Evidence or Assumptions? The Basis of the Five Economists' for Real Wage Cuts

By J W Nevile
EVIDENCE OR ASSUMPTIONS? THE BASIS OF THE FIVE ECONOMISTS’ CASE FOR REAL WAGE CUTS

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Abstract

Five economists, led by Peter Dawkins, have recommended that award wage rates be frozen so that real wages fall when the rate of inflation is positive. In papers supporting their recommendations they claim that work by Debelle and Vickery shows that a cut in real wages of 2 percent will reduce the unemployment rate by one percentage point. A careful reading of Debelle and Vickery’s work reveals that one could equally well argue that, even taken at face value, their work supports the claim that the unemployment rate will only fall by 0.4 of a percentage point if real wages fall by 2 percent. Moreover, a critical analysis of Debelle and Vickery’s work casts further doubt on the value of freezing award wage rates. Freezing award wage rates is an ineffectual way of reducing real wages, which increases inefficiency in the economy and inequity in society.

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1. Introduction

In October 1998 five economists led by Peter Dawkins wrote an open letter to the Prime Minister recommending that award wage rates be frozen in nominal terms so that for those in the award system real wages would fall as inflation occurred. Those on low wage rates in low income families would be compensated by the government giving them tax credits to boost their after tax incomes. This proposal was subsequently espoused, at least in part, by the Business Council of Australia. It and/or similar plans are likely to continue to play a significant part in the debate in Australia on policies to reduce unemployment. Hence, the need to evaluate the arguments put forward by the five economists.

The five economists argue that freezing award wages for four years would reduce the growth in average real wages by about 3 or 4 percent (over the four years as a whole not per annum). They invoke an “empirical study” by Debelle and Vickery (1998) to argue that this will reduce the rate of unemployment by 1½ to 2 percentage points. However, a careful reading of Debelle and Vickery shows that their empirical work does not lead to this conclusion.

Debelle and Vickery argue that reducing real wage rates may increase employment, and reduce unemployment, in two ways. The first is through the substitution of labour for capital (with no change in output). The second they call the scale effect. It is a further possible effect which occurs if reducing real wages increases output. All the empirical research of Debelle and Vickery is into the first of these effects. They explicitly state that they do not know the size of the scale effect or even if it is positive. They make two assumptions. One is that there is no effect on output; an assumption they think is at the bottom end of the range. The second is one at the other end of the range, that output
increases by so much that the final increase in employment is 2.4 times as large as that occurring just through the substitution of labour for capital with no change in output. It is results based on the second of these assumptions that the five economists use. They completely ignore results based on the first. Given the size of the scale factor, 2.4, it follows that more of the reduction in unemployment that they expect comes from an assumption about scale effects rather than from empirical research about the substitution effect.

Section 2 below discusses the work of Debelle and Vickery on the substitution effect in the context of other studies. Section 3 discusses the size of the increase in output, if any, which will occur as a result of a cut in real wage rates. The conclusions from Sections 2 and 3 taken together suggest that a cut in real wage rates will cause a very small, but positive, fall in unemployment. Hence, if freezing award wage rates were costless it would be an appropriate policy, even if it did not contribute much to reducing unemployment. However, Section 4 argues that freezing award wage rates is not costless. On the contrary it will increase both inequity in society and inefficiency in the economy.

Before closing this introduction, in fairness to the five economists it should be pointed out that they do not regard freezing real wage rates, with tax credits for wage earners in low income families, as a stand alone policy. Contrary to the tone of much media discussion of their recommendations, they also recommended macroeconomic policy that would produce strong economic growth and reduce the amplitude of business cycles, an upgrading of the education and training systems over the long term, a systematic approach to labour market programs and integrating labour market assistance with welfare reform in a way that reduces effective marginal tax rates for low income families.¹

¹ These recommendations are contained to some extent in the open letter to the Prime Minister (see e.g. the Sydney Morning Herald 26 October 1998). They are spelt out more fully in addresses and papers given or written in support of the open letter. The most accessible of these is probably Dawkins, 1999.
However, the most controversial element of the package is the freeze on award wage rates. Clearly the size of any effect of such a freeze on the level of unemployment is crucial to any assessment of the whole package put forward by the five economists. Because of this, and because popular discussion has concentrated on the freeze in award wages and the associated tax credits, this article focuses on this aspect of the five economists’ proposals.

2. The Elasticity of Demand for Labour with Output Exogenous

Before looking at serious studies of the elasticity of demand for labour, I want first to dispose of a myth that cross-country comparisons show it to be large. Rather *ad hoc*, not even back of the envelope, comparisons have been used to argue that at a macro level high wage rates are accompanied by high unemployment. In particular, contrasts were often made between the situation in Europe, especially continental Western Europe, and the United States. In Europe there are high minimum wage levels and unemployment is over 10 per cent in many countries. In the United States both the minimum wage rate and the level of unemployment are much lower. This contrast is striking: so much so that a few years ago it was almost conventional wisdom that OECD economies had a choice between massive unemployment and wage rates so low at the bottom end that many full time workers lived in poverty.

However, more careful examination shows this to be a myth. The argument is not really about total employment, or non-employment, but more about whether low relative wage rates at the bottom end of the distribution cause more unskilled workers to be employed. Although it focuses on relative wage rates and relative employment rates, it is important since the less skilled are the workers most vulnerable to unemployment.
Nickell and Bell (1996) point out that although there was not a large fall in the relative wages of the unskilled in continental Europe, there was in the United Kingdom, but the ‘unemployment record of the unskilled [there] has been worse than in countries like Germany and the Netherlands’ (p.303). Moreover, in continental Europe high wages and rising relative wages at the bottom end of the distribution do not appear to have affected the employment of low skilled workers. In the Netherlands relative wages at the bottom end have risen substantially, but unemployment of unskilled workers has fallen. In Germany real wages (for males) in the bottom decile are rising rapidly whereas in the United States they are falling both absolutely and relatively. Yet the unemployment rate for unskilled male workers is higher in the United States than it is for Germany. This is true although ‘the real wage of an individual in the bottom decile of the male earnings distribution in Germany is over twice that of his equivalent in the United States on a purchasing-power-parity basis’ (Nickell and Bell 1996, p.305).

In a more elaborate study, Card, Kramuz and Lemieux (1996) compared changes in wage and employment rates over the 1980s for different age and education groups in France, Canada and the United States. They found that, in response to changes in relative demand, relative wages of less-skilled workers fell substantially in the United States, somewhat less in Canada and not at all in France. However, in the last two mentioned countries ‘the patterns of relative employment growth over the 1980’s are virtually identical to those in the United States (p.29)’. The big fall in wages at the bottom end of the distribution appeared to have no effect in increasing employment among the unskilled in the United States.2 Careful

2 The differences in official unemployment rates between the United States and many European counties seem to be more the result of different unemployment benefit regimes. In the United States short lived social security benefits cause many unemployed to drop out of the labour force as officially measured (Mishra, 1995). In Europe relatively generous benefits and long entitlement periods, combined with little pressure on the unemployed to find work and few programs to increase the ability and willingness of the unemployed to obtain jobs, act to increase the unemployment rate (Nickell, 1997).
studies show that the United States Europe comparison has little to say about the elasticity of demand for labour.

Debelle and Vickery estimated the elasticity of demand for labour with respect to the real wage rate as \(-0.4\), if output is considered to be exogenous. This is a larger elasticity than has been found in the majority of studies. It is true that the majority of previous studies were made at the firm or industry level or for particular groups of workers, whereas Debelle and Vickery worked at the macro level, and that micro studies generally find lower (closer to zero) elasticities than do macro studies. I will return to this point at the end of this section after establishing the typical value of the elasticity found in micro and macro studies.

A second qualification is that many, but by no means all, of the micro studies look at the effect of minimum wages on the employment of particular groups of workers often teenagers. Not all teenagers will be on the minimum wage, but those on wages higher than the minimum wage will swell the denominator when calculating the proportional change in employment (the so-called inflated denominator). However, at least in the case of teenagers, this argument is not very strong. Teenagers who are receiving more than the minimum wage are still likely to receive low wages and it is likely that their wage rates will also rise to preserve a margin above the minimum wage. If this were not the case one would expect micro studies using an “inflated denominator” to estimate lower elasticities than those which avoid it. No such pattern exists. Also, of course, the whole issue is irrelevant when zero or positive elasticities are estimated.

The micro studies typically look at rises in wage rates, but Debelle and Vickery assume elasticities are symmetrical so this is not important in assessing their work on their own terms. In the thirty years to 1980 a substantial number of studies were made of the effects of changes in wage rates, especially minimum wage rates, on the level of
employment. A survey in the *Journal of Economic Literature* by Brown, Gilroy and Kohen (1982) concluded that:

“Time series studies typically find that a 10 percent increase in the minimum wage reduces teenage employment by one to three per cent. ...We believe that the lower half of that range is to be preferred; to the extent that differences in results can be attributed to differences in the specifications chosen, the better choices seem to produce estimates at the lower end of the range. ... Cross-section studies of the effect on teenage employment produce a wider range of estimated impacts ... but estimates of 0 to .76 percentage points are most plausible.

The effect of the minimum wage on young adult (20-24 years) employment is negative and smaller than that for teenage employment. This conclusion rests on much less evidence than is available for those 16-19 years. The direction of the effect on adult employment is uncertain in the empirical work, as it is in the theory.” (p.524)

Various studies suggest that when minimum wages are increased one effect is that adult employment increases at the expense of teenage employment (see e.g. Bureau of Labour Market Research, 1983). To the extent that this is the case the studies of teenager employment will overstate the elasticity of demand for labour as a whole.

In the 1980s there were fewer studies, but the pattern was for estimated effects of a rise in the minimum wage to be the same or smaller than those summarised by Brown, Gilroy and Kohen in the above quotation. Some of the more interesting studies included one by Solon (1985) who used more sophisticated economic techniques and found rather smaller effects for United States teenagers than had been typical in earlier studies. Another study, by Swidinsky (1980) looked at Canadian teenagers but considered males and females separately. The size of the effects of a minimum wage rise on male employment was the same as the bottom end of the range in the Brown, Gilroy and Kohen summary and that for females a little below the top end of that range. In a study of various industries in the United Kingdom, Kaufman (1989) found negative effects on employment for a 10 per cent rise in the minimum wage ranging from 0.2 per cent to 1.4 per cent.
The 1990s saw an increase in the number of studies published, most of which suggested that, if anything, the Brown, Gilroy and Kohen summary overestimated the effects on employment of a rise in the minimum wage. A study by Bazen and Martin (1991) for France found small effects for young people and virtually no effects for adults. Neumark and Wascher (1992) used panel data on US state minimum wage laws and found that the effects of these laws on employment depend heavily on the exact specification of the estimating equation. In their preferred specification a 10 per cent increase in the minimum wage caused a decline of one to two per cent in employment of teenagers and young adults. However, this specification includes school enrolment rates and the high correlation between this variable and employment rates causes a bias which is in the opposite direction to the bias Neumark and Wascher consider is introduced by omitting school enrolment rates. Hence, they argue that ‘specifications alternatively including and excluding the enrolment rate will bracket the true minimum wage effect’ (p.62). When the school enrolment rate is excluded they find that an increase in minimum wage rates has a small effect and increases rather than decreases employment. This suggests that the true effect is very close to zero.

Rather more striking were a series of United States studies by Card and Kreuger which found that raising the minimum wage increased employment rather than reducing it, although in only two studies out of 7 was the increase in employment statistically significant at the 5 per cent level. However, to quote Card and Kreuger themselves,

the results are uniformly positive and relatively precisely estimated. We find zero or positive employment effects for different groups of low-wage workers in different time periods, and in a variety of regions of the country. The weight of this evidence suggests that it is very unlikely that the minimum wage has a large negative employment effect (1995, p.390).

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3 Some of these studies were done separately and some together. Laurence Katz was co-author of two of the articles describing them. They are all set out in detail in Card and Kreuger (1995).
The most influential of the studies by Card and Kreuger was that of the fast food industry in New Jersey and Pennsylvania, published in the *American Economic Review* of May 1994. An increase in minimum wages in New Jersey in 1992 provided material for a case study of the effect on employment of increases in minimum wages. The fast food industry is a major low-wage employer in the United States. Card and Kreuger compared employment changes in New Jersey and the neighbouring state of Pennsylvania where the minimum wage was constant. They found “no indication that the rise in the minimum wage reduced employment” (1994, p.772).

This provoked a counter study by Neumark and Wascher using data supplied by a quasi lobby group – the Employment Policies Institute. They found that employment had fallen in New Jersey fast food restaurants, although the fall was only weakly significant by the usual statistical criteria. However, Neumark and Wascher (1995) acknowledged that the Employment Policies Institute had ‘a stake in the outcome of the debate’ (p.5). They undertook another study collecting additional data of their own. When they combined the two sets of data the rise in the minimum wage was followed by a fall in employment which was significant at the 5 per cent level. Their own data gave results which were not statistically significantly different from those of Card and Kreuger.

Arguments for and against Card and Kreuger’s position became very acrimonious, to say the least,4 but those arguing that the elasticity was negative not positive never argued that it was large. All sides implicitly agreed that it was small. The passion was over the sign of the elasticity.

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4 See Blinder 1996 for a description and evaluation of the controversy between Card and Kreuger and Neumark and Wascher.
The conclusion to be drawn from the studies so far reviewed (taken as a whole) is that the elasticity of demand for labour is smaller than -0.4 for teenagers and probably close to zero for adults. Overall, it is noticeably smaller than the Debelle and Vickery estimate. However, in many cases the elasticity estimated in a micro study may not be significantly different (in a statistical sense) from that obtained by Debelle and Vickery.

While there is a strong consensus among micro studies that the elasticity of demand for labour is close to zero, the evidence at the macro level is less clearcut. There have been fewer studies at the macro level. Moreover, estimating the elasticity of demand for labour is less straightforward at the macro level with different studies not estimating the same thing even at a conceptual level. The meaning of the *ceteris paribus* assumption is not clear and what is estimated in some studies is closer to the elasticity of the substitution of labour for capital and in others it is closer to the elasticity of demand for labour. Different macro studies often cover different categories of workers (e.g. total employment, private sector employment, male employment). This is also the case, by definition, in micro studies but is well recognised and taken into account. It is often glossed over in reviews of macro studies.

In the 1960s and 1970s only half a dozen relevant macro studies were made, or at least only that number were included in the survey by Hamermesh (1993, pp.78-79). With one exception they were all for hours worked in the private sector. The range of elasticities estimated was from 0.3 to 1.0. Surprisingly, the highest estimate was found in the only study for total employment, rather than private sector employment. It is hard to say that there was any consensus among 6 studies with a diversity of estimates, but the median value was a little below, and the mean value a little above, that of Debelle and Vickery after adjustments were made for the difference between private sector employment and total employment.
Studies undertaken in the 1980s and 1990s are more relevant, especially since now studies of the Australian economy are well represented. In the majority of Australian studies the estimated elasticities range from -0.6 to -0.8 (Lewis and Seltzer, p.41). Both the median and the mean of the estimates of elasticity are above Debelle and Vickery’s estimate. However, it is notable that studies using data from before 1978 have larger estimated elasticities than studies with a data set that starts on or after 1978. Debelle and Vickery (1998, p.248) themselves suggest that the wage elasticity declined over the 1980s. This implies, though they do not say so, that studies with a long run of data in the 1970s and 1960s are not so relevant to present conditions. Moreover, irrespective of whether the elasticity actually declined in the 1980s, macro studies could produce this effect because of the real wage rise in the 1970s picking up the influence of an omitted variable. In the 5 years or so starting in 1972 real wages rose substantially and employment growth was sluggish but so much was happening over this period that it is difficult to be confident about the extent of the causation between the real wages and employment. Thus, there are good arguments for looking only at the 1980s and the 1990s. If this is done Debelle and Vickery’s elasticity estimate of 0.4 is confirmed by other studies. If one prefers to take a longer period as the better sample, it is distinctly on the low side.

Either way the macro studies provide no reason to argue that Debelle and Vickery’s estimate is too high whereas the consensus of the micro studies is that overall the elasticity of demand for labour is close to zero. On which type of evidence should most weight be placed?

Differences between the estimates from macro and micro studies could arise because the firms and industries examined in the micro studies were not typical of the whole economy, because of more general aggregation problems or because of a bias introduced by
the factors which often make estimation more difficult at the macro level. Good macro economists are cautious about values estimated at the macro level which differ substantially from plausible micro level values unless there is a convincing explanation of why one would expect a genuine difference between macro and micro values. Labour economists also argue that micro results are a valid check on macro estimates and are generally to be preferred. To quote Hamermesh (1993, p.64), “research based on carefully measured micro data is likely to yield better estimates of the parameters of interest than that based on aggregated data”.

There is one sound argument why macro estimates of the elasticity of the demand for labour will be higher than micro estimates and two that go in the opposite direction. Cuts in real wages may lead to an expansion of labour intensive industries at the expense of capital intensive industries. On the other hand, there are two reasons to expect micro estimates to be larger than macro estimates. First, the micro studies have concentrated on the bottom end of the wage distribution. By common consent (including that of the five economists) this is where the elasticity of demand for labour is likely to be the greatest. Secondly micro studies have all been for the private sector. Many macro studies, including Debelle and Vickery’s, also include the public sector. Many economists argue that the elasticity of demand for labour in this sector is zero. This may be going too far, but it is undoubtedly lower than in the private sector. Taking all these points into consideration, the weight of the evidence is that Debelle and Vickery’s estimate of −0.4 for the elasticity of demand for labour is too high.

There is another reason to be cautious about the size of their estimate. The regression equation they use to obtain their estimate is mis-specified. The theoretical equation they are estimating includes the user cost of capital. Although the regression equation includes a variable called the user cost of capital, an examination of their appendix on data sources
reveals it to be a measure of the cost of financing new capital (Debelle and Vickery, 1998, p.262). If, as they believe, their model is always close to equilibrium, the variable is closer to a proxy for the marginal efficiency of capital than the user cost of capital. Not surprisingly the coefficient on this cost of capital variable is statistically insignificant and little difference is made when it is dropped. The mis-specification is more likely to bias upwards the coefficient on output than that on the level of real wages. Nevertheless, any significant mis-specification is a reason to be cautious about the coefficients in a regression equation.

There are good reasons to be cautious about the size of the elasticity of demand for labour estimated by Debelle and Vickery. An American 1996 survey of labour economists found a median value for the elasticity of demand for the labour of low-wage workers of –0.1 (Bernstein 1999). For better-skilled, better-paid workers the figure would presumably be even closer to zero. For all workers a figure between –0.2 and zero may be as close as one can get to a professional consensus. Hence, it is unwise, when designing policy packages to reduce unemployment, to take, as the best guess, an elasticity of demand for labour of -0.4. At the very least one should undertake sensitivity analysis, with the elasticity of demand ranging between –0.4 and zero.

3. **Do Cuts in Real Wage Rates Increase Output?**

If the elasticity of demand for labour (with no change in output) were -0.4, one might think that a fall in wages of 4 per cent would increase employment by 1.6 per cent and reduce unemployment by the same number of percentage points. However, the increase in employment will increase the participation rate, as hidden unemployed reenter the labour market, and the fall in unemployment will be less than one percentage point. Thus, largest slice of the action in the five economists argument, that a four per cent cut in real wages will
reduce measured unemployment by two percentage points, comes from effects of the wage cut in increasing output. Given that they appeal to Debelle and Vickery’s model to justify this, the five economists are saying in effect that a four per cent cut in real wage rates will reduce the natural rate of unemployment by two percentage points. Some of this comes from the substitution of labour for capital, but more because, with lower wage levels, “the firm (the economy) is able to move to a higher level of production, thereby employing more labour and more capital” (Debelle and Vickery, 1998, p.242). Since Debelle and Vickery’s results are for what they call an equilibrium situation when output is equal to potential output, one might wonder how more labour and capital can be employed. The answer lies in their model of the labour market. Figure 1 is an elaboration of their relevant figure (Debelle and Vickery 1998, p.241). Employment is at the level where the wage setting curve and the labour demand curve intersect. The wage setting curve is similar to that in Layard and Nickel (1986). It differs from the labour supply curve because it is assumed that there is an exogenous component in the wage rate. Freezing award wage rates would reduce this exogenous component and the wage-setting curve would shift to the right, e.g. to the position shown by the dotted line in Figure 1. This effectively increases the supply of labour and hence output. In words without neoclassical overtones, freezing award wage rates will reduce the NAIRU. Hence, if policy keeps the actual level of unemployment close to the NAIRU, it will reduce the actual rate of unemployment.

That is not hard to accept, but it is not easy to estimate how large this reduction will be. As we saw, Debelle and Vickery put any attempt to do this in the too hard basket, and instead made assumptions which might be thought to indicate the upper and lower limits of
the range for the size of the effect of freezing award wages on the NAIRU. The five economists ignored the lower assumption and only used the upper one.

Two approaches have the potential to shed some light on the plausibility of their assumption of substantial scale effects. One is to simulate full econometric models of the whole economy. As is well known, different econometric models give different answers to many questions, even when estimated over the same period with the same definitions of the data. This is because such econometric models incorporate not only estimated equations but also assumptions (or judgements) about the structure of the economy and how it works. Often they also include assumptions about particular parameters which are hard to estimate, or which are dictated by the economic theory held by the model builders. A full scale survey of econometric models is well beyond the scope of this paper, but even if it were to be carried out the judgement made on the results of a model’s simulations would depend on judgements about the economic theory and assumptions underlying the model. There may be strongly held views but there are no black and white answers on such matters.

A second and more promising approach is to examine, in a broad brush way, how the natural rate of unemployment (or NAIRU depending on one’s theoretical position) has changed following changes in real wage rates, or rather changes in real unit labour costs. Debelle and Vickery can only focus on real wage rate changes because of their assumption that productivity growth is both exogenous and constant. It is better to use the theoretically correct variable real unit labour costs.

The examination can only be broadbrush because estimating the natural rate of unemployment (and/or the NAIRU) is very difficult to do with any accuracy. Figure 2 (taken

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5 Assuming that the models are estimated competently which is usually the case.
6 The natural rate is a Walrasian equilibrium concept whereas, as Stiglitz (1997) put it, “the NAIRU essentially [is] a description about how the economy behaves out of equilibrium” (p.7).
from Debelle and Vickery 1998, p.236), shows that following an upward movement in the previous few years there was a sharp rise in real unit labour costs in 1973. There is no disagreement that this was accompanied, with no lag in most estimates, by a sharp rise in the natural rate of unemployment. However, many more things than a rise in real unit labour costs were occurring in the early 1970s and many of them might be thought to increase the NAIRU. In my judgement the most important reason for the rise in the NAIRU was a major change in the formation of inflationary expectations. In the 1950s and 1960s practical decision making with a horizon greater than a year or so assumed a constant rate of inflation around 2 to 2½ per cent, but this changed around 1970 (Nevile, 1977). The shattering of these expectations of a stable inflation rate at a time when nominal wage rates were rising very rapidly is enough to explain the rise in the NAIRU by itself.

After 1974 real unit labour costs trended downwards for 20 years at a trend rate of decline of over one half of one per cent a year. Most estimates show this massive fall in real unit labour costs having virtually no effect on the natural rate of unemployment. The Treasury’s estimate of this remained more or less constant from 1974 to 1994. Debelle and Vickery’s estimate of the natural rate did fall initially, but then rose again and was higher at the end of the 20 year period than in 1974 (Debelle and Vickery, 1998, p.239). Australian experience since 1974 gives no basis for accepting an assumption that the scale effect is large with a significant decline in the natural rate of unemployment and/or NAIRU occurring when real unit labour costs are reduced. The assumption that the size of the scale effect is 2.4 seems very optimistic.

The discussion in both section 2 and this section suggest that Debelle and Vickery have overestimated the effects of a cut in real wages on unemployment, especially when they
use the assumption that the size of the scale effect is 2.4. There is little reason to think that, given approrpriate macro policy, reducing real wage rates will not have any effect in increasing employment in the short run and it may reduce the size of the NAIRU in the longer run, but both effects are likely to be very small.\(^7\)

4. **The Efficiency and Equity Effects of Freezing Award Wage Rates**

Since the probable impact on employment and unemployment is so small, freezing award wage rates is only a desirable policy action if any efficiency and equity effects are positive or negligible. Unfortunately, on balance both efficiency and equity effects are negative and in the case of equity they are far from negligible.

One consequence of the five economists recommendations is that the government ends up subsidizing the employment of many low wage earners. Low wage earners are almost always workers with low productivity and are often employed in firms whose efficiency is low. Freezing award wage rates will enable some inefficient firms to stay in business when it would be better for the efficiency of the economy if they disappeared and were replaced by more productive enterprises. Since low wage earners are a substitute for physical capital, whereas skilled workers are a complement to capital, freezing award wage rates will also tend to reduce investment in efficient firms, which in the longer run will lower living standards. On the other side of the efficiency argument is the extra output that will be produced if employment rises and unemployment falls. This would be probably enough to offset the relatively lower use of capital by efficient firms and inefficient firms continuing in production except for one additional factor, the Salter effect.

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\(^7\) Another reason why the effects may be smaller than the five economists argue is that freezing award wage rates may reduce the average real wage by less than the five economists assume.
Because inefficient firms stay in business, probably investing very little in new physical capital and because of a general tendency for unskilled workers to be substituted for physical capital, the rate of capital accumulation will decline from the level it otherwise would reach. Salter (1960) pointed out that the rate of capital accumulation is a very important influence on productivity growth. A major determinant of productivity is the ratio of the average level of productivity, in each of the various industries, to the productivity in the “best practice” plants. Physical capital is durable and adjustment from “average” to “best practice” is often slow, but the greater the rate of capital accumulation the younger the average size of capital and the greater the proportion that incorporates the latest technology.

I would not argue that any of the effects on efficiency discussed in the previous two paragraphs are likely to be large. They will be small, probably very small, because the extra employment of low-skilled workers will be very small. However, they do work in the wrong direction.

One final efficiency point must be raised. The cost of the five economists’ recommendations with respect to tax credits is significant. There is no definitive statement about whom they recommend should be eligible for tax credits. Assume that tax credits are available to all full time low wage earners, in low income families and are reduced proportionally for part time workers. Assume too that the credits are big enough to offset very roughly the effects of inflation on the average after-tax earnings of those receiving credits. With an annual inflation rate of 2.5 to 3 percent, by the fourth year the annual cost of the tax credits would be in the range of 3 to 7 billion dollars, depending on income and asset tests and the taper rate. 5 billion dollars could be taken as a ballpark figure. One has to ask

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8 In the Australian Financial Review, 16/11/1998, Keating and Lambert estimate the cost of a similar sized earned income tax credit as 4.6 billion dollars.
whether there are other ways of spending 5 billion dollars a year, which would do more to reduce unemployment.  

However, the major arguments against a policy of freezing award wage rates are equity ones. The equity questions can be clarified by examining who gains and who loses. The major groups who gain are as follows.

(1) The firms whose wage bill is, in effect, subsidized by the tax payer. These are a very mixed bag. At one extreme are struggling small businesses where proprietors qualify for the label of “hard working battlers”. At the other are large corporations whose shareholders are, in the main, very well off and whose executives’ large levels of remuneration may be further increased because of apparent better performance.

(2) Those unemployed who find employment. I have argued that they will be a small group especially as the increase in employment is estimated in terms of hours not persons. Some casual and part-time employees will work for longer hours, or for more weeks a year, for less total take home pay. If they qualify for the tax credit they will be better off. If they do not they will be worse off.

(3) Low wage earners already employed who receive a tax credit. Because they do not pay tax on this they are better off than if they had received an award wage rate increase.

The losers are generally among the less well off in our community, but they do include low wage earners who live in rich or better off families. Many university students fit this category. The losers can be categorized as follows.

(1) Those low wage earners, previously employed, who do not receive tax credits because they do not live in low income families. These include teenagers and young

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9 Watts and Mitchell (2000) estimate that the net cost to the government budget of giving jobs at the living
adults in genuinely well off or rich families, where the only equity question is in relation to the desirability of family dependence. They also include many who struggle to live on a relatively low income although, as far as eligibility for tax credits is concerned, they are not classified as living in a low income family. By and large those whose wages are determined directly or indirectly by the award wage system are those with least industrial muscle and, if principal income earners, could be expected to live in families with incomes below the average.

(2) Secondly there are the families who have partially to support those low wage earners who do not qualify for the tax credit, and the families of those principal income earners whose wages are fixed directly or indirectly by the award system but who do not receive tax credits. This group has already been discussed, in effect, under the previous paragraph.

(3) The third group of losers could be thought to be taxpayers, but it is more likely that the 5 billion dollars a year in tax credits will not cause an increase in tax rates, but cuts in some other government expenditure. These will almost certainly bear more heavily on the less well off than on those in the upper half of the income scale. One group particularly likely to suffer because of this are the long term unemployed. Those who do move into employment because of the freeze on award wage rates will be those on the verge of employment. Freezing award wage rates will do nothing to help the long term unemployed, but the cost of the associated tax credits are likely to cause a lesser amount to be spent on labour market programs that do help the long term unemployed to obtain jobs.

wage to all unemployed, including hidden unemployed, is of this order of magnitude.
Finally there is society as a whole. Freezing award wage rates, even with the associated tax credits, will increase inequality in the sense that the gap will grow between the really well off and many in the lower and middle income ranges. Growing inequality, and even more growing perceptions of inequality, are causing significant stress in Australian society. These proposals will add to that stress.

Equity, like beauty, is to some extent in the eye of the beholder. My judgement is that the consideration of the winners and losers set out above suggests that freezing award wage rates will have substantial negative effects on equity. Of particular concern is the situation of those whose wages are set directly or indirectly by award wage rates and who are not eligible for tax credits, but do not live in well off families. If programs that help the long term unemployed are cut, or even not expanded, as a result of implementing the five economists’ recommendations, this would be a disaster from the point of view of equity. It would also be against the total package that the five economists recommend, but is a likely consequence of the perceived need to finance the tax credits without a budget deficit.

5. Conclusion

The proposal of the five economists will not quietly disappear, if only because the Business Council of Australia is pushing a version of it. This paper has concentrated on the narrow economics question of how much effect will freezing award wage rates have in reducing unemployment. The wider equity questions have only been discussed in general terms to show that there probably will be substantial negative equity effects. The biggest certain losers will be families whose income is dependent on award wage rates but is above the cut off point in the definition of low-income families. The long term unemployed may be
affected even more adversely. Some broader questions have not even been raised, e.g. the desirability of emphasising the distinction between the deserving and the undeserving poor.

It is appropriate therefore to end with the narrow economics question. Both the five economists and the present writer agree that unemployment will not decrease much if award wage rates are frozen, unless this reduces the NAIRU significantly. In Australia today award wage rates only determine, or have a large influence on, the wages received by those workers with little industrial muscle. An innovative incomes policy suitable to our current wage setting arrangements is highly desirable. An incomes policy which operates entirely on the wages of those least likely to secure inflationary wage increases is unlikely to be effective.
References


