CHALLENGING THE NEED FOR UNEMPLOYMENT

Any inflation targeting policy creates and maintains unemployment (by suppressing aggregate demand) as a policy to promote price stability. Political demands for government fiscal austerity, based on claims national debt is a burden and economic activity is constrained by government spending and taxation, makes unemployment worse. The idea that unemployment is needed by society must be challenged.

The main points:

- A government that issues currency has the power to respond to economic risks in order to achieve socially desirable outcomes.
- Economic models currently used by policymakers fail to adequately describe the workings of the economy or determine which policies lead to socially desirable outcomes.
- The government can pursue policies of full employment with price stability.

A CURRENCY ISSUING GOVERNMENT

The term 'household finances' (a rephrasing of the Attic Greek οἰκονομία – from which 'economics' is derived) does not adequately introduce the modern complexity of fiat currency, vested interests, globalisation, industrial relations, corporate structures, human behaviour, ideological differences, (dis)regard for environmental damage, and debatable outcomes of political systems.

Some commentators say that governments are like households and should have balanced budgets, as well as low national debt and defined limits to government spending as a proportion of gross domestic product (GDP). Economists have not helped with different schools of thought offering models and theories that disagree with each other and sometimes contradict themselves. The models being used by these commentators and economists misunderstand a basic fact. Economics is a social field of study – not a study of fundamental truths that are proved by repeated empirical confirmation.

Currency issuing governments are not like households.

A government that issues currency has the ability to respond to economic risks in a manner that a household cannot. An elected government should always be held accountable by the society it serves.

Economic risk is the possibility of some irregular condition adversely affecting economic outcomes. This means that the effectiveness of a government's expenditure and taxation policies in achieving socially desirable outcomes will be affected by short-lived or long-term shocks, distortions and inefficiencies.[1]

The importance of government to societal outcomes, and the problem with popular models and theories, suggest adopting a heterodox definition of economics is justified.

> Economics is the study of the social creation and social distribution of social resources.[2]

ECONOMIC MODELS ARE BASED ON ASSUMPTIONS

To respond to economic risk society requires accurate explanations of how the economy actually works and which policies result in preferred outcomes. However, economists and economic commentators have differing opinions resulting in statements like the following:

- "Lower taxes are better", and
- "Lower wages will increase employment".

These two statements, appear reasonable because they purport to have an economic basis. This basis is a reductive (ignores relevant variables) or deductive-axiomatic (creates a self-evident result) economic model. By ignoring the complexity of the economy these statements become invalid.

The notion that lower taxes are superior is based on the assumption that higher taxes infringe upon an individual's right to allocate their income as they choose. This premise implies that higher taxes have an economic impact by reducing income and investment, despite the lack of sufficient supporting evidence.[3]

The argument that higher employment can be achieved with lower wages assumes that a reduced production cost enables increased production and consequently more employment. However, this argument ignores how lower wages decrease consumers' income, thereby reducing demand and suppressing production, while implying that employees prefer lower wages more than higher wages. There is no evidence that lower wages encourage more people to seek employment, or existing employees to work more hours/jobs. However, there is evidence that people will have multiple low paying jobs out of necessity.

Arguments for lower taxes and lower wages assume all parts of the community are affected equally. This is not true. Low-income earners cannot benefit from lower taxes. Lower taxation reduces a government's ability to structure taxation and expenditure policies for the benefit of the community. The benefits of tax reductions disproportionately accrue to high-income earners. Low wages drive poverty and inequality, which are known contributors to poor social outcomes for individuals and macroeconomic under-performance.[4]

The Expansionary Gap and Non-accelerating Inflation Rate of Unemployment

The expansionary gap and non-accelerating inflation rate of unemployment (NAIRU) are examples of failed reductive or axiomatic models in current use by policy makers.

The expansionary gap (inflationary gap) exists when actual gross domestic product (GDP) is greater than potential GDP. Potential GDP is defined to occur at a level of employment that is below the total number of persons that could be employed at the existing size of the labour force and existing technological level. For actual GDP to exceed potential GDP there must be some spare productive capacity.

With spare capacity businesses can anticipate longer-term growth and shorter-term increases in demand by increasing the utilisation of capacity without increasing average costs. Only at the point all businesses are operating at maximum capacity and the total number of persons that could be employed are employed should inflation be expected. The expansionary gap model assumes the economy cannot operate at a level of employment above some theoretical level without increasing inflation.[5]

Full employment is defined using the Phillips Curve based concept of a non-accelerating inflation rate of unemployment. The Phillips Curve proposes a trade-off between inflation and unemployment. The NAIRU is that rate of unemployment that is consistent with potential GDP, thus is biased towards higher rather than lower unemployment. However, when the complexity of the economy affects the nature and interpretation of the data being used the NAIRU value derived will be unusable as a policy tool.

The Treasury paper referenced below makes adjustments for a range of structural changes in the economy, such as: an increasing importance of underemployment, changes in the stability of inflation and in inflation expectations,[6] the impact of global economic conditions (the Global Financial Crisis and covid-19), and evidence that Phillips Curve has 'flattened', resulting in inflation becoming less sensitive to unemployment.

Structural change affects both the expansionary gap and the level of the NAIRU, which means if they are to have any policy use, they must be re-calculated regularly for past, but not future periods.

The Treasury seems to recognise that the NAIRU has no real policy value because estimates lack precision and have no predictive value:

"The NAIRU is a latent (unobservable) variable and point estimates of the NAIRU typically come with large confidence intervals, with even larger intervals around endpoints" (The Treasury 2021: p26).

The expansionary gap and non-accelerating inflation rate of unemployment models do not explain how, why and when inflation and changes in unemployment occur.

The expansionary gap reduces the cause of inflation to an assumption of too much demand by assuming employment cannot increase as production responds to the increased demand, without explaining what caused the increased demand and increased production. The assumption that potential GDP must be lower than actual GDP creates an axiomatic conclusion.

The NAIRU model reduces the cause of inflation to an assumption of too much employment. The preferred level of unemployment is calculated using actual unemployment modified by variables believed to influence inflation. Estimates of NAIRU are not useful and can be disproved by observation. For example, from the December 2022 quarter onwards, unemployment has been below the estimated NAIRU of 4.25% (a 2019 value from Treasury 2021) and inflation has been falling.

Neither of these models provides accurate explanations of how the economy actually works or which policies result in socially preferred outcomes.[7]

Economic Policy or Something Else?

The difficulty of calculating the NAIRU presents a problem for the Reserve Bank of Australia (RBA) in setting its inflation targeting policy. If the RBA accepts a NAIRU lower than the current level of unemployment, there is less justification for increasing the official cash rate (OCR) – on the basis that the relatively high unemployment should be moderating inflation.

The RBA's justification for raising the official cash rate (OCR) becomes more compelling if they assert that the unemployment target (NAIRU) is higher than the current level of unemployment. In such a situation, raising the OCR becomes a nearly automatic (institutional or ideological) response to rising or high inflation. The preferred justification for lowering the OCR is an increase in unemployment, irrespective of other relevant factors.

One of the relevant factors being ignored is the flattening of the Phillips Curve. Inflation is less sensitive to unemployment now compared to the past. Unemployment might not increase, but inflation falls. The RBA effectively adopts a policy that purports to have an economic basis.

For reference, in the March 2022 quarter unemployment was 3.97%, the OCR was 0.10% and inflation was 3.79%. Inflation peaked at 6.76% in the December 2022 quarter, then began to fall. Unemployment in the December 2024 quarter was 3.98%, the OCR was 4.35% and inflation was 3.23%. (Sources: RBA Table F1.1, ABS A84423050A from 62002001 Table 1 and A3604509L from 640106 Table 8.)

Taxes Do Not Finance Spending

A government that issues currency has two unique characteristics: it cannot impose taxes without first spending money and doesn't need to impose taxes to spend. Consequently, the household constraint, which states that spending plus saving cannot exceed income plus borrowing, does not apply to the government.

The government fiscal constraint given by the following identity does not describe how the government finances its spending:

$$G + iB = T + \Delta B + \Delta M_h$$

where G is government spending, iB is interest paid on existing debt, T is tax revenue, ΔB is new borrowing through government bonds, and ΔM_h is net crediting of reserve accounts at the central bank (Mitchell 2019: p333).

The government cannot control its tax revenue, any unplanned spending, and how much cash the private sector prefers to hold over interest earning bonds. [The role of central bank reserves is not being mentioned because budget deficits are usually close to the value of additional bonds issued.] The equation above cannot explain how the values of T, ΔB and ΔM_h were determined by the economy.

Since government revenue does not determine government spending, fiscal policy can be designed to be countercyclical, meaning it adjusts to the ups and downs of an economic cycle over multiple accounting periods. This can involve deficits during recessions and surpluses during expansions.

Taxation policy and spending policy are entirely different and separate policies.

During a recession, a deficit is likely to maintain employment, reduce income inequality, and stabilise prices, among other desirable outcomes. Conversely, during an expansion, a restrictive fiscal policy can moderate undesirable outcomes.

The government can pursue policies of full employment with price stability. This is possible because spending drives output and income, which then drives employment. Taxes reduce the private sector's spending on real resources, which then become available for public sector use. A pool of unemployed persons (labour not wanted by businesses) provides a counter-cyclical employment buffer. Inflationary pressures are kept low by only utilising unused real resources within the productive capacity of the economy.

Employment is a human right (United Nations, 1948).

CONCLUSION

Economic theories and opinions that treat a currency-issuing government as a household and employ reductive and axiomatic models do not explain how the economy works or which policies result in socially desirable outcomes.

By recognising taxes do not finance government spending, fiscal policy can be used to generate full employment that does not exceed the real productive capacity of the economy or create inflationary pressure in the form of price and wage increases.

Society can choose appropriate economic policies that recognise the human rights its members.

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ENDNOTES

1. This definition of economic risk is an oversimplification of a complex inter-disciplinary field that (probably) includes political science, jurisprudence, geography, meteorology and sociology. A narrow definition is useful to confine attention to the role of economics.

2. See Mitchell, Wray, Watts (2019) p. 7. Chapter 1 delves into the shortcomings of the neoclassical definition, which hinges on the notion of resource scarcity.

3. See The Australia Institute (2020), for an analysis of the effect of tax on economic well-being.

4. The OECD paper (2015) provides an analysis of the gap between rich and poor, identifying where new policies are needed.

5. There is no precise definition of the expansionary gap. It is a latent (unobservable) variable that can be estimated using a variety of statistical methods each with different characteristics. It can be based on supply curves that are short-term (increasing demand results in inflation), medium-term (additional investment accommodates growing demand) and long-term (technological progress and labour supply growth increase potential GDP). Economists are not very good at explaining why the economy can respond to population growth in the long-term, but the economy cannot respond to the extra demand resulting from population growth in the short-term.

6. This premise suggests that inflation expectations are anchored around the Reserve Bank of Australia's (RBA) inflation target, which ranges from 2% to 3%. Consequently, inflation becomes less sensitive to changes in

unemployment. Higher or lower unemployment doesn't have a significant impact on inflation. Anchored expectations contradict the assumption that increasing unemployment to or above the non-accelerating inflation rate of unemployment (NAIRU) will lead to lower inflation. The anchored expectations model fails to explain how inflation initially surpasses the RBA's target. Inflation expectations are a latent variable that can only be estimated from sources with known limitations, such as inconsistent timeframes and a lack of information about future events.

7. Other flaws with these models include: time is a discrete variable (economic activity is largely asynchronous), data sources do not have consistent reference periods, the difference between stocks and flows is ignored, international sources of price increases are ignored.

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