

A POLICY PROGRAM FOR FULL EMPLOYMENT

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Unemployment is the greatest economic problem facing Australia and other OECD countries. Yet it has received less attention than issues such as tax reform and exchange rate policy. In part this reflects a general air of fatalism. It is generally accepted that nothing can be done to generate substantial reductions in unemployment.

This paper is based on the premise that the fundamental cause of rising unemployment is a decline in the demand for labor. This in turn may be traced to the failure of the publicly financed community services sector (primarily health and education) to continue the expansion of the post-war boom, thereby compensating for the contraction of employment in older sectors such as manufacturing. A second premise is that the contraction in the public sector, and particularly in publicly financed community services, has been greater than is consistent with efficiency and welfare objectives. Both of these premises are defended in more detail in Quiggin (1993).

It is argued that both an active labor market policy and an expansion of the publicly financed community services sector, sufficient to generate a substantial reduction in unemployment, is feasible. A number of proposals for financing such a program are advanced.

Policy approaches

The primary approaches to unemployment in Australia have been based on macroeconomic expansion and real wage restraint. It is clear from past experience that full employment is inconsistent with rapid real wage growth and with contractionary macroeconomic policies. However, getting macro policy settings and real wages right will not be sufficient to restore full employment. It is necessary to consider alternatives acting directly on the demand for labor and on the labor market position of the long-term unemployed.

Active labor market policies

The idea of active labor market policies gained increased acceptance in the late 1980s. Institutions such as the OECD moved away from the doctrinaire position that

freely operating labor markets would guarantee full employment. The implied contrast is with passive policies involving income support, which are frequently associated with disincentives to training and other forms of labor market participation.

The main forms of active labor market policies are training schemes, targeted wage subsidies and direct job creation. The relative merits of the different types of scheme have been discussed by Stretton and Chapman (1990). Targeted wage subsidies are typically paid to employers who hire people who have been unemployed for some period such as 6 or 12 months. Job creation ranges from pure 'make-work' to community projects normally selected on the basis of a high reliance on fairly unskilled labor. However, at least in Australia, jobs are normally short-term and selected so as not to suggest competition with the regular public workforce.

The general conclusion of the Stretton-Chapman analysis is that whether direct job creation or wage subsidy schemes are to be preferred depends on the stage of the economic cycle. It is argued that wage subsidy schemes are likely to be less beneficial to the long-term unemployed in periods of high unemployment, when many high-quality workers with relatively short periods of unemployment are available.

A dimension of active labor market policy that has received rather less attention is universality. Income support for the unemployed is normally universal, in that it is received as of right by all those without work or other means of support. By contrast, in the absence of an explicit commitment to full employment, there is no general expectation that an unemployed person will become entitled to participate in some form of labor market program leading to re-employment. The only country where a general commitment of this kind operates is Sweden, although other countries have offered guarantees to particular groups (for example, school leavers in the UK).

The crucial implication of universality is that it provides a basis for a model of reciprocal obligation. The social obligation to provide work for all is associated with an obligation on the unemployed to seek and accept it. Countries without a full employment policy, such as Australia, seek to impose such an obligation on unemployment beneficiaries, in the form of a 'work test'. However, when the number of unemployed consistently exceeds the number of vacancies, such a test must rely, not on the willingness of the unemployed to accept work, or even in any genuine sense to seek it, but merely on a requirement to go through the motions of applying for work. When applied in a stringent form, such 'work tests' are more likely to discriminate on the basis of ability to negotiate bureaucratic hurdles than to distinguish shirkers from genuine job-seekers.

The Swedish active labor market policy was associated with very low rates of

overt unemployment. Even taking into account those in labor market programs, the rate of unemployment remained below 5 per cent for most of the 1980s. Calmfors and Forslund, on the assumption that labor market programs have no human capital effects, argue that they are counterproductive, since they raise the reservation wage of those in work. To make this argument stand up, it is necessary to accept the proposition derived by Calmfors and Forslund that Swedish real wages are exceptionally responsive to overt unemployment and that, by coincidence, active labor market programs have been pursued most vigorously in the one country where they are unnecessary.

An alternative is to look for another factor explaining Sweden's good record on unemployment. The OECD (1992) argues that Sweden's high levels of public employment and high growth in public employment may provide the explanation. This issue is considered below.

Expanded public sector employment

The most obvious remedy for unemployment is to hire more people. As argued in Quiggin (1993), the failure of demand to keep up with growth in the potential workforce may be traced to the failure of the community services sector to continue the growth of the 50s and 60s. Unlike an active labor market policy, a program of increased public sector employment would not be targeted at the unemployed, but would have the effect of increasing the labor-intensity of any given level of aggregate demand and thereby raising the level of employment consistent with internal and external balance.

There are a number of constraints on a program of increased public sector employment. First, it is necessary to take account of impacts on external balance. The central idea behind the policies proposed here is to increase the level of employment consistent with any given level of external balance. The community services sector is more labor-intensive and less import-intensive than the economy as a whole. Because of the demand-switching effects of increased public sector employment the initial impact will be to reduce import demand. Hence the program is consistent with sufficient relaxation of monetary policy to allow aggregate private demand to remain unchanged. Second, there is the requirement for fiscal balance. Although countercyclical deficit financing may be desirable, the unemployment problem is present over the long term and any response must be fiscally neutral in the long term. As will be argued below, a program sufficient to generate large reductions in unemployment could be financed. Finally, it is necessary to take account of effects on labor discipline. If, as was feared during the 1980s, employment growth results in a real wage breakout, or alternatively

in slackening productivity, it will ultimately prove untenable.

The experience of the Accord suggests that, at least as long as memories of high unemployment are strong, and rewards in the form of employment growth are forthcoming, real wage restraint can be secured even with tighter labor market conditions. However, it remains to be seen whether the decentralised system now being proposed is consistent with such restraint. With current levels of unemployment, there is little doubt that a decentralised bargaining system will result in most people working harder for lower wages. This outcome seems less likely if unemployment falls to low levels.

The possibility of slackening productivity as a result of a reduced threat of unemployment must not be ignored. However, it should not be overstated. The retrenchments of the 1980s have greatly increased the discipline imposed on the general workforce, particularly in the public sector (there has been an offsetting increase in slack for private sector senior management). It seems unlikely that the associated changes in work attitudes will be reversed rapidly.

The primary constraints are political. An expansion of public sector employment can only be financed by an increase in taxation or a reduction in transfer payments and public consumption of goods and services. Even in the presence of a consensus on the general desirability of higher taxes and higher levels of community service provision, agreement to particular increases in taxation, or to cuts in particular transfer payments will be difficult to obtain.

Nevertheless, I believe the principal political obstacle to a serious assault on unemployment is the general belief that nothing effective can be done. If a program were widely agreed to be a workable route to lower unemployment, I believe it would ultimately secure the necessary political support. I have therefore sought to describe the outlines of such a program.

A program for full employment

In order to consider the scale of action that might be feasible, consider a program aimed at increasing total employment by 500 000 above the level that would prevail with a normal cyclical recovery. Such a program could be implemented over a period of about three years. Hence, if the cyclical recovery generated a rise in employment of 300 000, the target would be a total increase of 800 000. Such a rapid rate of increase has not been achieved in the past, at least since the beginning of World War II. However, there has been no recent period when the level of unemployment has been as

high as at present.

Assuming that a normal cyclical recovery would result in an overt level of unemployment of 8 per cent and hidden unemployment of 4 per cent, this would correspond to a total unemployment level around 6 per cent and a measured unemployment rate around 4 per cent. Although this level is high by the standards of the post-war boom, it could reasonably be regarded as full employment by the standards of earlier or later periods.

A program for full employment would consist of two main elements. The first is an active labor market policy, centred on a job guarantee. The job guarantee would be available to all long-term unemployed people (at least initially, this could be defined as unemployment for a period of twelve months). The forecasts of Chapman, Junankar and Kapuscinski (1992) suggest that, even under favorable labor market conditions, long-term unemployment will remain above 250 000, and probably above 300 000, into the mid-1990s in the absence of a change in policy.

The job guarantee would be implemented through a combination of direct job creation and wage subsidies to employers taking on long-term unemployed workers. I assume that in each case, employment is guaranteed for one year. These measures could be supplemented by an expansion of training schemes for the unemployed, although here it might not be desirable to target the schemes on the long-term unemployed.

The second main element would be an expansion of employment in publicly financed community services. This would not be targeted directly at the unemployed, but there would be an attempt to design new jobs that would permit a transition into the permanent workforce from direct job creation and training schemes. Although the majority of the new jobs would be in the public sector, the distinction between, say, a teacher in a state school and one in a publicly subsidised private school, is not critical here.

The main areas of expansion in community services would be health, education and public safety. All are currently subject to severe pressure as a result of increasing demands and the expenditure cuts of the last decade. Indeed, much of the 'expansion' proposed here would simply involve preventing cuts in services that would otherwise take place, particularly at the state level. If the program of expanded public employment proposed here were implemented entirely through grants to the states, it would only restore them (in real, per capita terms) to the level prevailing in 1983-84¹.

¹ This comparison is not exact, since some funds which were then part of general grants are now allocated in different ways. Nevertheless, it reinforces the point that the growth in community services proposed here is no more than might have been expected in the absence of the crisis in public funding.

A subsidiary element would be the abolition of payroll tax and its replacement by a higher level of company tax. In the case of public trading enterprises this could be carried further. The net returns objectives for management of these enterprises could be specified on the basis of a 'shadow wage', 10 per cent below actual wages. This would be offset by raising the target rate of return on capital. Savings here would be particularly great because many of these enterprises are in the process of reducing staff numbers through costly redundancies.

The target of an increase in employment by 500 000 might therefore be achievable with the creation of 250 000 new public sector positions and the generation of 250 000 short-term jobs through wage subsidy schemes and job creation/ training programs. There would be some offsetting effect on private demand for labor arising from the tax increases and expenditure savings needed to offset this increased demand. However as argued in Quiggin (1993), this effect could be countered in two ways. First, replacement of payroll tax by company tax will increase private sector demand for labor, possibly generating a 1 per cent increase in total employment. Second, the demand-switching effects of the program imply that the stance of fiscal and monetary policy may be relaxed without a net adverse effect on private sector employment. A variant of the balanced budget multiplier applies in this context. Even if there were crowding out, to the extent of, say, 25 per cent, the employment gains would be substantial.

Budgetary Costs

Employment provided through the public sector could be expected to incur gross costs of around \$35 000/yr/employee, allowing for salaries (at about median weekly earnings), on-costs (assumed at 20 per cent) and some additional equipment expenses (\$5000/yr/employee).

Increased tax receipts (both income and indirect taxes) would recoup about \$7000/yr/employee. In addition, about 50 per cent of the extra jobs would go to previous recipients of DSS allowances (or their spouses). An average saving of \$10 000/yr would arise for each such person, implying a saving of \$5000 per new job created. The budgetary cost would thus be about \$23000/yr per new position created.

Employment generated through short-term job creation schemes and via wage subsidy schemes would have a somewhat lower cost. However, the value of output from these schemes would be lower than from new jobs in the community services sector, From the analysis of Chapman and Stretton, the typical net expenditure on these schemes would be about \$9000 per position created.

On the calculations above, a scheme providing 250 000 places in labor market programs and 250 000 additional jobs in the community services sector would require additional annual net public expenditure of about \$8 bn.

Financing

Since the additional public expenditure proposed here would be a structural increase in outlays it would have to be met either by reductions in other outlays or by increases in taxation. In considering reductions in outlays we are constrained to allow only for savings in non-labor costs (since any savings achieved by reduced employment would require additional employment elsewhere to achieve the desired net gain). Thus savings must be derived from reductions in transfer payments or purchases of goods.

I will follow budgetary convention and classify as reductions in expenditure any offsets to outlays achieved through cost recovery and as increases in taxation any tightening of tax deductions. The following areas appear as potential sources of expenditure savings

Defence Equipment and Facilities: Outlays in this area have increased substantially in real terms over the 1980s, despite the disappearance of our main potential adversary. Current long-term outlays are predicted to run about \$4.5 billion/year. A reduction of \$500 m would be consistent with maintaining the level of defence preparedness of ten years ago. Given the reduction in apparent threats, a short term cut of \$500m/year and a long-term reduction of \$1 bn/year seems feasible. Because a large proportion of defence equipment is imported, much of this reduction would come directly off net imports.

Education: Despite the introduction of the Higher Education Contribution Scheme (HECS), the subsidy to participants in higher education remains large and regressive. It is combined with a limit in the number of available places due to constraints on the funds available for subsidy. A doubling of the current HECS contribution would raise the nominal student contribution to 30 per cent of the cost of higher education (the contingent nature of the charge and the absence of interest make the real cost lower). Assuming an accompanying increase in the number of places, a doubling of the HECS charge could be expected to raise about \$500m/year in the medium term and up to \$1 bn /year in the long-term. In view of the current excess demand for university places, it is unlikely that extra places would go unfilled, even with a lower subsidy.

Industry Assistance: Outlays on industry assistance currently total about \$3.5 bn/year, very little of it in forms that might be expected to promote employment. The largest single example is the diesel fuel rebate scheme, costing over \$1bn/year. Although

part of this rebate is justified on efficiency and equity grounds because it applies to fuel used off-road, and in remote areas, some part of the excise must be regarded as a contribution to general revenue and as an externality charge for the global effects of fossil fuel use. A reduction in the rebate to 20c/l would save about \$350m/year.

Roads: The need for a proper system of cost recovery for the damage imposed by heavy vehicles has long been recognized. Such a cost recovery system could be expected to raise as much as \$1 billion/year.

Social Security: The anomaly by which women become eligible for old age pension at 60 while men become eligible at 65 should be eliminated. If the pension age for women were raised to 65, long-term savings of about \$300 m would be generated. Further tightening of asset and income tests and further restrictions on eligibility for recent migrants for age and other pensions could save between \$200m and \$400m.

This proposal would run counter to ideas of encouraging withdrawal from the labor force through early retirement. However, as argued in Quiggin (1993), there is little evidence that labor force withdrawal has any long-run effect on unemployment.

The measures outlined above would generate medium-term expenditure savings of nearly \$3bn, with the potential to save a further \$1 bn in the long term. This would make a significant contribution to the financing of an employment program. However, an increase in tax revenue, relative to that projected under current policies is required.

The simplest method of financing the maintenance of community services would be to forgo the tax cuts for 1994/95 and 1995/96 included in the August 1992 budget statement. According the estimates in the One Nation statement, the net cost of these cuts is \$6.2b.

However, at least part of this cut must be regarded as a restoration of the increase in income tax rates associated with bracket creep. Because the steepest jumps in marginal tax rates occur at relatively low incomes, bracket creep generally makes the income tax system less progressive. Hence a preferable starting point for analysis would be to replace the proposed tax cuts with effective indexation of the tax scales, thereby compensating for bracket creep.

Several difficulties arise in computing the adjustment for bracket creep. The first is the choice of an appropriate inflation measure. The CPI is probably the best measure since it estimates the change in the cost of living for ordinary households. However, because of the volatility of mortgage interest rates, it is difficult to predict. Hence the underlying rate of inflation, excluding mortgage interest, will be considered here. This permits a reasonably confident estimate that inflation over the period 1993/4–1995/6

will average around 2 per cent per year.

The remaining difficulty is the need to select a starting point. If the current scales are taken as a starting point, only three years of inflation need to be compensated for. On the other hand, it is arguable that the adjustment should be carried back to the last substantial tax cuts in 1990. I will take the middle course of compensating for bracket creep between the *One Nation* statement of February 1991 and the financial year 1995/96. Assuming inflation remains at 2 per cent over this period, the cumulative inflationary impact is 8.2 per cent. This implies that effective indexation would cost around \$2.2b (Estimates derived from 1990-91 Income Tax statistics, Australian Taxation Office 1992).

Relative to the proposed income tax cuts, maintenance of the existing income tax scales in real terms would save about \$3.7b. This amount alone would be sufficient to maintain most of the community services now subject to cutbacks and associated public sector labor shedding at federal state and local levels. However, there is scope for further expansion of revenue without unreasonable increases in tax burdens or efficiency losses.

Increase in the top marginal income tax rate: The dramatic reductions in top marginal tax rates over the 1980s have yielded little apparent benefit. If the top marginal tax rate were raised to 50 cents in the dollar, a revenue gain of over \$1b/yr could be achieved. If a rate of 60 cents in the dollar were reintroduced on incomes above \$55000 it would generate an additional \$2b/yr.

Superannuation reform: Reform of the tax treatment of superannuation is an essential element of a national savings strategy. The current system involves annual subsidies of around \$3.5b/yr, mostly accruing to upper-income earners (Treasury, Tax Expenditure Statement 1992). The most important reform would be a limit on the amount of annual deductions. A limit of \$6000/yr would yield savings in excess of \$600m/yr.

Dependent spouse rebate: The introduction of the Home Carers' Allowance, promised during the recent election campaign indicates that the appropriate focus of assistance to families is on assistance to families raising children. It follows that the dependent spouse rebate should be abolished for individuals with dependent spouses not engaged in raising children.

Other tax expenditures : A number of other tax expenditures could be reduced or eliminated . These include

- the availability of income-splitting to upper income earners;

- the use of companies and trusts as channels for individual income;
- unlimited deductibility of nominal debt payments for business expenses (in practice frequently including private expenditures); and
- unlimited exemption of principal residence from nearly all forms of taxation

It is difficult to obtain an estimate of the potential revenue gains here, but they would be substantial.

Reintroduction of death duties: The abolition of Commonwealth estate and gift duties in 1979, which followed the gradual removal of duties left Australia without any form of taxation on accumulated wealth. The introduction of the capital gains tax improved the neutrality of the system with respect to income from accumulated wealth² but did not address the basic gap in the system.

With current data, it is difficult to estimate the potential revenue from a reintroduction of estate duties, or some other form of taxation on wealth. However, during the 1960s the Commonwealth estate and gift duty system raised around \$80m/yr or about 1.7 per cent of total tax collections. Extrapolation to current levels of nominal GDP and tax collections suggests a potential revenue yield of around \$1.5b/yr.

Although the task of raising an additional \$7.5 billion/ year would involve sacrifices on the part of those in employment, the price would be small compared to the social costs of continuing mass unemployment, and they would be offset by improvements in community services (or, in many cases, preservation of services that would otherwise be lost). The measures discussed above would be sufficient to release net expenditure of more than \$10 bn in the long-term so that only a subset of them would be needed to finance the proposed program.

The impact on the public sector as a whole would be to raise outlays and revenue by around 1 per cent of GDP and to raise public consumption by around 2 per cent of GDP relative to the anticipated trend. This would still leave outlays and revenue below their peak levels and public consumption only marginally above the levels prevailing in the early 1970s.

The proposed cuts in transfer payments and increases in taxes would affect demand, but this would be largely, if not wholly offset by increased demand arising from higher public sector employment. Cuts in defence equipment programs would be

² The progressive equity impact of this measure was largely balanced by the introduction of dividend imputation. Although the combination of dividend imputation and capital gains tax is considerably more efficient than the old system of combined company and income tax, it does not address the loss of equity caused by the removal of estate duties.

particularly desirable, since they fall primarily on imports.

The Australian case

Many of the arguments presented above are applicable to the OECD countries as a group. However, for a number of reasons, Australia is particularly well-placed to benefit from a program of the type proposed here.

First, our present expenditure on active labor market programs is remarkably low compared to that of other OECD countries, suggesting that many of the most favorable opportunities remain unexploited. In the late 1980s, expenditure in active labor market programs made up only about 10 per cent of total expenditure on the unemployed. The ratio was higher in nearly all the of the OECD countries examined by Stretton and Chapman, and, in particular in all of the relatively good performers on unemployment. For Sweden it was 90 per cent, for the United States nearly 50 and for Japan about 30. The only countries with a stance more passive than that of Australia (Belgium and the Netherlands) have fairly high absolute expenditures on active labor market programs, but these are outweighed by very generous benefit systems and chronically high rates of unemployment.

Second, Australia has a very low current inflation rates, and low inflationary expectations. The structural changes of the 1980s reduced the likelihood of nominal wage inflation and the experience of the recession has almost certainly reinforced these changes. Provided that policies are targeted at the long-term unemployed, reductions in unemployment to levels below 6 per cent seem unlikely to engender a resurgence of inflation.

Third, and most importantly, the fact that Australia has a very tightly targeted welfare system means that outlays and revenues constitute a relatively small proportion of GDP. The efficiency obstacles to an expansion in public, and publicly financed, consumption are correspondingly smaller.

The political calculus is somewhat more complex. Historically, the universalist welfare systems of Northern Europe have generated strong popular support which has permitted them to achieve a somewhat greater degree of egalitarian redistribution despite their lack of targeting. This reflected the fact that, in targeted systems such as that of Australia, many voters have seen themselves as taxpayers, but not as beneficiaries of the welfare state.

However, I believe that political support for a tax-financed expansion of community

services and an assault on unemployment could now be forthcoming. In particular, the combination of the recession and structural changes in the economy have weakened the belief that unemployment is 'somebody else's problem.' Formerly secure jobs such as those of public servants and bank employees are now subject to the vagaries of the economy in much the same way as the building industry. The evidence of unmet needs for community services, especially with respect to health and education, is also widespread.

Concluding Comments

Unemployment is the biggest challenge facing the Australian community today. Our response thus far has been inadequate. The current policy proposals of the major political parties will do little to change this.

The program proposed here is based on an analysis of unemployment as a failure to coordinate social needs and unemployed resources. It involves some sacrifice on the part of those in secure employment, arising from a small increase in tax and a redirection of public expenditure. However, for the majority of workers, the threat of unemployment is now real enough that such a trade-off may be politically acceptable. For many of those in secure employment, the possibility of social breakdown arising from sustained mass unemployment is now a more important concern than the top marginal tax rate. The fine details of the financing measures proposed here are not central to the argument. They are provided merely as an illustration of the kinds of measures that would be required to finance a large-scale program aimed at raising employment and reducing unemployment.

Even if the analysis of the unemployment problem proposed here is not accepted, the need for an adequate response remains. This is unlikely to happen while the electorate is faced with a choice between policy packages aimed at delivering the maximum feasible tax cut to swinging voters.

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