What's A Job?

KEN PHILLIPS

NAIRU Bound

From the late 1950s until recent times, economists held to a theory called NAIRU, the non-accelerating inflation rate of unemployment. The theory was that there is a fixed level of unemployment below which an economy could not go without causing wage-induced inflation. This, in turn, meant that macroeconomic planners needed to use their power over the setting of interest rates and other instruments to ensure that the pace of economic growth avoided reaching a level that would push the unemployment rate below NAIRU and result in wage-push inflation. The acceptance of NAIRU theory led to governments giving their central banks inflationary and unemployment goals, and sometimes targets. Indeed, Australia did so until the late 1990s.

It's an unfortunate idea because it implies that there must always be a pool of unemployed people if inflation is to be kept in check. If this is correct, it would appear to assign a certain percentage of the population to unemployment—albeit for the public interest.

Through most of the later half of the twentieth century, the evidence seemed to support NAIRU. But from the late 1990s and into 2004, the evidence began to change. Excluding Germany and France, most OECD countries appear to be achieving low inflation with unemployment rates below the perceived NAIRU. The question is why?

NAIRU derives from traditional theories of labour economics, where labour is seen to be in a constant battle with capital over who shares the spoils of the firm. When unemployment is high, the fear of unemployment causes the employed to restrain their demands for higher wages and so wage-induced inflation will be capped. When unemployment is low, the employed will have greater bargaining power and so can extract higher wages from the capitalists. It's a macro view that fits macro-models used by macro-economists.

But to understand wage-induced inflation it's necessary to dig into microeconomics to understand behavioural patterns in the firm.

Every firm has a theoretical potential to pay endlessly high incomes to its staff and dividends to its shareholders. But the prices a firm can charge for its goods and services are dictated by markets, not by their costs. The market will pay only a certain amount for goods and services, thus restraining the potential income of the firm and thus limiting the available money a firm can pay either in wages or dividends. Further, every firm competes in different market segments and so the pool of money available to each firm for distribution will vary endlessly across an economy. Pretty obvious stuff really!

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What happens with wage-induced inflation is that market signals at the individual level of the firm are prevented from penetrating inside the firm. The dynamics and politics of labour relations ignore market signals and push the price of labour beyond the firm's market signals. The firm's response is to push its prices up, hoping that it won't lose market share. When this distortion of market signals occurs systemically across all firms in an economy, they can ignore those signals, and push up prices while retaining some market share balance.

Inflation escalates and macroeconomic managers are forced to suppress economic activity and to push up unemployment, thus scaring labour into curtailing their demands. NAIRU applies, but it's a pretty crude way of running an economy!

What appears to have changed is that labour has become more aware of, and responsive to, the external market signals experienced by firms. This is happening for a number of reasons relating to both cultural and structural issues. The alleged 'deregulation' of labour markets underway in many economies is, in fact, a shift to a different type of labour regulation—one that is more in sync with the regulation applied to free markets. It's most obviously witnessed in the shift to enterprise or individualized employment contract settings and in the movement away from employment contracts to commercial contracts in the engagement of people to do work. These come in many shapes and forms.

NAIRU has most relevance where labour processes ensure that market signals stop at the door of the firm. Where labour regulation facilitates internal response to market signals, NAIRU diminishes in relevance.

If the current trend can be understood and encouraged, we may yet see the day when unemployment will be restricted to the sick and those in job transition.

Ken Phillips is a workplace reform practitioner who promotes the principles of 'markets in the firm'.

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