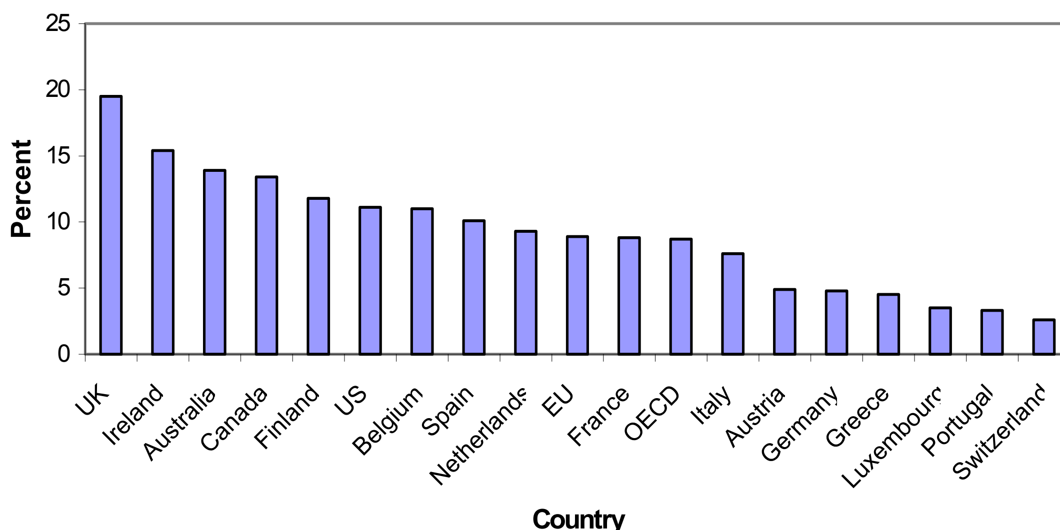
FULL EMPLOYMENT: "THE FIVE ECONOMISTS' PLAN" REVISITED

1. Introduction

Restoring full employment is critical for a fair Australia where everyone has the opportunity to realise his or her potential. But even after a decade of economic growth, unemployment remains unacceptably high. This is our major economic and social failing.

Arguably of even more significance than the traditional unemployment rate, is the incidence of jobless households which has grown substantially over the last two decades. Almost one in six children now live in jobless households. (Dawkins, Gregg and Scutella 2002). The rate of jobless households with children is one of the highest in the OECD (see figure 1).

Figure 1: Jobless household rate by country for households with children (OECD – 1996)



Source: OECD (1998)

Lower unemployment and joblessness depends partly upon sustained economic growth. However, while growth is necessary it is not a sufficient condition for reducing unemployment.

Three years ago the so called "Five Economists"[1] were concerned that growth alone might not reduce unemployment much below seven per cent on a sustained basis. Reappraisal of the impact of the various reforms of the last twenty years suggests that the rate of unemployment that could be sustained may now be a little lower than that earlier estimate of seven per cent. What we do know with certainty is that the present rate of unemployment is too high, that we can lower the target rate of unemployment which could be sustained, and that the speed with which we approach that target is not dependent on economic growth alone. We also know that the number of jobless families is far too high and that we need to increase the supply of labour from jobless families as well as the demand.

The two authors of this paper have written a number of articles on the subject of the five economists plan (see for example Keating 2001, Dawkins 2001). Dawkins (2001) includes a detailed discussion of some of the criticisms that have made of the plan, and concludes that it remains a very robust proposal. Indeed it is argued that following various pieces of research and modelling the credibility of the proposal has been further enhanced since the debate that occurred in the immediate aftermath of the letter that the five economists sent to the Prime Minister.

We do not intend to rehearse all the arguments in detail, in this brief presentation. Rather we wish to emphasise some central points, which we believe make the case for the plan, a compelling one. Interested readers can find more detailed discussion of the arguments in the references mentioned above.

2. The Employment Content of Growth.

The employment content of economic growth can vary significantly. In the 1980s GDP per capita increased at an annual average rate of 1.8 per cent, only slightly less than the 2.1 per cent recorded in the 1990s. The key difference between the two decades was that employment and productivity increased at average annual rates of 2.4 per cent and 1.0 per cent respectively in the 1980s, and by 1.3 per cent and 2.1 per cent respectively in the 1990s.

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[1] The Five Economists are Peter Dawkins, John Freebairn, Ross Garnaut, Michael Keating and Chris Richardson.

Various explanations have been offered for this difference in the mix of growth between the two decades. Doomsayers variously blame globalisation, economic rationalism and economic reform, or technological change. The evidence, however, is not compelling.

These various forces operated also in the 1980s, and the fact is that increases in unemployment have been exclusively confined to times of recession. The challenge we face is to reduce the likelihood of recession and to expand the number of jobs sufficiently fast to take up the slack following a recession.

What distinguished the 1980s from the 1990s was that employment growth was faster and wage and productivity growth were slower. To some extent the three are interconnected. Increased productivity is a good thing. It is the basis for realising peoples' aspirations for improved living standards. But in the 1990s real wages increased at an annual rate of 1.7 per cent, whereas in the 1980s they hardly changed. The counterpart was faster job creation in the 1980s relative to much the same rate of economic growth as in the 1990s.

Table 1

Economic Growth in the 1980s and 1990s

Average annual rates of change

	1978-79 to 1989-90 per cent	**1989-90 to 1999-00 per cent**
GDP per capita	**1.8**	**2.1**
Employment	**2.4**	**1.3**
Productivity (GDP per hour)	**1.0**	**2.1**
Real wages	**0.1**	**1.7**

Clearly the gains from economic growth based on higher productivity should be fairly shared, and while unemployment is higher than is acceptable, we argue that not all the gains from higher productivity should or need to be paid out in higher wages.

In sum the experience of the last two decades is that it is risky to rely on economic growth alone to bring down unemployment. A combination of labour market reform to encourage wage restraint and associated welfare reform can help increase the amount of employment for any given rate of economic growth, and further it should help to achieve a higher rate of economic growth on a sustained basis.

3. The Five Points in the Five Economists Plan

Such a combination of wage restraint and welfare reform is the basis of the five point plan put forward by Five Economists a little more than three years ago to bring unemployment down to around 5 per cent over the four years to 2002. The key elements of the Plan were:

1. Steady fiscal policy and monetary policy and microeconomic reform aimed at continued strong and stable economic growth
2. A reduction in the rate of wage increases relative to the rate of productivity growth, to be achieved by replacing Living Wage adjustments, for the time being, with tax credits for low wage earners in low income families
3. These tax credits would be introduced in a way that lowered the effective marginal tax rates facing low income families and improved their incentives to pursue employment opportunities, with a long-term commitment to further reduce effective marginal tax rates for low and middle income families
4. A systematic approach to labour market programs
5. Upgrading the education and training systems over the longer term.

The wage-tax trade-off – point 2 – is arguably pivotal in increasing the employment content of future growth. It is the feature of the Plan that has attracted most attention and on which we will accordingly concentrate our remarks today.

4. The Wage-Tax Trade-Off and Employment

The Five Economists estimated that if minimum award wages were frozen for four years then the real wages (before tax) of those dependent upon safety net adjustments would decline by a bit over 10 per cent. In aggregate this could translate into average real wages being about 2.5 to 3 per cent less than they otherwise would have been. The Five Economists then estimated that a relative reduction in average real wages of this order would result in an increase in employment of 2.5 to 3 per cent, and that unemployment would fall by around 1.25 to 1.5 per cent. More recent estimates suggest that the reduction in unemployment might be slightly less at around 1 to 1.25 per cent.

The impact of a freeze of the minimum wage on the overall average wage depends, however, upon responses to that freeze. On the one hand, some people on minimum

award wages would move to obtain a wage increase outside the award system. On the other hand, a freeze on award wages would flow on and affect the wage claims of people who are not part of the award system. Dixon and Rimmer (2000) modelled both of these effects and found that the proposed wage freeze would lead to strong and sustained employment growth if the wage increases foregone during the period of the wage freeze are not subsequently restored. In that case real economic growth also gets a big boost, with much of the higher employment coming in response to higher economic growth. If, however, the wage freeze is only temporary and the wage increases foregone are subsequently recaptured, then there are useful short-run gains in employment and output, but these are not sustained in the long run. Never-the-less even these short-run gains would ameliorate the particular problem of long-run unemployment.

On balance it seems likely that the effects of the proposed award wage freeze are more likely to be permanent. First, the relatively high minimum wage in Australia is probably significantly higher than market outcomes. Second, the tax credits would more than compensate the most needy people, so that they would be less inclined to try to recapture any wages apparently foregone.

5. Employment and Skills

The proposed freeze of the minimum wage would of course reduce the relative wage cost of the least skilled members of the labour force, and could be expected to increase their employment relatively. Indeed the available evidence suggests that the demand for their labour is most responsive to a reduction in wage costs.

However, a reduction in the relative wage costs of around 10 per cent may not be sufficient to make the most disadvantaged members of the labour force who have been out of work for a long time fully competitive. Accordingly the Five Economists Plan also proposed that these people should receive additional support and encouragement in the form of labour market programs and welfare reforms. These should involve a combination of training and education assistance, administrative requirements for job search etc, and wage subsidies for a limited period. This would help to overcome the lack of job readiness experienced by many long-term unemployed persons. Experience suggests that this targeted assistance is most effective when the demand for labour is growing strongly, as could be expected in response to the proposed wage freeze.

6. Employment and Incentives

The proposed tax credit would significantly improve work incentives for many low paid workers in low income families, because of the reduction in their "replacement ratio" and in their effective marginal tax rates (EMTRs)

On the other hand, at higher levels of income, because it would take longer for the combined family tax credit and employment conditional credit to be withdrawn, it would slightly raise EMTRs over a small range.

Indeed the major concern with tax credits or any other forms of assistance that are targeted towards those on low incomes is that the assistance is necessarily withdrawn over some range of income. People with incomes falling within that range can then face an increased disincentive to work as the withdrawal of that assistance operates like an addition to their marginal income tax rates. However, in the scheme proposed by the Five Economists the additional assistance would be withdrawn in such a way that there would be no overlap with existing means tests, and therefore minimal possible upward effect on present maximum effective marginal tax rates when it is withdrawn.

Thus the policy would increase labour supply for many households, especially jobless ones (especially lone parents), but could slightly reduce the labour supply of some second earners in couple households, the net effect being significantly positive.

International studies of earned income tax credits suggest that they can have positive effects on the labour supply of some (especially sole parents but also some other single and married workers), but can also have a modest negative effect on the labour supply of some second earners (see e.g Eissa and Hoynes 1999, Eissa and Liebman 1996, for US evidence, and Duncan and McCrae 1999, Blundell et al, 2000, for UK evidence)

It should be stressed, again, that the way that the tax credit is implemented is important in determining the magnitude of these effects. Considerable care has been taken to ensure that the five economists proposed tax credit is well integrated with Family Tax Benefit Part A, so as not to cause very high effective marginal tax rates for low income families with children. However the presence and size of these is an empirical issue.

One way of estimating the likely magnitude of these effects is to model the earned income tax credit in a behavioural micro-simulation model of the tax-transfer system such as the

Melbourne Institute Tax and Transfer Simulator (MITTS). Such a study is underway and preliminary findings are that there would be sizable positive labour supply effects for lone parents and some relative small positive and negative effects for other households, with the negative effects primarily for second earners[2].

7. The Wage-Tax Trade-Off and Equity

A major advantage of the Five Economists proposal for a wage-tax trade-off is that it would improve equity. Wage increases are not an efficient way to improve equity because people earning low wages are well spread throughout the distribution of family income (Richardson and Harding, 1998). Indeed the lowest incidence of minimum wage earners is found in the third decile of the income distribution and the highest incidence is found in the fifth or middle decile. In addition, the effective marginal tax rates facing low-income families are typically very high, so that most of any wage increase is lost through higher income tax and reductions in various forms of means tested government assistance.

By comparison tax credits can be targeted towards those who are low wage earners in low-income families so that only they benefit, and they retain the full amount of the higher credit. Thus for a two income family with two children and a combined annual income of $44,600, an earnings credit of as little as $10 per week would lead to the same increase in their disposable income as a $23 increase in the 'living wage'.[i] While for a single income family, with or without children, the increase in the 'living wage' required to match an earnings credit of $10 per week would be $14.29. Admittedly the credits would also be paid to those low wage earners in low-income families whose wages were not frozen. But Lambert (2000) has shown that overall such a tax credit would increase the share of disposable income accruing to deciles 2 to 7 and reduce the share of the upper income deciles 8,9 and 10. In addition, the increase in employment as a result of this policy would further advantage low-income households.

8. Can We Afford a Wage-Tax Trade-Off

Perhaps the biggest single impediment to adopting a Wage-Tax Trade-Off is its perceived cost, which would undoubtedly be substantial in the first few years. As has already been

[2] Detailed findings of this analysis will be presented in a forthcoming Melbourne Institute Working paper.

noted, however, the Five Economists Plan is expected to boost GDP growth. As a result the government's tax revenues are increased and expenditure on unemployment assistance is reduced. Over time, modelling by both Richardson (1999) suggests that the policy could be expected to pay for itself inside ten years, and modelling by Dixon and Rimmer (2000) suggests that the pay back period could be much shorter. Indeed, Dixon and Rimmer conclude that the cost of the tax credit is a small price to pay for the very large benefits.

Nevertheless governments are more likely to be held to account in the short run than in the long run, and given the Government's commitment to balance its budget over the next few years, a tax credit would have to compete with other demands upon the public purse. In this context it might be noted that in recent years government social expenditures on income support, education, health and housing have been restructured in favour of higher income groups. In particular, the changes to family assistance, aid to private schools and the health insurance rebate have all contributed to upper middle class welfare. Thus there would seem to be significant scope to review government priorities and achieve savings in favour of the most disadvantaged. And assisting these people to realise their full potential by participating in work and society would then improve economic performance over time. Indeed the question might well be put can Australia afford not to take action along these lines? The alternative, if there is not closer attention to priority setting, is that there would be little scope for tax reductions if we want to maintain an equitable society, and there may even be some upward drift in taxation.

9. Recent Developments in the Wages Safety Net Case and Conclusions[3]

Recently the Commonwealth Government has effectively acknowledged and promoted the logice of the Five Economists' Plan. As the Minister for Employment, Tony Abbott wrote in *The Australian* on March 5th, and the Commonwealth Government has just pointed out in its Safety Net submission, "changes to the tax-transfer system are much more effective than wage increases at helping low income families," Abbott (2002)

First, most people who benefit from award wage rises are not in low-income families, whereas the use of "in-work benefits" through the tax-transfer system, can be designed for

[3] This final section of the paper is based upon an article written by all of the five economists in the Australian Newspaper on Wednesday March 6th (Dawkins et. al. 2002) We therefore thank John Freebairn, Ross Garnaut and Chris Richardson for their contributions to the material included in this section.

low-wage earners in low-income families. Second, low-income families do not generally benefit much from award wage increases. Many have little or no paid work. For many who do have paid work, much of the increase in award wages is lost because of tax paid and the withdrawal of means-tested benefits.

In addition, Tony Abbott and the Government's submission also pointed out that a substantial award wage increase would cause higher unemployment and "end up making poverty significantly worse rather than better".

Indeed, this is precisely why in1998 we used the same argument, to propos a tax supplement to the wages of low-wage earners in low-income families, rather than continually increasing minimum award wages. This policy would help to restrain the costs of employment, especially of low-skilled workers, and thus boost the demand for labour, especially low-skilled labour.

This would reduce unemployment. It would be more beneficial for the incomes of low-wage earners in low-income families than increases in minimum award wages. It would also increase the incentive for people to move from welfare to work. Further, for about a half of low-wage workers the initial low wage job provides skills which enable them to get higher paying jobs in the future.

There has been an extensive debate about the "five economists plan". Further research and modelling has given additional credibility to the proposal. We are pleased that the Minister for Employment has taken an important step by supporting the underlying idea in the Government's Safety Net submission. It will be very helpful if the Industrial Relations Commissioners (IRC) endorse the idea. This would help to ensure that they can play an important role in integrating of the wages safety net and the tax-transfer system, and creating new jobs.

The links between unemployment and a lack of self-esteem are clear. Further, the growth of jobless families over the last twenty years is Australia's major economic and social problem. Nearly one in six children now live in jobless households. The impact on kids is a major concern as well as the effects on the jobless themselves.

That is why governments, employers and unions, should not cling to the old-fashioned cold war mentality of institutionalised wage fixing in Australia. Rather, we should look around the globe to benefit from world's best practice in cutting unemployment. And there the news is good. Moves to tackle unemployment via a mix of tax credits to boost take

home pay and limited wage rises to put a leash on costs to employers proved strikingly successful in several nations during the 1990s - including Clinton's America and Blair's Britain. The Netherlands have also been pursued similar policies with success. We have an historic opportunity to learn from the best practice elsewhere

If the IRC gives the green light to a future Government submission offering a supplement to the wages of low-wage earners in low-income families through the tax-transfer system, as an alternative to raising minimum award wages, hopefully the Government will take up the challenge.

In our original letter to the Prime Minister we argued that it would be difficult to get the unemployment rate much below seven per cent on a sustained basis by economic growth alone. A more imaginative approach was required. The fact that the unemployment rate still remains around seven per cent, despite almost a decade of very good economic growth, tends to support this view.

It is possible that the economic reforms of the last two decades have produced an economy that could sustain a slightly lower unemployment rate after further sustained economic growth. However, further reform of the labour market, especially of the link between the wage-setting system and the tax and welfare system, would make this much easier. It would also further lower the feasible unemployment target significantly.

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[i] This calculation assumes a two income family receiving Family Tax Benefit Part A, where the primary earner receives just over $14 per hour and works full time and the spouse receives the same wage and works three days per week. Both the primary earner and the spouse would be eligible for an earnings credit related to their respective earnings and each would benefit from an increase in the 'living wage'. If the same couple only received the minimum wage of $11 an hour for the hours that they worked, they would still need an increase in the 'living wage' of $17.60 to match an earnings credit of $10 per week.

Over time the benefits of an earnings credit of an extra $10 maximum in each year would accumulate faster than the net benefits from 'living wage' adjustments, which are reduced by taxation and the means testing of the Family Tax Benefit, and more people would progressively gain. Thus in the first year, if each adult member of the family earned two thirds of male and female average ordinary time earnings respectively, then their entitlement to an earnings credit could be matched by a 'living wage' increase of only $7. However, after three years this family would require 'living wage' increases totaling $51.43, or an average increase of $17.14 in each year, to match their entitlement to the then earnings credit.