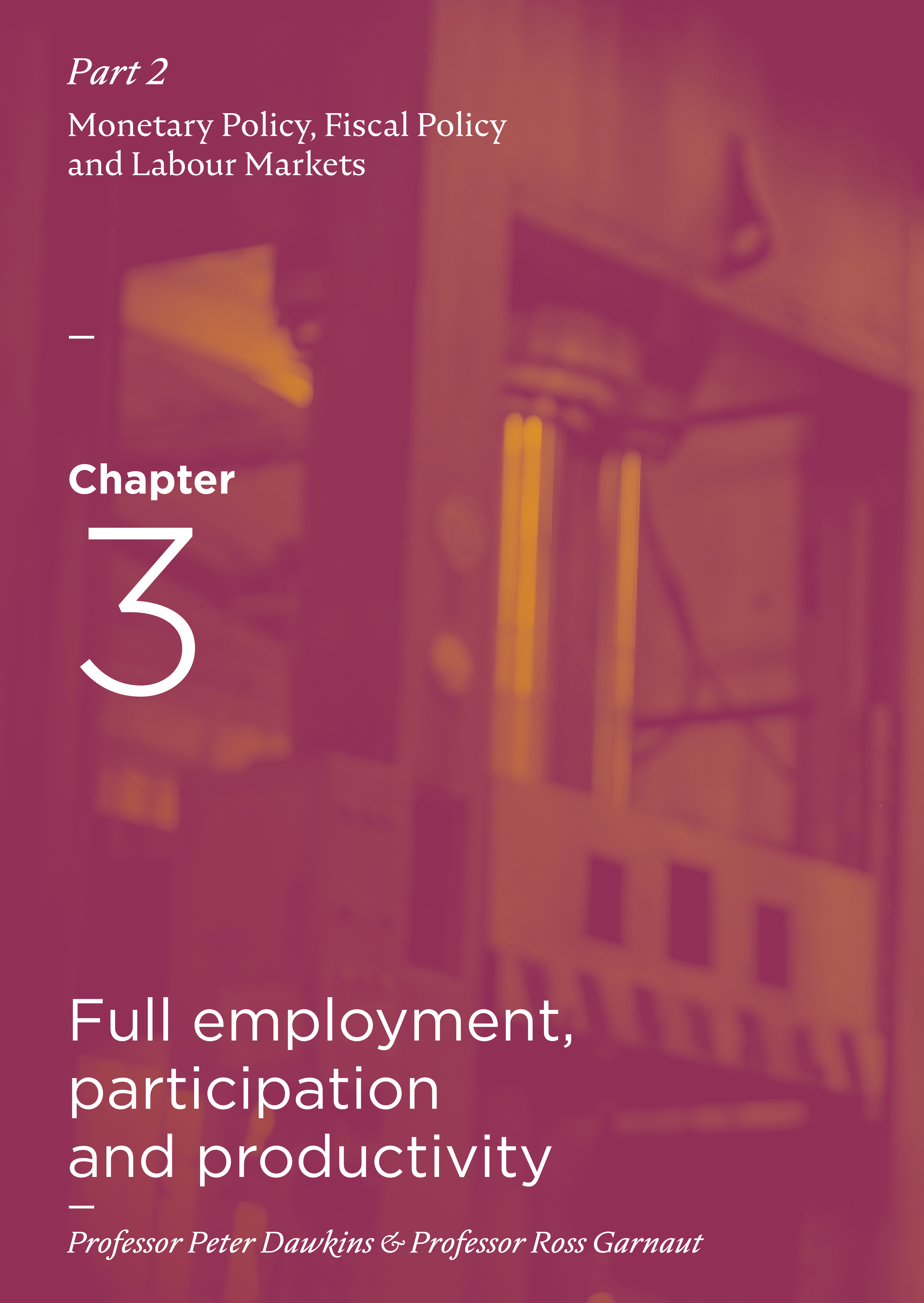


Part 2

Monetary Policy, Fiscal Policy and Labour Markets

Chapter

3

Full employment, participation and productivity

Professor Peter Dawkins & Professor Ross Garnaut

Peter Dawkins and Ross Garnaut discuss the large equity and efficiency benefits of full employment. Evidence suggests that the full employment level of unemployment, or the non-accelerating inflation rate of unemployment, can now be below 3.4 percent—as it was for the quarter century to the early 1970s. They question whether the 2022 aggressive tightening of monetary policy places sufficient weight on full employment. They suggest a more balanced blend of fiscal and monetary policy to support sustainable growth in incomes. Alongside achieving full employment, reform of education and training and the tax and transfer system can increase skills, participation, hours of work and productivity, and lead to a more equitable distribution of income. Investment in child care and early childhood education would increase parents' labour supply, and enhance childhood development and therefore human capital in the long term. Achieving full employment along with such reform would increase real wages, before and after tax, and distribute income more equitably. There is a strong case for sophisticated simulation economic modelling using state-of-the-art tools to strengthen the evidence base for policy design.

INTRODUCTION

In December 2021, in a presentation to the Melbourne Economic Forum (Dawkins and Garnaut, 2021), we revisited the Five Economists' Plan of the late 1990s and drew lessons for the current Australian labour market. The Five Economists' Plan was directed at reducing unemployment and increasing labour force participation and had five elements (Dawkins et al., 1998).

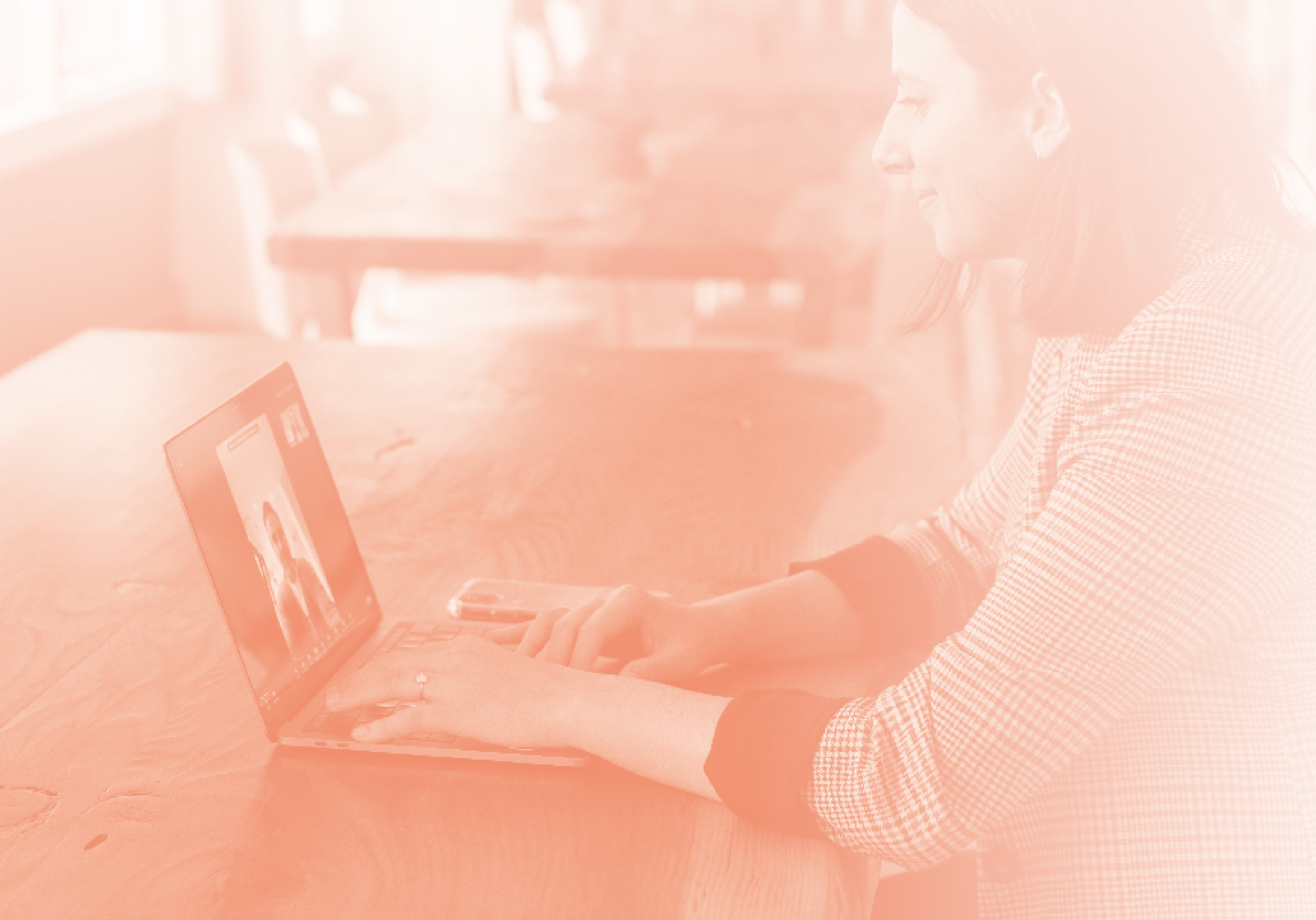
We commended the Reserve Bank of Australia (RBA) and the then Treasurer on their recently renewed commitment to full employment and noted that expansionary fiscal and monetary policy was moving us closer to that goal. We also argued that, as we approach full employment, a policy agenda focused on raising labour force participation and productivity is critical to sustaining growth in total output and increasing real wages (Dawkins and Garnaut, 2021). We outlined promising avenues for achieving this.

This chapter expands that discussion. We note the primacy of full employment as an economic policy objective, and the importance of a balanced approach to monetary and fiscal policy in managing aggregate demand to promote full employment. We discuss possible reforms of the tax and transfer system to promote participation and productivity and the growth in after-tax real wages, whilst paying particular attention to distributional issues at the bottom end of the income distribution. We also comment on the importance of education and training to enhance workforce skills.

Our analysis is timely, given the Albanese Government's recent Jobs and Skills Summit, which is to be followed by a White Paper on Full Employment. The Summit had five themes:

- maintaining full employment and increasing productivity;
- boosting job security and wages;
- lifting participation and reducing barriers to employment;
- delivering a high-quality labour force though skills, training and migration;
- maximising opportunities in the industries of the future.

We hope the Summit and the White Paper herald a new era of evidence-based economic reform. This should have a central focus on achieving full employment, raising productivity and participation and increasing real wages, with a view to achieving sustainable growth in living standards and ensuring a fair distribution of income. That is the subject of this chapter, which draws on a range of evidence and highlights ways in which additional information and analysis can support the development and refinement of this policy agenda.



FULL EMPLOYMENT

The objective of full employment

Full employment was the first objective of Australian economic policy from the end of the Second World War in 1945 until the mid-1980s. Full employment was built into the legislated objectives of the RBA early in this period and retains prime place today. Unemployment was rarely above 2 percent and mostly well below until 1974, when a sharp contraction during the global recession precipitated by the first oil price shock took it above 4 percent. It rose above 5 percent through the years immediately following, and above 10 percent in the recession of 1982–1983. It stayed above 4 percent, and nearly always above 5 percent and often much higher, until the massive fiscal and monetary expansion and restriction on immigration during the COVID-19 pandemic took it down to 3.4 percent in mid-2022.

Full employment was largely overlooked in discussion of monetary policy after the 1980s, when holding down inflation became the dominant objective of monetary policy. Attention has focused on the non-accelerating-inflation rate of unemployment, the NAIRU, which was estimated or presumed to be 5 point something or higher. This remained the case even as actual unemployment in Australia as a whole briefly fell to 4 percent without accelerating inflation during the China resources boom, and below that in the large states of New South Wales and Victoria. It remained the case as fiscal and monetary expansion saw the unemployment rate in the United States fall from almost twice Australia's in the aftermath of the global financial crisis, to 3.5 percent on the eve of the pandemic.

The Australian Government's 1945 *White Paper on Full Employment* discussed the risks of inflation. Interestingly, the average unemployment rate fell to lower than the authors had in mind, to below 2 percent for two decades, without high or accelerating inflation. This begs the question—how low can unemployment go without accelerating inflation? The NAIRU is better thought about as an observable reality than an output from an econometric model.

These matters are discussed in *Reset: Restoring Australia After the Pandemic Recession* (Garnaut, 2021). Garnaut notes that it may be possible for the Australian unemployment rate to fall to 3.5 percent without generating accelerating inflation—the rate in the United States on the eve of the pandemic. The lowest rate without accelerating inflation may be lower—or higher. There is no need to guess. We will know when unemployment is so low that labour market pressures are causing inflation to accelerate.

Full employment disappeared from the RBA's discussion of monetary policy through the decade of persistent unemployment that preceded the pandemic recession. There were signs of change late in 2019 and in the first year of the pandemic. A senior officer of the RBA said in a public lecture at the University of Melbourne that the NAIRU may be 4 point something, rather than the 5 point something that had long been presumed (Ellis, 2019). The Governor mentioned full employment in monthly public statements after Board meetings from October 2019 through 2020. In 2022, full employment did not get a mention during the period in which there was a number of 0.5 percent interest rate increases, but pleasingly was mentioned in the October statement.

In the months in which full employment was regularly discussed by the RBA during the pandemic's first year or so, the Governor said that monetary policy would remain highly expansionary, with the cash rate steady at close to zero, until sustained wages growth above the inflation rate was accompanied by sustained general inflation above the range of 2 to 3 percent. That would be the signal that full employment has been reached.

As unemployment fell in 2022, there were no signs in the Australian Bureau of Statistics (ABS) data of sustained high rates of increase in wages placing upward pressure on inflation. By June 2022, the data had established that the NAIRU was no higher than 3.4 percent, but not exactly how low. Faced with significant price but not wage inflation, the cash rate was raised quickly from 0.1 percent to 2.35 percent between May and September 2022 and markets and RBA commentary suggested that further tightening would follow. RBA and Treasury statements accept that the unemployment rate will rise to 4 percent during 2023.

There has been much discussion of why real wages have not risen in Australia in 2022, as unemployment fell below levels once presumed to be full employment. The simple explanation is that Australia does not have full employment. Faced with significant price inflation, the RBA abandoned its strategy of resisting tightening monetary policy until we reached full employment before it was known how low the rate of unemployment could go without becoming the source of accelerating inflation.

Will larger nominal wage increases follow if global energy and other prices continue to rise strongly? Probably. Would that mean that full employment has been achieved? Probably not. If nominal wages rise more rapidly, but more slowly than average prices, they are not the source of accelerating inflation. The spectre of a virulent wage-price spiral arose from memories of conditions in the 1970s and 1980s and not the conditions of the 2020s.

The advantages of full employment for equity, productivity and real wages

With full employment, workers can leave jobs that do not suit them and quickly find others—often moving from lower to higher productivity firms. Employers put significant effort into training and retaining workers. Labour income is secure and can support a loan to buy a house. Labour is scarce and valuable and not to be wasted on unproductive tasks. Businesses that cannot afford rising wages close and release their workers into more productive employment. Steadily rising real wages encourage economisation on labour, which lifts productivity.

In addition to large benefits for productivity, full employment has immense social benefits. It provides the best social security for people who are able to work. The Australian Jobseeker benefit in September 2022 may be adequate if its role is to provide sustenance briefly while recipients are looking for their first jobs or moving quickly from one to another. It is too low to support people for longer periods.

Full employment creates opportunities for people whose long unemployment make them unattractive as employees. Employment makes them employable. Full employment encourages and increases the value of high labour force participation. Employers seek out potential workers amongst people who had been unemployable. This encourages participation of women who have spent long periods out of the labour force; the infirm and old; the poorly educated; and those with little established engagement with the wage economy.

Full employment is hard work for employers. Many prefer unemployment, with easy recruitment at lower wages. Yet full employment has advantages for many employers. It brings larger and more stable demand for consumer goods and services for businesses selling into the Australian market. And for employers who identify as Australians, it brings enjoyment of a more cohesive and successful society.

THE DEFINITION OF FULL EMPLOYMENT

In 1945, both the United Kingdom and Australia, in that order, published White Papers on full employment. The United Kingdom paper, by William Beveridge, defined full employment as the level of unemployment where the number of vacancies equalled the number who were unemployed, but argued that we should try to keep unemployment below that level if possible. The Australian White paper produced by John Curtin's government was less precise in defining full employment but implied something similar. The Beveridge paper postulated that full employment would occur at about 3 percent unemployment with all that unemployment being 'frictional', that is, people moving between jobs.

On this definition the United Kingdom and Australia achieved full employment for most of the period from the 1940s to the mid-1970s, with unemployment in Australia averaging 1.9 percent over that period (Borland and Kennedy, 1998). The concept of the Phillips Curve emerged during this period, which suggests a trade-off between inflation and unemployment and that we can obtain a level of unemployment around 2 percent if we are willing to accept a rate of inflation of around 2 to 3 percent.

Then, in 1974, supply shocks led first to increases in food prices and then oil prices, resulting in substantial increases in the cost of living in Australia. In the institutional circumstances of that time, this led to a wages breakout and increased interest rates, and a period of stagflation in which both unemployment and inflation increased dramatically. The Phillips Curve was seen as having shifted and 2 percent unemployment combined with 2 to 3 percent inflation now looked unobtainable.

In the inflationary era that followed, internationally as well as in Australia, the term, full employment, went out of fashion. It was replaced by the NAIRU concept, which in the 1980s and 1990s was estimated to be in the order of 5 to 7 percent in Australia (Gruen et al., 1999), and increasing over this period. Understood here was that inflation expectations had increased and became built into wage setting. Less discussed, but of significance, was that institutional and regulatory pressures led to substantially higher real wages and real unit labour costs in the 1970s and early 1980s, which increased the NAIRU.

The combination of the Prices and Incomes Accord from 1983, followed by labour market reforms and reduced trade union power, and inflation targeting in monetary policy, lowered inflation. In the 2010s, earlier labour market deregulation, lax enforcement of law, more open immigration policy and reductions in inflation globally helped to bring inflation below the RBA's target range.

From the late 1970s high unemployment itself lowered the value of labour and increased the NAIRU. This began to be corrected by the experience of low unemployment in 2022 (Martin, 2022). Unemployment remained persistently high through the 2010s, when it was falling in the United States. Garnaut (2021) and Gross and Leigh (2022) suggest that excessively tight monetary policy caused inflation to remain below the target range and keep unemployment unnecessarily high, with large, unnecessary loss of output, incomes and public revenue.

By July 2022 much lower unemployment was accompanied by historically high labour force participation rates. The number of unemployed persons was approximately equal to the number of vacancies—Beveridge's definition of full employment. But remember Beveridge said we should aim to keep unemployment below that level. There was no sign of excessive wage inflation as measured by the ABS. The NAIRU, no higher than and possibly well below 3.4 percent in mid-2022, can be expected to continue to fall with experience of low unemployment. The underlying relationships determining the NAIRU change over time and with economic circumstances and we will not know what it is until unemployment has fallen to the point where we observe wages as a cause of accelerating inflation. Our experience teaches us to be wary about using estimates based on analysis of data for other times and circumstances.

THE FIVE ECONOMISTS' PLAN

In 1998, we were two of the five economists who proposed a five-point plan to then Prime Minister, John Howard, to reduce unemployment to 5 percent while also increasing labour force participation. Following the 1990-1991 recession, unemployment had gone over 10 percent. It was still just a little under 8 percent in 1998, which we regarded as Australia's major economic and social problem.

John Howard called a special cabinet meeting, and the RBA held a conference on the subject. We based the plan on the best available evidence and while it was not fully implemented, it did influence policy in the years that followed.

The five elements of the Five Economists' Plan were:

1. steady fiscal and monetary policy and continued microeconomic reform aimed at strong and stable growth;
2. replacing living wage adjustments for the time being with earned income tax credits for earners of low wages in low-income families;
3. a long-term commitment to reduce effective marginal tax rates, especially for low-and middle-income families;
4. a systematic approach to labour market programs;
5. upgrading of the education and training systems over the longer term.

The centrepiece of the plan was the wage-tax trade-off, which aimed to support real incomes of low-income workers while reducing labour costs to expand employment. The trade-off was focused especially on low-skilled workers, who had the highest unemployment rates. The tax credit would ensure that low wage earners in low-income families received an increase in their real incomes while real wages fell. We argued that the increased labour demand from the wage restraint, combined with an ongoing commitment to productivity and output growth, should lower unemployment to 5 percent and keep it there. Steady productivity and output growth would come through steady monetary and fiscal policy, productivity-increasing microeconomic reform, labour market programs to support the most disadvantaged members of the labour force, and upgrading the education and training system to increase labour force skills over the long term.

Various assessments of the employment impact of the plan (see Borland, 2002; Richardson, 1999; Dixon and Rimmer, 2000; Dawkins, 2002) came to a range of conclusions about the expected size of the employment effects, though they all concluded that they would be positive.

While the wage-tax trade-off was not formally adopted, what transpired over the next 20 years was a steady reduction in real-unit labour costs, alongside attention to the tax treatment of low-income families, through a family tax benefit and the low-income tax offset (LITO).

Monetary and fiscal policy did not prioritise full employment for more than two decades. Once it did, it contributed to moving us towards full employment with much higher rates of labour force participation.

MONETARY AND FISCAL POLICY

Expansionary monetary and fiscal policy were centrally important to bringing unemployment down to 3.4 percent in mid-2022. But this was accompanied by a sharp increase in inflation. This was driven by large increases in international prices. Supply chain shocks from COVID-19 dislocations were exacerbated by sudden withdrawal of large amounts of food and fossil energy from world markets with the Russian invasion of Ukraine. Several-fold increases in global gas and coal prices were transmitted fully into the Australian market despite Australia being the world's largest exporter of these commodities. Historically unprecedented increases in gas and electricity prices to domestic producers and consumers followed. The sharply increased consumer prices had not been reflected in ABS data on wages by August 2022, with the basic measure still showing average wage increases at 2.4 percent. The Treasurer's statement on the economy in July 2022 anticipated a fall in real wages of 7 percent in the two years to June 2022. If this were to occur, it would be by far the largest two-year fall in average wages ever recorded in Australia. The acceleration in Australian inflation was not caused by wage pressures.

The RBA raised cash interest rates from 0.1 percent to 2.35 percent between early May and early September. The RBA said that it needed to subdue demand to avoid large increases in inflationary expectations and a virulent wage-price cycle. The RBA and the Treasury are forecasting that unemployment will rise to 4 percent by 2024 but hope for a 'soft landing' and to avoid a recession.

Australia's tightening of monetary policy over these five months was the largest of developed countries over a comparable period. New Zealand started earlier and had gone further by mid-2022. Australian tightening was closest to other English-speaking countries with much higher inflation rates (the United States, the United Kingdom, New Zealand and Canada), all of which were thought by financial markets to face high probability of recession in response to the tightening cycle.

We do note, however, that as this chapter goes to print, the RBA has at least slowed the rate of increase in interest rates and its latest statement does mention 'full employment' and that future interest changes will include an assessment of the outlook for inflation and the labour market. We would encourage the RBA to continue to comment on the expected impact of its interest rate policy on the objective of full employment in the months and years ahead. The central banks of the two largest developed country monetary systems outside the United States, the European Union and Japan had policy rates of 0.5 percent and minus 0.10 percent in early September, though the European Central Bank has increased them since to 1.25 percent.

Is there a risk of a wage-price spiral?

The RBA has said that it is worried about a wage-price spiral of the kind that occurred in the 1970s. But the labour market is not producing increases in wages that are a source of accelerating inflation. After a submission from the incoming government calling for a 5.2 percent increase in regulated minimum wages, the Fair Pay Commission significantly increased regulated minimum wages. Corporate profits are at unprecedented highs, and many businesses find it expedient effectively to index wages of senior personnel. Public institutions are loathe to let salaries fall markedly in real terms—and are under trade union pressure to this effect. We will see higher average nominal wages in the ABS data. But for as long as wages lag average prices, they are a response to, and not a cause of, accelerating inflation. At some time in the future, the international pressures for price increases will ease and exercise downward pressure on Australian average prices. This will have its own moderating effect on Australian wage increases.

The possibility of a return to a virulent wage-price spiral of the kind established three and four decades ago cannot be ruled out. However, there are no signs of it now. The tightening of monetary policy would bring forward by a small amount and a small time the reduction in Australian inflation that will follow international developments.

The RBA published data from its own liaison survey of firms—less scientific but coming out more quickly than the ABS data—that 60 percent of surveyed firms are expecting wages to grow by more than 3 percent over the next year. But with price inflation much higher, real wages will fall at an unprecedented rate. Pressures from the labour market do not seem to threaten a serious wage-price spiral. Nor do data on inflation expectations suggest this as a source of pressure for accelerating inflation. The greater risk is that the tightening of monetary policy will lead to rising unemployment before full employment has been achieved, and possibly to an unnecessary recession.

Balancing fiscal and monetary policy for full employment, low inflation and the right amount of debt

It matters how we get the jobs that take us to full employment. Increased employment comes from both domestic and trade-exposed industries. Employment in domestic industries is expanded by higher government expenditure, lower taxes and lower interest rates. Employment in trade-exposed industries is driven by competitiveness—by currency exchange rates and by Australian relative to international productivity and wages. Too much domestic demand and too little export growth can lead to full employment with undesirable levels of debt. There has to be a judicious balance between domestic and trade-exposed industries.

The level of domestic demand calibrated to achieve full employment without accelerating inflation can be achieved by various combinations of fiscal and monetary policy. If reductions of demand are achieved with tighter money and looser budgets, the real exchange rate will be higher. More of the growth in employment will come in domestic and less in trade-exposed industries. Full employment will be achieved with larger amounts of public and international debt. That will reduce future relative to current living standards.

Full employment with low inflation and the right amount of debt requires judicious balancing of fiscal and monetary policy. At a time of peacetime record highs in public debt and facing immense fiscal challenges, we are relying too little on fiscal and too much on monetary tightening to reduce demand. With unemployment the lowest for 40 years, if not at full employment, and terms of trade the highest ever, one would expect budget surpluses. But the Treasury is projecting deficits forward as far as we can see.

Strong growth in export industries depends on access to international markets for goods and services, as well as on competitiveness. Here we face barriers from the breakdown of the multilateral trading system and our relationship with our biggest trading partner, China; and the coming climate-change-induced decline of coal and gas. Fortunately, Australia's potential as the energy superpower of the zero carbon world economy can allow us to bypass these blockages (Garnaut, 2022).

MINIMUM WAGE ADJUSTMENTS

What adjustment to the minimum wage should be made in 2023? In 2022, the Commonwealth supported a 5.2 percent increase to compensate for inflation. Subsequent comments by the RBA Governor have opposed maintenance of real minimum wages while inflation is well above the target range.

The annual rise in the CPI is likely to be well over 5 percent at the time of the 2023 national wage case decision. That could also be a time of weakening demand and rising unemployment following the tightening of monetary policy from May 2022.

In that situation the government would do well to consider the use of an earned income tax credit, or more fundamental change based on integration of taxation and social security arrangements around a minimum basic income payment, as an alternative to a substantial rise in nominal minimum wages to support low-income families. This was part of the Five Economists' Plan back in 1998 and has recently been put forward by Hamilton (2022) for the Jobs and Skills Summit.

There is mixed evidence about the impact of rising minimum wages on employment (Hamilton, 2022; Holden, 2022). The most famous studies of the effects of minimum wages on employment have been in the United States, including those by Card and Krueger (1994) and by Neumark and Wascher (2000). The former found positive and the latter negative impacts. Each study deals with particular situations, using particular methodologies. Generalisation of conclusions to other circumstances requires caution. One challenge of evidence-based policy is to exercise wise judgement about what evidence is relevant in each situation. There is no question that if minimum wages are raised beyond some limit, employment will be lower than it would be otherwise.

Australia's minimum wages have fallen as a percentage of the median wage since the Five Economists' Plan. They remain high by international standards. The Fair Pay Commission will no doubt consider the effect of a large increase in minimum wages on employment at a time of policy-induced rising unemployment and weakening demand.

An earned income tax credit could be designed to have a larger benefit for low wage earners in low-income families than a wage increase. It could be an alternative to complete implementation of the stage 3 income tax cuts. It could be designed to have a more positive effect on labour supply than the Low and Middle Income Tax Offset (LMITO), which is due to be removed and which benefits those on middle incomes rather than those on low incomes.

PRODUCTIVITY, REAL WAGES AND LABOUR'S SHARE OF NATIONAL INCOME

The contemporary world and Australia are experiencing an unprecedented abundance of capital as planned private savings exceed planned investment even at low or negative real interest rates. This is reflected in historically low real interest rates. Together with declining natural increase in the labour force, the standard neo-classical models would suggest rising real wages once we approach full employment. The opposite is happening in Australia.

Other factors can intervene. One is immigration. Immigration affects the link between productivity and real wages. Unlimited immigration would take us into a world in which economic output and productivity can rise strongly without lifting real wages (Lewis, 1954). Immigration is much more likely to raise rather than lower average real wages the more it is focused on permanent migration of people with genuinely scarce and valuable skills that are bottlenecks to valuable Australian production and that cannot be provided by training Australians. What is genuinely scarce and valuable? Garnaut (2021) suggests a market test: admitting skilled migrants when they are to earn wages higher than the Australian average.

A second factor is oligopoly. We have to think about the increasing role of economic rents in our economy. Productivity is reduced and the profit share of income increased by monopoly and oligopoly. Former Chairman of the ACCC Rod Sims has drawn attention to the increasing role of oligopoly in the Australian economy, and the competition policy reforms that would reduce it. In some parts of the economy, competition is not possible, or would not lead to efficient use of resources. Here we have to rely on taxation of economic rent or regulation of investment and prices to secure the public interest. A significant part of the increase in the profit share in recent years is in mining, where wages are high relative to other sectors. The appropriate public policy response is mineral rent taxation and not pressures for higher wages.

REFORMING TAXES AND TRANSFERS TO ENHANCE PARTICIPATION, PRODUCTIVITY AND THE DISTRIBUTION OF INCOME

Effective marginal tax rates and labour force participation

Since the Five Economists' Plan, labour force participation has risen significantly. In June 1998 the seasonably adjusted labour force participation of those aged 15 to 64 was 63.4 percent (ABS, 6202.0, July 1998). In June 2022 it was 66.4 percent. This is higher than the United States (61.6 percent in 2022, down from 63.7 percent in 2012), the United Kingdom (63.1 percent) and Japan (63.0 percent). However, international benchmarking indicates that it could be higher. The labour force participation rate in mid-2022 was 70.1 percent in New Zealand, 73.1 percent in Norway and 75.1 percent in Sweden.[1]

A major focus of the Five Economists' Plan was the depressive effect of high effective marginal tax rates (EMTRs) on participation. High EMTRs from our tightly means-tested social security system create disincentives to work, especially for low- to middle-income families. The five economists' suggestion of an earned income tax credit (Keating and Lambert, 1998) was designed to boost the income of low wage earners in low-income families in compensation for pausing living wage adjustments, and also to raise labour force participation and hours of work. We also argued for a long-term commitment to reduce effective marginal tax rates, especially for low-and middle-income families.

With this in mind, the Melbourne Institute developed the Melbourne Institute Tax and Transfer Simulator (MITTS) to model the labour supply effects of changes in income taxes and social security payments, and the feedback effect on the government revenues (Creedy et al., 2002).

While there have been piecemeal attempts at reform, high effective marginal tax rates causing disincentives to work remain critically important. Increasing labour force participation is more important to economic growth as we approach full employment. High effective marginal tax rates are caused by the interaction of the tax on marginal employee wages with the withdrawal of:

- the LITO and the LMITO;
- means-tested family payments;
- JobSeeker; and
- child-care payments.

EMTRs of the order of 70 percent are common. Some are significantly higher. For example, a parent in a two-earner family with two children in 2016 faced EMTRs of well over 100 percent for working beyond three days a week, due to the combination of income tax, the withdrawal of family tax benefit and the net costs of child care (Stewart, 2018). There was no incentive to work beyond three days. Changes made to income taxes and child-care benefit by the Morrison Government in 2018 and then in 2021 reduced EMTRs (Stewart, 2018; Stewart and Plunkett, 2022). But they remain around 70 percent for such a family, higher for a sole parent, and much higher for some categories of workers.

Child care and early childhood education

This takes us naturally onto child care and early childhood education. The labour force participation and hours of work of parents (especially mothers who take a disproportionate burden of child-care responsibilities) is noticeably lower in Australia than in many other developed countries. The elasticities of labour supply of mothers with children are high. Mumford et al. (2020) use HILDA data to estimate elasticities.

Wood et al. (2020) and Dixon and Hodgson (2020) show that public investment in child care would substantially increase labour supply and GDP. It could potentially pay for itself in the government's budget. Wood et al. (2020) analyse the impact of cheaper child care, making reasonable assumptions about the elasticity of labour supply. Dixon and Hodgson (2020) analyse data on the hours unpaid carers say they would like to work, and estimate the cost of boosting care to enable that to happen.

The Centre for Policy Development (2021) has proposed a policy agenda: *Starting Better: A Guarantee for Children and Young Families.* Investment in child care raises economic output both through increasing the labour supply of parents and improving the health, wellbeing and educational achievement of children and later their lifetime careers and productivity.

The policy agenda proposes, amongst other things, a guarantee of three days free or low-cost early education from birth until school, with more days available at low cost. This would shift the emphasis from child care to early childhood education, while reducing the costs to parents of paying for child care to enable labour force participation.

The proposal includes more shared paid parental leave. Wood and Emslie (2021) show that this would also boost the labour supply of mothers and increase their lifetime earnings, while boosting GDP by $900 million a year.

Later, we discuss research that would help to test the validity of the findings of the studies reported above.

A possible overhaul of the tax transfer system

Child care and early childhood education look like the single most promising avenue for boosting labour force participation. It would also be timely to undertake a comprehensive review of the tax transfer system and its impacts on labour supply and the distribution of income, with a view to increasing disposable incomes of low-and middle-income Australians while promoting participation in the labour force, and employment of low-skilled labour.

There was a moderate increase in inequality in the distribution of household income in Australia in the late twentieth and early twenty-first century (Wilkins, 2017; Productivity Commission, 2018; ABS, 2022). Increasing wage inequality had driven inequality upwards, while the progressive tax and transfer system and employment growth in low-income households tended to drive it down. Wage inequality and a large decline in the wage share of incomes and the absence of initiatives in the tax and transfer system may have exacerbated the tendency more recently—with the important temporary exception of the early period of the pandemic when the JobSeeker intervention was highly egalitarian.

In the several years from 2007 there was actually a slight reduction in inequality of household disposable income, but this was much less influential than increases in housing costs, disproportionately affecting low-income households (Coates and Chivers, 2019). One response would be policies to reduce the cost of housing. Another is to make the tax-transfer system more generous to low-income households. It was noticeable that in the period of the higher JobSeeker payments, financial stress of low-income families diminished significantly and this led to calls for ongoing significant increases in JobSeeker payments, which had been indexed to CPI, and not to average weekly earnings like many pensions and benefits. There was an increase of just below 10 percent in the Jobseeker rate in April 2021—the first real increase since the mid-1980s. Apart from budgetary and funding costs, increases in the unemployment benefit rate in the absence of other measures risks increasing EMTRs for part of the relevant income range and therefore negative effects on labour supply.

Equitable income distribution, as well as optimal economic growth, require steady full employment. They would be assisted by comprehensive reform of the tax-transfer system to increase the incomes of low-income families while increasing labour supply and reducing pressures for employment inhibiting increases in regulated minimum wages.

Guaranteed minimum income (GMI)

The idea of a guaranteed minimum income (GMI) has been explored from time to time since the early years of the Melbourne Institute in the 1960s. Dawkins et al. (1998) used NATSEM's microsimulation model STINMOD to model a universal basic income/flat tax system, which provides a guaranteed minimum or basic income, combined with a flat tax on all income earned, without any incomes or assets tests. This could be administered through the tax system, with the basic income provided as a tax credit. Payment would be made regularly into bank accounts, whether or not recipients are unemployed.

Dawkins et al. (1998) did not allow for any increase in labour force participation from reductions in EMTRs and required complete fiscal neutrality. The flat tax (which is also the EMTR in this system) was found to be 57 percent—much lower than some of the highest EMTRs in the pre-existing system, but unacceptably high. Other versions of negative income taxation systems were also modelled, incorporating varying tax rates, the tapering out of tax credits, and placing some restrictions on the granting of tax credits. This made negative income tax feasible with lower marginal tax rates.

Once the Melbourne Institute developed the MITTS, modelling the labour supply effects became possible. Scutella (2004) used MITTS to model the basic universal income flat tax system, concluding that for revenue neutrality and a single tax rate, a flat tax of over 50 percent would still be required to coincide with current benefit rates. While increasing equity, the system as modelled would reduce labour supply. Positive labour supply effects required a lower basic income.

The early estimates of the costs of a form of guaranteed minimum income were premised on 'revenue neutrality'—that is, comparing revenue receipts with what would have been received in the absence of the changes. Past episodes of taxation reform in practice have not been 'revenue neutral'. For example, the package accompanying the introduction of the GST in July 2000 had a net revenue cost of about 1 percent of GDP—corresponding to about $25 billion per annum today. The stage 3 tax cuts legislated by the Morrison Government prior to the pandemic recession in 2019 and to come into effect in 2024 are estimated by the Parliamentary Budget Office to cost about a quarter of a billion dollars over a decade.

Conditional minimum income with an employment conditional supplement

Dawkins et al. (2003) modelled a variation on this approach using MITTS in 2003. Their model was built on the then current structure of payments in Australia's social security system, with significant differences. It included an employment conditional supplement (that has a similar effect to an earned income tax credit). Minimum payments would not be guaranteed—mutual obligation conditions on receipt of the payment would remain. It did not seek to incorporate the current disability support system or the age pension system. This model gained a significant positive labour supply response at a net cost of $1.5 billion due to the fiscal dividend from the increased labour supply.

Australian income security

Garnaut (2021) revisits the idea in his paper on 'Investing in Full Employment' (Garnaut, 2002), in his proposal for Australian Income Security (AIS). The arithmetic in this proposal preceded the April 2021 increase in the JobSeeker rate. To contain the cost, Garnaut suggests excluding from basic payments resident non-Australians and people whose wealth and incomes remove any close connection between withdrawal of the basic payment and incentives to work (say income over $250,000 and net assets above $2 million). Assets could be shared among family members who have legal right to ownership of assets. Marginal taxation rates would remain at the current higher rates for people on high incomes. On the presumption that Australia would move to full employment, increases in labour force participation would be reflected directly in greater economic output and public revenue.

All eligible Australians would receive a basic payment equivalent to the JobSeeker allowance plus supplements that are reflected in the current social security system, for example, for children, disability (to the extent recognised in disability pensions), and age (as reflected in age pensions). He also proposes a supplement for being unemployed at times of high unemployment, which would not be necessary when there is full employment. Income would be taxed at the basic rate from the first dollar. This would have a much greater positive effect on revenue than at the time of Dawkins et al.'s (2003) modelling because of the large increase in the tax-free threshold in the intervening years.

Garnaut (2021) suggests that the budgetary cost of this proposal could be modelled using MITTS. Pending that detailed modelling, the net revenue cost of the scheme at the time of its introduction, when there was still unemployment, would be about 2 percent of GDP, falling to about 1 percent of GDP as labour force participation increases.

We note that the large increases in the tax-free threshold in 2011, at the time of the introduction of carbon pricing through the Gillard government's Clean Energy Future legislative package, were not withdrawn when the Abbot government repealed the carbon pricing laws in 2013–2014.

An alternative to the stage 3 tax cuts

Since the pandemic recession, the need to reduce historically high public debt, competing budgetary demands and their regressive nature, have led to widespread calls for removal or modification of the stage 3 tax cuts. They are a tax cut focused on higher incomes rather than efficiency-raising reform. Rather than simply being withdrawn, the stage 3 tax cuts could be replaced by tax reform built around introduction of something like the AIS.

A well-designed reform of taxation and social security would substantially increase labour force participation at a time of full employment, thus increasing domestic and national output and income. It would be progressive at a time when market outcomes were placing downward pressure on real wages and increasing the profit share of domestic income to unprecedented levels. The increased participation would be largest for workers subject to the highest EMTRs, who include mothers preferring to work more hours but facing powerful disincentives to doing so. The replacement would supplement wages of low-income workers. This would reduce pressures on equity grounds to raise regulated wages and so reduce growth in employment at the lower end of the labour value spectrum.

Detailed modelling using the Melbourne Institute's revised MITTS, supplemented by general equilibrium modelling from the Centre for Policy Studies, could calculate the ultimate budgetary implications of replacing the stage 3 tax cuts with AIS. We suggest a serious modelling effort.

Rent and externality taxes, as an alternative to wage regulation for equity

The Australian Council of Trade Unions (ACTU) and major unions participating in the Jobs and Skills Summit drew attention to the unprecedentedly high profit and low wage share of income and the unprecedentedly low real unit labour costs in Australia in the first half of 2022. This was seen as supporting higher regulated wages and changes in institutional arrangements for wage negotiations that would lead to higher rates of increase in wages.

The steady reduction in the wage share and real-unit labour costs over the past decade, and its acceleration in the aftermath of the pandemic recession, are undoubtedly of significance for income distribution and long-term economic performance. Increased wage regulation and changes in institutional arrangements for setting wages as discussed in the Jobs and Skills Summit should be considered on their merits, for their contributions to equitable income distribution and the rate of increase in productivity, outputs and incomes. Those contributions depend on the origins of the low and declining wage share and on the impact of various corrections on the unemployment rate that can be achieved at full employment, on growth in labour productivity, and more generally on growth and distribution of income.

Garnaut (2022) observed at the Jobs and Skills Summit that failure to achieve full employment, the level and composition of immigration, and the rising share of rents and declining share of competitive profits in domestic incomes all contribute to the falling wage share. Conscientious pursuit of full employment, refocusing immigration on high skills and permanent residence, and reform of competition policy to reduce the power and influence of oligopolistic arrangements would contribute to reversal of the declining wage share without raising the NAIRU. They would contribute to increased average incomes of Australians. However, some of the increase in profit share resulting from increasing oligopolistic income is likely to remain, as it is associated with changes in the structure of the Australian economy that are impervious to changes in competition policy. These include the increased share of mining income following the increase in the relative prices of mineral products in the twenty-first century—taken much further since the disruption of the global energy trade by the Russian invasion of Ukraine in early 2022.

Much of the adverse distributional impact of the increase in the share of oligopolistic, mineral and other rents in profits is more efficiently corrected with changes in taxation than by increases in wages resulting from changes in regulation and institutional arrangements for setting wages. Shifting the base for corporate income taxation from conventional accounting income to cash flow would allow an increase in taxation of rents while increasing incentives for corporate investment and productive innovation (see Garnaut et al., 2020). A higher rate of taxation on cash flows could be applied to mineral rents—some variation on the proposals suggested by the Henry Tax Review.

More generally, in contemporary Australian economic circumstances, there is a strong case for seeking more equitable income distribution through fiscal rather than labour market interventions. This is likely to generate lower unemployment and higher growth in household living standards. Fiscal interventions with a net cost to the revenue but advantages for economic efficiency would include increased public expenditure on child care and early childhood education and the shift to AIS.

In this context, a second theme from the Henry Review warrants new consideration in this context: the potential for taxation of external environmental costs, including carbon externalities, to contribute to public revenues while enhancing economic efficiency.

SKILLS, EDUCATION AND TRAINING

Meeting the future skills needs of the Australian economy was a central issue at the Jobs and Skills Summit hosted by the Commonwealth government at Parliament House, Canberra on 1 and 2 September 2022. Mike Keating, one of the five economists, suggested in the lead-up to the Summit, that 'low wage growth can contribute to low productivity growth' because low wage growth depresses consumer demand and in turn investment in new plant and machinery (Keating, 2022). If we could address the structural causes of low wage growth, he argued, it is entirely possible that we could 'accelerate wage growth and consequently consumer demand, which would accelerate productivity growth, giving us wage growth without a wage-price spiral'. He argued that 'technological change and globalisation have hollowed out routine middle level jobs, depressing pay in these occupations relative to higher-paid occupations'. He quoted Thomas Picketty: 'the best way to increase wages and reduce wage inequalities in the long run is to invest in education and skills' (Picketty, 2016)

Skills shortages were much discussed at the Jobs and Skills Summit. The reductions in unemployment between mid-2020 and mid-2022 were accompanied by strong increases in the number of vacancies. Employers expressed extreme difficulties in filling vacancies. Areas of skill shortage that have been widely publicised include teaching, nursing, aged care and IT workers to name a few. Employers' difficulties in recruiting unskilled workers at wages that they are prepared to pay are receiving similar attention, for example, farm labourers and general workers in the hospitality and care sectors. Employers have become accustomed to recruiting unskilled and skilled workers alike from developing countries with low wages and poor conditions in the twenty-first century and especially in the years immediately preceding the pandemic. Many businesses depended on continuing inflow of immigrants on conditions inferior to established Australian levels. These businesses are in difficulty as immigration policy again focuses on people with reasonable prospects of contributing to increased economic welfare of Australians, and to enforcement of established Australian laws and practices. Many will not survive scrutiny of immigration from an Australian national perspective and will release demand for labour to more productive enterprises able to offer higher wages and conditions.

A genuine shortage of skills would survive a disciplined adjustment of immigration to the needs of the Australian economy. The National Skills Commission, to be superseded by Jobs and Skills Australia, produces a skills priority list, based on its assessment of skills shortages and ongoing analysis of trends in the labour market to support education and training policy.

There is also a very strong case for strengthening the education and training system to meet skill needs, enhance workforce productivity and real wages. It is necessary for growth in productivity and output. The case for investment in skills is stronger with full employment. Employment forecasts indicate that most jobs of the future will require a tertiary education qualification of some type, that is, a vocational education and training (VET) qualification and/or a higher education qualification. We will need a high-quality tertiary education system, available to all, offering both initial tertiary qualifications for school leavers and qualifications and micro-credentials to re-skill or upskill mature aged workers.

While on most measures the higher education system is of high quality by international standards, it is only average when it comes to collaborating with industry (Bean and Dawkins, 2021). This provides considerable scope for investment in the system that will enhance the value of higher education qualifications.

The VET system, which has had a tradition of working closely with industry, has been in decline, suffering from inadequate funding and excessive numbers of low-quality providers not adding much to the skills of its students. This has resulted from inadequate regulation and poor market design The VET system needs more investment and a greater focus on quality assurance and improvement (Hurley and Picher, 2020).

A review by Noonan et al. (2019) of the Australian Qualifications Framework (AQF), which applies to both the VET and higher education systems, finds that the AQF is not fit for purpose for the workforce of the future. Alongside a reformed AQF, Bean and Dawkins (2021) propose the development of a national skills taxonomy with rich skill descriptors, which can blend with the AQF. They have proposed an associated national credentials platform that enables students, employers and employees to define more clearly the skills they need and the credentials that will foster them.

These proposed reforms to the architecture of tertiary education, would help ensure that education and training providers more effectively meet the needs of students, employers and employees, and enhance the market for skills and qualifications.

Differences in funding models for higher education and VET, and differences between different jurisdiction in the funding of VET, as well as the lack of income contingent loans for VET courses, also create distortions in choices between VET and higher education. Noonan and Pilcher (2015) and Higgins and Chapman (2015) have explored funding reforms to remove these distortions and create greater harmony between VET and higher education.

The Mitchell Institute and others (see, for example, Dawkins et al., 2019), have been undertaking a major program of research to help design such a new tertiary system, much of it led by the late Peter Noonan. A joint project of the Mitchell Institute and the Centre for Education and Training at the Australian Industry Group draws this together into a flexible plan for the future. This should provide an evidence-based policy agenda to enhance skills and productivity in Australia.

CONCLUSIONS AND THE NEED TO FURTHER DEVELOP THE EVIDENCE BASE

This chapter puts forward a broad policy agenda for the new Albanese Government in its pursuit of full employment, increased labour force participation and enhanced skills and productivity, while seeking a fair distribution of income. It draws on previous policy analysis by the authors and the findings of many empirical studies.

Australia needs a major economic reform agenda to get to full employment and to raise productivity and participation, to enable sustained economic growth and enhanced real wages. This must be undertaken while restoring the strength of Australian public finances in the face of challenging international economic and geopolitical circumstances and domestic demographic tendencies. This will inevitably require a substantial increase in the share of taxation revenue in GDP, alongside public expenditure reductions in areas that have low or negative benefits for equity and economic efficiency. We need tax reform to raise productivity and participation and to increase public revenue.

In crafting this chapter, we have been mindful that economic policy needs to have clearly defined objectives, a theory of how policy works and evidence against which to test and refine that theory and the policies that flow from it. Policy needs to be constantly evaluated. That is how we see evidence-based, or evidence-informed policy.

Evidence-informed policy is multi-dimensional. It requires well-defined objectives. It takes advantage of empirical evidence about how previous policies have worked, natural and deliberate policy experiments, and simulation modelling.

In suggesting reforms to deal with contemporary economic and social challenges, we have drawn on earlier studies of the likely effect of similar policies. More detailed estimates of the likely effects of such policies can be obtained through simulation modelling. The Melbourne Institute and the Centre for Policy Studies have put together a proposal to join the Melbourne Institute's MITTS and CoPS dynamic CGE modelling to simulate the economy-wide effects of such policies. MITTS would need to be integrated with the HILDA Survey. HILDA provides data on child-care costs and labour supply, which will enable MITTS to estimate labour supply responses to changes in child-care costs.

Such analysis would also take into account the constraint that would be imposed by a limited supply of child-care workers and early childhood educators. This should guide the speed of introduction of such policies and suggest the wage increases that may be required to secure the early childhood workforce to make this policy work. The same modelling technology can also be used to examine the likely effect of an overhaul of the tax-transfer system to reduce effective marginal tax rates.

We have covered many other issues in this chapter and drawn on a range of evidence in proposing policy directions. In considering these suggestions, policy-makers would be wise to draw on modelling and sometimes policy experiments.

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