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THE SLIDE INTO MASS UNEMPLOYMENT:
LABOUR MARKET THEORIES, FACTS AND POLICIES

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The Academy of the Social Sciences in Australia
Annual Lecture 1982
Discussion Paper No. 76
September 1983

ISBN: 0 948838 77 2
ISBN: 0735-430X
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THE SLIDE INTO MASS UNEMPLOYMENT: LABOUR MARKET THEORIES, FACTS AND POLICIES

by

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There can be little doubt that we are watching a slide into mass unemployment both in Australia and overseas. Within the countries of the OECD, on average, unemployment increased from 3.3 per cent to 5.2 per cent between 1974 and 1975, stabilised for five years at the highest levels since before World War II, and then between 1979 and 1982 rose again from an average of 5.1 per cent to about 10 per cent. A common expectation at present is that if 10 per cent is the peak of the current recession then perhaps unemployment will stabilise at 9 or 10 per cent during the next economic upswing before increasing again during the next recession. In any event it is fair to say that almost all forecasters can see no significant reduction in unemployment during the decade of the eighties.

The very large increases in unemployment over the last eight or nine years have also been associated with extremely high rates of nominal wage increases. In some years real wages\(^1\) have also increased quickly. In Australia, for example, during 1981-82 when unemployment was for that time only marginally below the highest level of unemployment for forty years, nominal wages increased by about 16 per cent. Real wages increased by about 5 per cent. In both instances these magnitudes were well above the average of the fifties, sixties and seventies.

The co-existence of a rapid increase in the price of labour in an environment of considerable excess supply of labour is bringing the workings of the labour market and the determination of wages to the forefront of academic enquiry and policy interest. In tonight's lecture I will begin in Part I by sketching out what has been, until recently, the prevailing theory as to the relationship between excess labour supply and real and nominal wage increases. This theory is that excess labour supply, measured by unemployment, should lead to significant reductions in the rate of growth of real and nominal wages. To a significant extent this prevailing view has been, in one form or another, a cornerstone of much of macro-economic policy during the seventies. A
macro-economic policy which, to date, has quite clearly failed when measured against what it was expected to achieve.

The emphasis in tonight's lecture will be upon the relationships which flow from the demand and supply in the labour market to wage changes. The other important, and equally controversial, relationships which flow in the opposite direction from wage changes to the demand and supply of labour are not considered as there is not sufficient time.

In Part II the focus is shifted to an investigation of the causes of the recent acceleration of nominal and real wage increases in Australia. An attempt is made to show how our recent history supports and encourages the efforts that are being made to develop different macro models to explain how labour markets work. These models place more emphasis on social and institutional factors and highlight the differences between markets for labour and markets for commodities.

In Part III we look at some of the policy options that are being canvassed in response to the inability of conventional macro policies to produce both full employment and low rates of inflation. The policy options considered are all aimed to bring about institutional changes in the Australian labour market. Other policies which may have a bearing upon wage inflation — government deficits, the rate of growth of the money supply, exchange rate management and so on — are not considered.

PART I: The Phillips Curve and its Collapse

There has always been a long-standing tension in labour economics between those who devote their life to the study of labour markets and tend to emphasise the role of institutions in the determination of wages, and those whose primary interest often lies elsewhere in economics, who tend to emphasise that at the end of the day the labour market is much like any other market — excess demand for labour causes the wage to rise in the same way that an excess demand for eggs causes the price of eggs to increase.

After 1958 it became clear to most economists which side was nearest the truth. In that year Professor Phillips — a New Zealand engineer who was a Professor of Economics at the London School of Economics and later held a Chair in a department of economics at the Australian National University — published an econometric analysis of wage changes in the UK between 1861 and 1957 [Phillips (1958)]. This seminal work was interpreted to have established that for all practical purposes, and at the economy level in the UK, the rate of growth of wages could be explained by the level of unemployment which was a measure of the state of excess supply in the labour market. When

[Diagram: The Phillips Curve]

unemployment was high the rate of increase of wages was low or even negative. When unemployment was low wages increased. This statistical regularity between wage changes and unemployment can be presented as in Figure 1a and became known as the Phillips curve.
The Phillips curve appeared to present governments with a clearly defined range of policy choices. Governments, by the adoption of appropriate macro policies, could choose to move to the left along the Phillips curve and bring about less unemployment and more wage inflation or they could move to the right and create more unemployment and less wage inflation. Managing the economy appeared to be a relatively simple task. After the politicians chose the appropriate wage inflation-unemployment combination along the Phillips curve, managing the economy became the preserve of technocrats.

Professor Phillips did not attempt to explain the position of the curve — just that it was well defined. The position presumably depended upon institutional factors so that those who studied institutions did not lose all their relevance. Institutional changes could make the unemployment-wage inflation trade-off better or worse. Despite this important role, however, the behaviour of the profession clearly showed that most economists believed that the analysis of institutions in the labour market should be relegated to a minor role.²

Within a very short time of the discovery of the Phillips curve and the finding that it had been stable for almost 100 years the curve began to shift outwards. The profession adapted to this phenomenon fairly easily by adding another term to the equation. Originally the Phillips curve could be written as

\[ w = a - bu \]

where \( w \) is the rate of growth of nominal wages and \( u \) is the unemployment rate. The terms \( a \) and \( b \) are constant if the curve is stable. The new variable added was \( p^c \), expectations as to price increases so that (1) became

\[ w = a - bu + cp^c \]

where \( c \) is a constant and \( p^c \) is usually measured as a weighted sum of past price increases.

The justification for including \( p^c \) — apart from mere pragmatism — was that if the labour market was to be like any other market then the long-run market clearing price would need to be measured relative to other prices. Employers and employees would be interested in real wages — the wage that is paid relative to the price of commodities — rather than nominal wages. Including \( p^c \) in the Phillips curve allowed a place for real wages.³

This change to the Phillips relation did not remove unemployment from the key role. Price expectations, \( p^c \), would depend upon past price changes which, in turn, would depend upon past wage increases. Past wage increases depended upon past unemployment. The link between wage increases and the excess supply of labour as measured by unemployment just became a little more complicated and the process whereby an increase in unemployment reduced wage increases a little more drawn out through time.

With this very brief theoretical background behind us we can look at some Australian data. Figure 1b plots the rate of increase of nominal wages against the unemployment rate for each year since 1967. It is obvious that the Phillips curve as hypothesised in equation (1) does not exist. Nominal wage increases cannot be explained by the rate of unemployment alone. If a trade-off between wage increases and unemployment existed then it has shifted to the right and become worse. Relative to the late sixties, and indeed the whole post World War II period, Australia is now experiencing both higher rates of inflation and higher rates of unemployment.

Figure 1b: Unemployment and Annual Change of Australian Wages, 1967 - 1981
It does appear to be true, however, that initially an increase in unemployment is associated with some reduction in the rate of increase of money wages. The moderation of the wage increases during the 1971-72 and the 1973-78 period appear to be evidence of this. But when the labour market improves and unemployment begins to fall a new relationship appears to emerge with higher rates of wage inflation at each unemployment level. The period since 1979 is very marked in this respect. Unemployment, which is still at record levels for the post-World War II period, has fallen slightly but the rate of increase of money wages during 1981 has been exceeded only in three of the last fifteen years. This is the key puzzle to be solved. Why is the rate of nominal wage increase so insensitive to unemployment? What factors led to the acceleration of nominal wage inflation when unemployment was so high?

PART II: The Acceleration of Wage Inflation During 1979-82

We consider three hypotheses that may explain the sudden acceleration of wage increases during a period when unemployment averaged 6 per cent.

The first hypothesis relates to the price expectation term \( p_t \) of the augmented Phillips curve of equation (2). Perhaps there were factors unrelated to the past rate of increases of prices which led employers and employees to believe that the rate of price inflation was suddenly about to accelerate. Under these circumstances unions will seek in advance, and be successful at obtaining, wage increases that are larger than otherwise. We refer to this hypothesis as an expectational explanation of the increase in the rate of wage inflation.

The second hypothesis is that there was excess demand for labour and the labour market operated just like any other market, except that unemployment as a measure of the gap between the demand and supply of labour was no longer appropriate. Although unemployment was high there were in fact severe shortages. We refer to this hypothesis as a structural explanation.

The third hypothesis is that wage increases were never causally related to the level of unemployment per se. Perhaps wage increases are primarily related to factors other than the level of unemployment and these factors are no longer strongly correlated with the level of unemployment. For reasons that will become clear later we refer to this hypothesis as an implicit contract explanation.

Before we consider each of these hypotheses we should note that there will probably be elements of each of these explanations underlying the rate of wage increases and these elements may interact in a wide variety of ways. In this lecture, however, an attempt is made to keep the three hypotheses as distinct as possible and to get some rough feel as to their relative importance.

1. The Expectations Hypothesis

There are some facts that are consistent with this explanation of the sudden acceleration of wage inflation. During 1978-79 and 1979-80 there were a number of influences, originating overseas, that put upward pressure on the rate of inflation. Food and petrol prices increased considerably during this period and the average price of imports rose by 17 per cent during 1979-80 (i.e. about 10 percentage points more than the increase in the consumer price index). These factors suggest that if real wages are to be maintained then money wages should increase a little faster than in the past. Under these circumstances it is to be expected that the Phillips curve will move to the right.

The best way to test this hypothesis is to examine a direct measure of price expectations. Such a measure can be constructed from a quarterly survey undertaken for the Institute of Applied Economic and Social Research of the University of Melbourne. In this survey about 2,000 respondents are asked whether they expect prices to rise, fall or stay the same over the next twelve months. A further question asks those respondents who expect a price change to express a percentage estimate.

The arithmetic mean of this series of expected inflation is given in Figure 2 as the unbroken line. The broken line is the actual rate of inflation. The expected and actual rate of inflation are fairly well correlated although, since 1977, the expected rate of inflation has been continually above the actual rate of inflation. There are a number of general comments that can be made as to the behaviour of this series of price expectations.

First, the relationship between the actual and the expected series suggests that expectations as to future price changes have been slower to adjust downwards than actual prices. Hence the recessions of 1975-76 and 1977-78 led to a downward movement in expectations that appears to be less than the change in the rate of inflation.

Second, the upward movement in expectations that is observed in 1979-82 pre-dated the increase in actual inflation and is consistent with two explanations. One explanation is that which was suggested earlier. Expectations moved upwards in response to external stimuli such as the increase in the price of oil or the price of imports. The other is that once the initial shock of the 1977-78 recession passed, expectations as to the rate of inflation returned to something like their previous level, i.e. the recession did not change people’s
long run expectations that inflation rates similar to those of 1974 to 1977 would prevail in the future. It is not possible to distinguish between these two hypotheses on the basis of Figure 2 alone.

Figure 2: Annual Inflation Rates, 1973 - 1982

![Graph showing annual inflation rates from 1973 to 1982.]

My hunch, however, is that the second explanation is nearer the mark. After observing the very rapid inflation during 1974-75 and the very slow wind down during the recession — despite the fact that unemployment was high by historical standards — the community has not adjusted its price expectations downwards. It held the belief that the restoration of faster economic growth rates would be accompanied by higher rates of inflation. If this hunch is right then during the period 1979-82 any attempt to maintain real wages would lead to a real wage increase as wage earners and employees looking ahead may well have operated on the basis of an expected rate of inflation that was above the actual rate of inflation.

In many respects the process whereby expectations as to future wage and price increases are generated is probably at the heart of the stagflation problem, and I am sorry that in tonight’s lectures I am unable to take the discussion further. We will, however, return briefly to the topic later.

2. The Structuralist Hypothesis

It is sometimes argued that 1980-81 was a period of excess demand for labour, either in aggregate or in that there were pockets of extreme shortages which were generating wage increases. Given the nature of Australian wage fixing procedures, these increases spread to other sections of the labour force. The origins of the wage increases during this period, it is suggested, lie in the excess demand for labour and the unemployment rate is an unreliable guide to labour market conditions.

These views can be found in a number of publications. The report of the Department of Labour Advisory Council in 1980 argued that there was an unusual degree of skilled labour shortages which would be accentuated during the following year. Also, in Statement No. 2 of the Budget Papers of August 1980 the Treasury remarks.

"Skilled labour is already in short supply in many areas; and (as a result) . . . there will be pressures for higher wages to attract labour to expanding areas. Under Australia’s centralized wage determination process, there is a very real danger that such wage increases, however desirable they may be in themselves, could flow into a general lift in wages" (p.59).

Support for these views might also be drawn from the composition of the unemployment pool. Unemployment tends to be heavily concentrated upon the unskilled who could not fill gaps in the labour market for skilled labour. During 1980-81, for example, fifty per cent of the unemployed were under 24 years of age and therefore possessed few skills and little experience. Twenty per cent of the unemployed had been without work for at least 12 months, suggesting that they possessed skill levels that were not in demand, and finally none of the unemployed are drawn from among the lowly-educated of the labour force. A large unemployment pool therefore does not guarantee that there will not be shortages of skilled labour.

However, my own view is that there were not unusual shortages of labour during this period and that while 6 per cent unemployment may not represent exactly three times more excess supply of labour than 2 per cent, it nevertheless represents an excess supply of labour greater than at any other time since before World War II.
There are a number of surveys which can help us to determine whether there was a structural problem in the labour market and whether there were severe shortages of labour in particular areas. The Bank of New South Wales and the Confederation of Australian Industry conduct a survey of manufacturers which includes the question, "What single factor, if any, is most limiting your ability to increase production?"

In Figure 3 we plot the percentage of respondents who replied that labour was the most limiting factor acting as a constraint on production. It is evident from Figure 3 that there have been three periods of acute labour shortages in Australia since 1960: the years 1965, 1970 and 1973. There is no evidence of a comparable shortage during the period 1979 to 1982 although the proportion of respondents replying that labour was a constraint increased from about 6 to 12 per cent. However, 12 per cent of respondents is still a long way short of the 35 to 45 per cent of respondents who gave this answer during the three years of acute labour shortages.

Since the debate as to skill shortages was focused to a significant degree upon the minerals and metal manufacturing areas, the data have been disaggregated to include only those establishments involved in basic and fabricated metal products. These data are plotted in Figure 4, where they are presented in a slightly different form from Figure 3. The broken line represents the per cent of respondents who reported capacity shortages as the constraining factor. The unbroken line is the sum of the per cent that reported capacity shortages and the per cent that reported labour shortages. The proportion of respondents who reported labour as a constraint is measured by the vertical gap between the two lines.

The same story is evident as before, except there is evidence of capacity constraints similar to that of 1965. Any shortage of labour, representing a constraint on production, is much smaller than that during the previous three boom periods. There does not seem to be any significant evidence in these data to suggest that we should discard the unemployment rate as a measure of excess supply in the labour market and to argue that despite the level of unemployment there was excess demand during 1979-82.
In fact there is considerable evidence from other sources to suggest the opposite. The experience of the seventies suggests the unemployment rate is likely to underestimate the quantity of labour that is available to be utilised. There seems to be a large number of people who are not counted as unemployed who are prepared to enter the labour force if job opportunities present themselves. Most of the increase in the growth of employment of 1979-82, for example, was met by an increase in labour force participation rather than by reductions in unemployment. A full analysis of the way in which the level of unemployment understates the size of the pool of available labour can be found in Stricker and Shechter (1981).

3. Implicit Contract Theories

The idea that a significant part of wage increases is not related to excess demand or supply in the labour market is not a new idea. Indeed before the advent of the Phillips curve it was probably the most common view.

This view of the labour market has been presented in a number of guises. It is sometimes called a real wage maintenance theory, or a trade union pushfulness theory of wage changes. We will sketch out the latest form of this idea, the Implicit Contract Theory.

The basic arguments have been developed by Arthur Okun (1981) and a number of others [Solow (1980), Hall (1981), Hicks (1973)]. In Australia similar ideas can be found in Gregory (1982), Bandy and Richardson (1982) and Isaac (1982).

The key propositions are as follows:

First, workers tend to stay in their current job for a long time. For example, Gregory (1982) has estimated that for those employed in Australia at August 1976 the average expected completed job tenure in the same geographical location with the same employer is about 13 years. Throughout the seventies about twenty-five per cent of those employed at any particular time will complete a job tenure of more than 20 years.

Second, this long job tenure is in the interests of both the employer and the employee. The employer can reduce the risk of unemployment by not changing jobs since unemployment is heavily concentrated upon new entrants to the labour market and those whose previous job was of short tenure. For example, those whose previous job had lasted for more than five years typically account for only about 6 to 10 per cent of the unemployed. A stable workforce reduces hiring and training costs. The workers build up firm specific skills and experience that facilitate the production process.

Third, as a result of these mutual gains from long tenure it is suggested that a network of implicit agreements is developed between the firm and its workforce. The implicit agreements or contracts — which Okun has called "invisible handshakes" — are dominated by long-term considerations and may explain why so much of the behaviour in the labour market is not what might be expected on the basis of short-run economic considerations alone. The long-job tenure and implicit agreements may explain the importance of social customs and the roles of equity and fairness in the determination of labour relations. [See Isaac (1982).]

Some of the elements of these implicit contracts are the following. The firm will

(i) deliver a reasonable rate of growth of real wages over the long term;
(ii) not attempt to reduce real wages during a recession or hire new workers under conditions which are less advantageous than those currently enjoyed; and
(iii) attempt to uphold labour during the slump and allow profits to absorb as much of the short-run economic fluctuations as possible. This behaviour generates the familiar pro-cyclical variation of labour productivity. When output falls, labour productivity usually falls because firms are reluctant to fire their experienced workforce.

For their part workers undertake to:

(i) moderate real wage demand during the profit slump; and
(ii) vary their work effort in the short-run to help the firm. The variability of average hours worked and labour productivity over the economic cycle suggests that most adjustments of labour input occur on the job rather than between employment and unemployment [see Hall (1981)].

As a result of these features of the implicit contracts Hall remarks:

"The greatest recent progress in understanding the labor market comes from the study of long-term employment arrangements. There is no point any longer in pretending that the labor market is an auction market cleared by the observed average hourly wage. In an extreme case, wages are just instalment payments on a long-term debt and reveal essentially nothing about the current state of the market". [Hall (1981, p.120).]

Fourth, the unemployed are not a party to the implicit agreements. They have no stake in the long-run future of the firm and, in turn, the firm has no
stake in developing a long-term relationship with them. The process of determining wage increases should be dominated by the relationship between the firm and its long-term labour force. Wage increases should be largely unrelated to the level of unemployment. However, when unemployment increases quickly, the rate of growth of wages will be moderated, not directly as a result of the increase in unemployment, but because of the same slowdown of economic growth that generated the increase in unemployment also reduced the profitability of the firm. A part of the implicit agreement is that under these conditions wage increases will be moderated.

This view of the labour market suggests a very segmented market and a high degree of separation between the employed and unemployed. As a result, higher but steady levels of unemployment will not be a significant factor restraining the rate of growth of real wages. This may explain why real wages continued to increase during the great depression of the 1930s [see Bostock (1981)]. It may also explain why, in Australia during 1981 and 1982, nominal and real wages were increased quickly when unemployment was six per cent.

The question therefore becomes to what extent had the pre-conditions for the normal rate of wage increases been re-established during the 1980-82 period so that workers could expect, and firms would deliver, the rate of wage increases implicitly promised. We present two pieces of evidence to suggest that these pre-conditions had been re-established. First, Figure 5 presents a measure of factory overtime. These data indicate the degree of labour utilisation within the firm. It is clear that by 1979 factory overtime had substantially recovered from the low levels that accompanied the 1973 economic recession and was approaching the average of the pre-1974 levels. A similar picture emerges from the CAI-Bank of New South Wales survey. By 1980 about 45 per cent of factories were working at full capacity which is about the average for the 1950-74 period. These facts suggest that the pre-conditions were being established to reactivate the normal rate of real wage increases.

Second, Figure 6 plots the rate of growth of employment of the male labour over the past decade and a half. During 1980-81, and for a period of about 18 months, the rate of growth of employment of male labour returned to the norm of the early seventies. Under these conditions, it is likely that the activity levels within the firm, as perceived by the employed labour force, would approximate normal activity levels and therefore warrant a return to normal levels of wage increases.

![Factory Overtime](image-url)

Figure 5: Factory Overtime

![Employment and Labour Force](image-url)

Figure 6: Employment and Labour Force: All Males

Labour Force

Four Quarter Percentage Change

Source: Bostock (1981a) and CAI (1981).
There seems, however, to be two unresolved problems with this analysis. First, why was there such a large increase in nominal wages? Why were the real wage increases not restored by further reductions in the rate of price inflation relative to wage increases. The answer here seems to be that the expectations of inflation above the actual rate of price increases had yet to be eradicated from people's minds (see Figure 2). Consequently, the wage bargains in nominal terms involved large wage increases.

Second, why were the increases in real wages that occurred so large? The answer as above is probably the result of wrong expectations as to the rate at which prices would increase. Both sides of the labour market probably expected a higher rate of price inflation than was observed.

PART III: Some Policy Proposals

The first and obvious point that emerges from this discussion is that a Phillips curve approach to controlling wage inflation has not been successful. There seems to have been a ratchet effect operating in the economy. An increase in unemployment reduces wage inflation a little but when the economy expands again, even at a rate not sufficient to reduce unemployment significantly, wage inflation takes off again. At the end of the day the economy ends up with much the same wage inflation but much higher unemployment.

In this respect the experience of the 1980-82 period is very sobering. It would have taken about 12 years of continuous employment growth at the rate observed in this period to reduce unemployment from 6 to 2 per cent. Such a steady and continuous rate of employment growth seems impossible. To grow sufficiently fast to reduce unemployment would appear to lead inexorably to wage inflation. Now that unemployment is 10 per cent the task seems even more daunting. It would now take 24 years to restore full employment.

The lesson of the past decade that should be applied to the current recession is that policies should be adopted quickly to stop unemployment increasing further. Most of the gains that higher unemployment can deliver in reducing wage inflation have already been delivered by the increase in unemployment from 6 to 10 per cent. It is unlikely that more deterioration in the labour market will reduce wage inflation much further. But each percentage point increase in unemployment will make the restoration of lower rates of unemployment that much more difficult.

The second point that emerges from the discussion is that if unemployment is to fall without being accompanied by faster rates of wage inflation then radical changes are needed in the labour market. There needs to be either significant changes in attitudes of the parties who are involved in the determination of wages or some institutional changes which will allow faster employment growth and a lower rate of nominal wage increases. We now turn to a discussion of three possible institutional changes.

Radical Suggestions

(i) The Treasury View

One radical proposal for change has been made by the Australian Treasury. The proposal has two parts. The first part is to abandon the Conciliation and Arbitration Commission and allow the labour market to pursue unfettered collective bargaining. The second part is to change the structure of collective bargaining to a company by company or an establishment by establishment basis and to move away from unions organised along craft lines.

In Statement No. 2 of the Budget Papers for 1982-83 the Australian Treasury moved to the position adopted in this paper that high unemployment would be insufficient to reduce inflation.8 They say:

"It would be consistent with experience in several major countries overseas, under a variety of wage determination systems, if, beyond a point, the weakening in activity brought greater restraint in wage claims. However, that alone would not be enough; it is more likely merely to be a recipe for stagflation...."

Over the longer term (and subject to appropriate policy settings), the change to more decentralised wage determination arrangements should work to make wage levels more responsive to economic conditions and capacity to pay at the industry level — and should thus promote higher employment and lower unemployment. Whereas the centralised wage indexation system tended to maintain real wage levels (for those still fortunate enough to be in jobs) in the face of weak activity and high levels of unemployment, the industry bargaining approach should allow greater scope for wage settlements to respond to the need to restore industry profitability and, hence, maintain employment levels.

Of course, even wage bargaining on an industry basis will not necessarily lead to outcomes which are appropriate to every firm within that industry. The bargaining in the metal trades industry in late 1981, for example, was seen at the time as representing a considerable advance — by way of greater decentralisation — upon the processes of preceding years. With the benefit of hindsight such a bargaining process can be seen to be still
far too centralised (in this case, in the metal trades area as a whole) to be able to take appropriate account of all the units involved" (p.52).

It is not at all clear that the Treasury proposals, if implemented, would provide for a better wage determination process, or a system that would deliver lower nominal wage increases. It is also not clear that such a system is possible given our history.

Consider first the proposal to implement collective bargaining. To a significant extent Australia operated a collective bargaining system after the abandonment of indexation in July 1981. The Metal Trades Agreement of December 1981 was the outcome of that collective bargaining system. That agreement resulted in a nominal wage increase of between 20 and 30 per cent for a 12-month period at a time when the most commonly accepted forecast of price inflation was about 12 per cent. The real wage increase implied in the agreement therefore was somewhere between 8 and 18 per cent. Even with the benefit of hindsight it seems difficult to understand why both sides accepted the agreement. There was a reasonably high incidence of strikes in the industry, but nothing exceptional relative to the past, and the data of Figure 4 does not suggest any labour tightness in the industry. The collective bargaining in this instance did not deliver a more reasonable rate of nominal and real wage increases than would have been expected from a centralised system. Indeed, it is conceivable that a centralised system may have resulted in a lower wage settlement.

The Treasury defence of collective bargaining, after such a bad experience as the Metal Trades Agreement, is that the transition period could be expected to be difficult and both parties need time to learn. The difficulty with this defence is that both parties were not doing anything very different from what was required under the previously more centralised system. The same unions and employer associations were involved. The same process of negotiation seemed to be involved.

The second line of the Treasury defence of collective bargaining, and of its rejection of the outcome of the Metal Trades Agreement as evidence of the failure of such bargaining, is to argue that the negotiating units in Australia are too large. They advocate that negotiations should be more decentralised and take place on a firm by firm basis. This would bring the "forces of responsibility for bargaining outcomes closer to the workforce and to the fortunes of the individual firm involved and its employees" (p.53).

This is an extremely radical proposal because it involves not only the abandonment of the Conciliation and Arbitration Commission but the break-up of Australian unions from a craft structure to a firm or establishment basis. All large unions therefore would be split into perhaps hundreds of small unions. There are, in fact, 10,000 enterprises in manufacturing, mining and construction alone. It doesn't seem possible that the Trade Union movement, or the Australian public, could agree to the abolition of all unions that extend their membership beyond the firm or enterprise. Such a proposal would be seen to be an attack on the very raison d'être of unions which is to change the balance of power between employer and employee by being able to bring pressure from outside the firm.

Finally, the Treasury appears to be advocating that Australian wage determination should become more like the system that operates in the UK. The history of wage settlements there, however, does not suggest that a great deal is to be gained by moving in that direction.

It could be, however, that the major purpose of the Treasury proposal is to weaken the unions and to shift the balance of power towards the employer. In this instance the more relevant model may not be the UK but the US where union coverage of the workforce is lower. If the wage response to unemployment in the US is much more favourable over the next few years there will be some pressure to move in this direction.

(ii) Incomes Policies

Many writers have advocated that the evolution of wage determination processes should proceed in the opposite direction to that advocated by the Treasury. These writers advocate a more centralised wage system and the operation of a prices and incomes policy. Many of the arguments in favour of such a system are rehearsed by Dr Izaac in the 1982 Shaw Memorial Lecture and no attempt will be made to discuss them in a thorough manner tonight.

There are a number of comments, however, that should be made on the operation of a prices and incomes policy.

First, a prices and incomes policy alone will not solve our inflation and unemployment problem. This proposition is recognised by all parties to the debate as to the most desirable wage-fixing procedures. A prices and incomes policy needs to be accompanied by a sound macro-economic strategy that avoids excess demand for labour.

Second, a prices and incomes policy should not be directed towards the goal of income redistribution. This goal should be met by other policy instruments. Attempts to use incomes policies to change the distribution of income place too much political pressure upon incomes policies and they invariably break down.
Third, in other countries, and in earlier times, prices and incomes policies have sometimes succeeded and sometimes failed. It doesn’t follow, however, that because of the low success rate incomes policies should be abandoned. As the economic situation deteriorates not only does the case for alternative policy instruments become stronger but the likelihood of some success increases as the deteriorating economic situation makes some contribution towards bringing home to the parties the unacceptable outcomes flowing from the maintenance of the status quo.

Fourth, prices and incomes policies are a new policy instrument. There is considerable scope for learning how to increase the chances of success. This learning can only occur by the application of the policies. It appears inevitable that we must go down this road to see where it leads.

(iii) Inflation Tax Policies

A number of economists have advocated an inflation tax. There are a variety of such proposals, see Wallich and Weintrob (1971), Leiner (1978), and in Australia, Withers (1982). The tax proposal that I would like to discuss tonight is perhaps the simplest and most likely to succeed. It is discussed more fully in R. Layard (1981) and R. Jackman and R. Layard (1982).

The basic idea is to allow the market to determine wages but to impose a tax on wage increases. It is argued that such a tax will moderate wage increases by softening employer resistance to wage claims. The cost to an employer of a wage settlement will be the wage increase that is agreed upon plus the tax that is paid on that increase. The tax should also moderate wage claims by unions because the tax quite clearly reduces the ability of the employer to pay wages. If unions believe that employment depends on wage costs they will also moderate their claims since the tax results in an increase in the employment cost of any given wage rise.

The system would work as follows. Each budget session the government announces an hourly wage increase norm for the next 12 months, say 8 per cent. Every firm will be allowed to increase its average hourly wage by this norm without incurring a tax penalty. If a firm increases its hourly wage bill by 20 per cent, then it will be subject to a tax obligation equal to the tax rate times 12 per cent of the wage bill. The 12 per cent is calculated as the actual wage increase 20 per cent minus the norm 8 per cent. If the firm increases its rate of hourly wages by less than the norm then it receives a tax rebate.

The administrative procedures and requirements are relatively straightforward, as can be seen by comparing the scheme to the payroll tax system. The differences between the payroll tax and this proposal are:

(a) To assess payroll or company income tax the Taxation Commissioner needs to know the wage bill of companies. The inflation tax is levied on the increase in wages. Therefore two years data as to the wage bill are required. This is a relatively straightforward requirement. The inflation tax is not a tax on high or over-award wages; it is a tax on the change in wages.

(b) The only extra piece of data needed by the Tax Commissioner that is not already reported to him is the average hours worked per person. These data are readily available from the pay sheets which form the heart of the payroll tax. There seems to be no special administrative difficulty here and relative to other tax proposals such as value-added taxes or capital gains taxes the administration of the tax appears to be straightforward.

To keep the administration simple, all increases in hourly wages above the norm would be subject to the tax. There would be no exemptions as to the source of the increase. An increase in the average hourly wage bill due to an increase in overtime hours worked would be treated in the same way as an increase due to a wage settlement.

There are a range of worries that are often expressed about inflation taxes. I will briefly state some of these concerns and offer quick answers.

The first, and most common objection, is that firms which upgrade the skill level of their labour force will be taxed on the hourly wage increase when in fact they may not have increased the wage for any skill category and therefore not contributed to wage inflation. Such an effect of the tax is obviously undesirable and unjust.

The inflation tax could be adjusted to allow for changes in the quality of labour but such adjustments are administratively difficult, if not impossible, and open the way for tax evasion and avoidance. I would suggest that no attempt be made to meet this problem. All taxes involve undesirable side effects similar to this. Income taxes distort work/leisure choices, they fall on some sources of income but not on others, and they encourage under-the-counter cash payments to reduce tax liability. Nevertheless we live with an income tax, judging the advantages to be sufficient to offset these disadvantages. The answer to the first objection then is that the point is valid but not believed to be particularly important in practice.

A second objection is that the tax will discourage the efficient allocation of labour. If the most productive firms attract labour by increasing wages above the average then the tax will interfere with this process and thereby
contribute to the inefficient allocation of labour. The answer again is that the objection is valid but that it is probably of little quantitative significance. There is considerable evidence that most labour is allocated across firms by variations in job opportunities rather than by variation in wages and in any event the tax is not a tax on high wages but a tax on firms attempting to change their position in the wage hierarchy. The relatively minor role played by changes in wage differentials across firms and industries is documented in Blandy and Richardson (1982).

A third, and to my mind the only serious objection, is that if all firms pay the same rate of tax and pass it on then the inflation tax is unlikely to significantly affect inflation. If every firm agrees to wage increases believing that all firms will be similarly affected then prices will increase to cover some fraction of the tax. Under these circumstances the tax is likely to be ineffective and to magnify the inflation rate. To cope with this problem it is necessary to introduce as much variability as possible in the tax burden across firms. It is important therefore that the norm should not be too much lower than the actual wage increase for the economy as a whole and that there should be significant tax credits for those who grant wage increases below the norm.

Finally, because the tax is levied on, and designed to reduce, the rate of increase of wages, the labour movement may believe that it is designed to reduce real wages and therefore oppose the tax. This is certainly not the intention behind the advocacy of the tax nor should it be the outcome. What is being proposed is a tax on the gap between the nominal wage increase and the nominal wage increase norm. It is not being proposed that there be a tax on real wages.

There are only one or two more points that should be mentioned. What should be done about pay increases in the public sector? Perhaps the role should be that the public sector is paid the wage norm increase plus a catch up which is equal to the difference between last year’s private sector pay growth and last year’s norm. In this way distortions can be avoided between the private and public sectors.

The tax has a number of advantages over the incomes policy proposals. It is designed to permanently reduce inflation and once in place can remain on a permanent basis. In this way the political pressures that seem inevitably to arise to break incomes policies can be avoided as can the wage/price scramble that usually occurs after the incomes policy is removed. In addition incomes policies inevitably seem to lead to special exceptions which eventually act to destroy the policy. I would envisage, with respect to the tax, that no exemption be given.

The reason why incomes policies break down is that they politicise an area of life which the community at large appears to want to leave to a decentralised decision-making mechanism. The tax-based incomes policies do not involve regulation or politicisation. It leaves all the individual agents with all the decision-making powers that they had before.

Finally, the tax-based incomes policy will not get involved in income distribution questions which inevitably plague incomes policies. No decisions have to be made as to whether high paid workers will get increases equal to or less than low-paid workers. Income distribution can be left to other policy instruments.

PART IV: Concluding Remarks

It took decades of very high unemployment and the depths of the Great Depression before the economics profession responded by the development of Keynesian economics and governments introduced the radical change of adopting full employment as an objective.

The problem we face today in achieving low unemployment and low inflation must seem as difficult to us as the problem of achieving full employment must have seemed in pre-Keynesian days. We are still struggling for an answer. The first attempt at an answer, monetarism, seems to have failed. Perhaps, as is suggested by the choice of subject matter for tonight’s lecture, the second attempt should be made by the introduction of radical changes in institutions in the labour market.13

Notes

1. Nominal wages are the actual wages that are paid. Real wages are nominal wages deflated by the price level of commodities.

2. Over the last few years this dichotomy has become less clear as more economists are turning towards the economic analysis of institutions. There is also a growing awareness that social factors are important in labour markets. See Okun (1981), Sobot (1980) and Ackelof (1979).

3. Some institutionalists with modern econometric techniques attempted to fight back but they met with limited success at the time. Some of their ideas, however, are now coming into vogue. See Hines (1969).
(1) Professor Phillips also allowed the Phillips curve to shift. He included the price of imports into the UK as an extra variable but its contribution was relatively minor. For most of the period that he was concerned with he believed that nominal wage changes were sufficiently close to real wage changes that the distinction could be ignored.

(2) A similar story may be told with respect to real wages. The initial rise in unemployment checked the rate of growth of real wages quite dramatically during 1975, but recently real wages have begun to increase again and at rates which are only slightly less than those of the pre-1975 period. There is an obvious move to the right of the real wage-unemployment relationship. The recovery of the rate of growth of real wages after each initial shock of an increase in unemployment is also evident.

(3) During the early years of the survey which began in 1973 the sample size was much smaller. As a result the mean of the series is more volatile.

(4) There may be a statistical bias upwards in the expectations series. If there is, however, it needs to be emphasized why this bias has increased since 1978.

(5) The evolution of the Treasury attitude and the learning that all the economics profession is undertaking can be seen in the changing wage and price relations of the Treasury Econometric Model. See Gregory (1983).

(6) Such a tax was advocated by a number of Adelaide economists during 1974. The Cabinet responded by establishing a special committee to report on what may be done through the taxation system "to restrain cost inflation, including the possibility of excluding wage and salary increases beyond an established norm from acceptable costs for the assessment of company income." The Committee also considered the relationship between taxation and the balance of payments, savings and investment. The Committee met on four consecutive days in August. The members were H.C. Coombs, F.H. Wheeler, E.T. Cail, T.W. Swan, F.H. Groen and B. Biogen.

Some of the conclusions of the Committee were as follows:

(a) a tax penalty on wage increases could, if practicable, be a valuable supplement to demand management in slowing down price increases;

(b) good demand management and avoidance of excess demand is a pre-condition for the tax to be effective;

(c) such a scheme, on the advice of the Commission of Taxation, was administratively feasible through the assessment of company income but because of administrative costs should be confined to large employers;

(d) if the scheme were employed it should be done as a short-term measure to minimize the growth of avoidance.

The Committee emphasized anomalies and injustices of such a tax scheme and seemed to believe that they would be serious but most of the difficulties mentioned are not already present in other taxation measures. For example, not all companies would be subject to the tax — this is already true of payroll tax: firms working an unusual degree of overtime during a good year would be taxed more — this problem already exists for tax payers who do not have access to income averaging. At the time the Committee briefly considered this policy instrument there was not the degree of belief that exists now that conventional macro policies cannot restore full employment and low inflation in the near future. The case for new taxes therefore appeared to be much weaker then.

(10) Most wage and salary earners have their pay related to hours worked. Where this does not occur the employer could state the average hours and not be allowed to change them from one year to the next.

(11) Like a payroll tax, the tax could be applied only to large firms to save administrative costs if they appeared to be a problem.

(12) It should be made clear that the objection to the tax is not that no allowance is made for skill upgrading — the average rate of skill upgrading in the economy is taken into account by the level at which the norm is set. The objection flows from the differential rate of skill upgrading by firms leading to differential tax burdens. My best guess is that firms very rarely change their relative position in the skill hierarchy of firms and that any extra costs from this source are likely to be small relative to the impact of genuine wage inflation upon the tax bill.

(13) If the reader is disappointed by the lack of advocacy of a clear and simple solution to the problem of achieving moderate nominal wage increases and full employment, then I fall back on the following defence which B.E. Irwin used in the beginning of one of his papers (1982).

"As far back as 1948, in his first edition of Economics, Paul Samuelson referred to the wage-price issue as "the biggest unsolved economic problem of our time", (p. 436). A few years later, he said:

"When an economic theorist comes to write an apologia pro vivo suo, he writes certain chapters at great speed and in considerable length, knowing full well the worth of his contributions... But I fear that when the economic theorist turns to the general problem of wage determination and labor economics, his voice becomes muted and his speech halting. If he is honest with himself, he must confess to a tremendous amount of uncertainty and self-doubt concerning even the most basic and elementary parts of the subject." (Samuelson in, McCord Wright (1950), p. 812)

And in his latest (the tenth) edition of Economics he (Samuelson) says:

"No jury of experts can agree on a satisfactory solution for the modern disease of 'stagflation': many of the preferred curves may be as bad as the disease itself. That is why one can say that some young economist can win for himself or herself a Nobel Prize on the basis of an empirical or theoretical breakthrough that will help the mixed economy cope better with this present day scourge." There does not seem to have been much progress over the last thirty years.

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