responsible, it might be expected that the underlying rate of unemployment would have increased smoothly throughout the period.

## **Cyclical Unemployment and Future Prospects**

The focus to this point has been on real wages and the underlying rate of unemployment. Of course, much of the unemployment literature is concerned with the relationship between cyclical unemployment and the rate of increase of nominal wages. In its simplest terms, the analysis usually proceeds as follows; when unemployment becomes low, nominal wages begin to increase in response to market pressures and then monetary policy is tightened, unemployment increases in response to higher interest rates and nominal wage increases are moderated. The variations of cyclical unemployment take place around the underlying rate of unemployment. In this literature, the underlying unemployment rate is usually called the natural rate of unemployment.

Throughout most of the last 50 years, it has been thought that this model of the unemployment cycle has fitted the Australian data well. But there is increasing evidence that the relationship between nominal wage increases, interest rate cycles and unemployment cycles is not as close as it was in the past.

After the 1982 recession, it was hoped that the Accord would enable Australia to avoid large nominal wage increases, avoid tight monetary policy and, in this way, protect the economy from large increases in cyclical unemployment. Although the Accord was fairly successful at moderating wage and price increases, it could not control the rate of growth of asset prices that accelerated quickly during the 1989 to 1991 period. During this time there was widespread concern that the asset price boom would spread to the labour market and lead to increases in nominal wages and inflation. Hence, monetary policy was tightened and Australia experienced the largest recession of the post World War II period. Nominal wage increases did not initiate the interest rate increases.

There is also some evidence that the Australian economy has responded to the adverse experiences of the last major recession, as wage and price increases have been moderate over the last decade. However now, in early 2000, another cycle of interest rate increases has begun with more interest rate increases to come. It is an interesting aspect of the present interest rate cycle that, to a considerable extent, interest rate increases have been following the tightening of US monetary policy rather than responding directly to Australian nominal wage outcomes. The mechanism by which the US tightening has generated a response here has been via the Australian exchange rate, which has devalued considerably over the last 12 months and, at the time of writing, was falling further. It is being argued that this will eventually increase the domestic inflation rate, as import price increases and the export income stimulus feed into the Australian economy. Hence, the need for interest rate increases to prevent the exchange rate from falling. If cyclical unemployment increases, as is likely, it will not have been triggered by increases in nominal wages.

How far might interest rates increase? Could we expect as large an increase in unemployment as in the 1982-83 and the 1991-1993 recessions? It is surprisingly difficult to answer these questions. Official forecasts are still predicting a significant decrease in unemployment over the year 2000-01, which seems a little surprising, given that interest rates are clearly on the increase. However, official forecasts failed to predict the seriousness of the downswings in 1982 and 1992.

Australian recessions have always coincided with world recessions. Australia has never been able to escape the domestic consequences of a world downturn<sup>5</sup>. Consequently, the extent to which cyclical unemployment increases depends critically on the rate of growth of the world economy over the next year or two. Although forecasts of world economic growth are optimistic, it is noticeable that world interest rates are increasing along with those of the US.

## **Conclusion**

Over the last decade, deregulating the labour market, discouraging unionism and encouraging enterprise bargaining have been the major policies to reduce unemployment. The belief has been that these policies will increase wage flexibility and allow wages to fall in particular labour markets of high unemployment. Many other policies have been introduced, such as privatising the Commonwealth Employment Service, changing the social security system and encouraging education, but they have clearly been of second order importance.

Have these policies been successful? They have certainly achieved many of their intermediate targets. Unions are weaker, enterprise bargaining is more common and centralised wage fixing has been abandoned, except for safety net adjustments. However, success at changing the underlying rate of unemployment has been limited.

On the positive side, the rate of labour productivity growth has increased and has returned to growth rates typical of the pre 1975 period. Higher labour productivity growth rates have allowed a looser monetary policy regime and presumably faster economic growth. In turn,

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<sup>5</sup> *In the past, Australian nominal wages increases have always coincided with world boom periods and increases in world interest rates. Hence, it has always been difficult to separate out how much of the tightening of Australia's monetary policy is a response to the Australian domestic economy and how much is a response to world interest rate changes.*

faster economic growth has helped employment growth. However, it is clear that the rewards of higher productivity growth have been primarily directed towards real wage increases, rather than employment growth.

To date, the labour markets new institutional structure has not delivered faster employment growth and, therefore, from the viewpoint of unemployment, the policy has not succeeded. But perhaps it could be argued that it is too early to make this judgement? In the longer term, it may be that the success of the new labour market will be judged by whether Australia can avoid another major recession in the near future. If Australia can avoid a deep recession, the current rate of unemployment of around 7 per cent might form a platform from which unemployment can be further reduced. The economy's growth rate is already showing signs of slowing as Australian interest rates move upwards along with those of the US.

Will avoidance of a major recession be sufficient to achieve a sustained and significant reduction in unemployment? It is not clear. There are two clouds on the horizon. Firstly, to the extent that reductions in the underlying rate of unemployment require real wage moderation, there is not much room for optimism. The increased rate of technological change is being primarily directed towards real wage increases rather than employment gains. Secondly, there must be some concern as to future labour supply changes. Over the last decade, unemployment has fallen because of significant reductions in the labour supply. Indeed, the proportion of the population employed full-time is the lowest it has ever been. If a new policy evolves to move people off social security income support into the labour market, then the need for a faster rate of job growth will increase. It is difficult, at the moment, to envisage how the economy can deliver these jobs.

What then will be done about unemployment? My guess is very little. None of the political parties have any new policies that are likely to be effective. All seem to be hoping that a recession can be avoided and, hence, economic growth and continual falls in the relative pay of the low paid will eventually reduce the unemployment rate. All this suggests that the reduction in unemployment may well be a slow process, especially if labour supply reductions, which have been such a noticeable feature of the past, are no longer an important source of unemployment reductions.

Unemployment is a large topic and we have not been able to cover all the issues that matter, but many of our omissions will be discussed in other chapters<sup>6</sup>. Perhaps the most important omission is a discussion as to how Australian experiences relate to those of other countries, in particular the US. There are three points that should be made with respect to this comparison. Firstly, the Australian pattern of technological changes through time has also occurred in the US. For example, not only did the US experience a marked slow down in technological change at the beginning of the 1970s but technological change has also accelerated there since the early 1990s. Therefore, it may be quite incorrect for us to attribute the recent increase in the rate of technological change in Australia to changes in labour

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<sup>6</sup> *Now that the chapter has been completed, I am a little surprised at the emphasis that has been placed on the real wage-labour productivity balance, especially as I have always been sceptical of real wage explanations of unemployment. My original intention was to be more eclectic in the discussion. So why direct so much attention to this issue? The reason is that among important economic policy institutions – such as the Treasury, the Reserve Bank of Australia, the OECD and the IMF – there are only two consistently advocated positions to explain the high rate of unemployment. One is that the demand for labour is insufficient because real wages are too high. The other is that the economy is operating near full employment because of supply side constraints.*

market institutions. After all, the US has shared the same experiences. Secondly, over the last decade, the US has generated a larger increase in employment than during any other decade over the last 50 years. It is not as though there is something about all modern economies that prevents job growth and that all economies cannot cope with sudden shifts in the rate and nature of technological change. In the US, real wage increases responded very quickly to the technological slowdown in the early 1970s and the US labour market avoided the large real wage increases that occurred in Australia. Finally, all Australian recessions have coincided with US recessions and it is the US environment that is generating the current round of interest rate increases. Therefore, to a significant extent, our ability to avoid a major recession in the near future may well depend on influences outside our control.

## References

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