# QUARTERLY WAGE INDEXATION AND INCOME SHARES(1)

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## Introduction

Quarterly adjustment to wage and salary incomes has, at first glance, an intuitive appeal as a means of protecting real living standards from erosion through inflation. A further look shows that this benefit accruing to wage and salary earners comes at a cost. Normally, there is at least room to argue about the relative strengths of the costs and benefits, but the Australian economic situation at the end of 1974 and the prognosis for early 1975 is far from normal. This paper argues that the economic costs of introducing wage indexation at this time have risen sharply from the levels of twelve months earlier when many of the formal cases proposing its introduction were prepared. On an economic cost-benefit basis it may be argued that the economic costs of introducing indexation now far outweigh the potential benefits.

## Some background

Automatic quarterly adjustments to the basic wage in proportion to movements in a retail price index were introduced in 1921 and continued until 1953. Automatic adjustments were introduced out of a concept of the base wage as being a needs wage and the desire to ensure that the needs incomes were not eroded by prices. The system was abolished mainly because, over time, the basic wage became no longer a needs wage but became based on a concept of economic capacity to pay. The Courts felt that the further it had moved from relating the basic wage to the fulfilling of any particular standard of needs, the less had became the justification for keeping the nominal wage automatically adjusted. Other reasons given by the Court for discontinuing indexation were: the belief that "undoubtedly quarterly adjustment had been an accelerating factor in the rapid increase in prices in the years 1951 and 1952"; the influence of overseas (particularly commodity) prices; and the administrative burden of applying the scheme.

Following rejection of the prices and incomes referenda in late 1973, union pressure increased for the reintroduction of a quarterly cost of living adjustment to earnings and a (further) application was lodged with the Australian Conciliation and Arbitration Commissioner. The Australian Government backed the claim in the 1974 National Wage Case, supporting a scheme of quarterly indexation to all wages by an amount equal to the cost of living adjustment to the minimum wage.

Some arguments FOR wage indexation

Some of the common arguments cited in favour of indexation (e.g. in a paper[1] prepared by the Department of Labour and commissioned by Clyde Cameron for the Industrial Peace Conference in January) include the following:

(i) it formalises the relationship between wages and prices but is unlikely to affect the relationship between wages and prices that would normally exist;

(ii) it may lead to moderation in wage demands as unions would no longer base claims on the highest expected rate of inflation;

(iii) it may lead to greater industrial stability, and

(iv) with this stability, firms may follow more efficient planning, therefore increasing efficiency and having a dampening effect on the rate of inflation.

... and some AGAINST

Correspondingly, some of the common arguments used against wage indexation, and particularly that form of indexation supported by the Federal Government in the 1974 National Wage Case, include the following:

(i) quarterly indexation speeds up the adjustment between prices and wages from what it would otherwise be and may lead to faster price rises;

(ii) through shielding people from inflation it creates an atmosphere of indifference to inflation;

(iii) being a system of flat adjustments based on the minimum rather than the total wage it would compress relativities and may tend to increase industrial unrest as unions seek to restore relativities;

(iv) it may hamper demand management policies by building into the wage system cost increases initiated by the Government through taxation or other budgetary measures in an attempt to ease demand pressures;

(v) indexation of only wages magnifies the inequalities and distortions associated with rapid inflation by "squeezing" those whose incomes are not indexed i.e.

1. See Department of Labour, "Wage Indexation for Australia?" a discussion paper, Australian Department of Labour, Melbourne, January 1974.

those on fixed incomes, those deriving incomes from real or financial assets, etc. To avoid this, all incomes would need to be indexed, but this requires perfect indexation - indexation of taxation, assets and liabilities, interest and rents, payment of interest on currency, maintaining profit margins constant, etc.

Other arguments for and against could be cited and many of those mentioned could be challenged but the rest of this paper concentrates solely on developing some of the implications of this last point (point v). The arguments of this paper relate firstly to the inherent problems of "partial" indexation and secondly, to the particular problems of introducing a system of partial indexation at the present time.

## Some problems of "partial" indexation

Many of the problems of partial indexation ("partial" being used here to refer to the indexation of only one part of total incomes, i.e. wages and salaries) arise out of its inflexibility and particularly its inability to recognise the influence of the business cycle on wage and profit shares.

Typically, over the period of a business cycle, we may expect labour's share of total earnings to decrease in the upswing and to increase in the downswing. Conversely, company profits typically increase on the upswing and decrease on the downswing. The reason is that most forms of incomes, excluding company profits, are fairly "sticky" in the downward direction. As the growth in total real income slackens, this stickyness in the non-profit components ensures that the adjustment is taken by company profits as they are squeezed between the fall in total incomes and fairly stable non-profit incomes.

What, then, may be the effects on this fairly typical cyclical behaviour of a system of partial incomes indexation? To answer this, we should note the fact that wage indexation is designed to, and has the effect of maintaining the real value of wage rates over the business cycle. Unions attempt to maintain this value in the absence of indexation by, quite properly, introducing price changes into wage negotiations but indexation is likely to be more efficient in achieving this stability of real wages than union negotiators for two reasons. Firstly, the lag between price rises and their passing into wages is likely to be shorter and secondly, the weakened bargaining power that unions suffer during periods of high unemployment, and particularly for the industrially weaker unions, may result in their accepting wage agreements that do not fully reflect price rises. Thus, indexation may be expected to be more effective in maintaining the real value of wage rates. Therefore, with indexation, real wage rates may be expected to be more inflexible over the period of a business cycle, varying in accordance with movements in productivity but not with movements in prices.

The important implication of this is that as total real incomes fall, as they do during a downturn in the economy, and if the indexed components of income maintain their real levels then an additional squeeze is imposed on the non-indexed components of income. All the non-indexed components of income will be squeezed, but the additional squeeze will be particularly felt by company profits. There are several consequences of this, both of which affect employment. Firstly, with higher real wages, as profits decline firms may economise on labour and secondly, with lower profits, lower cash flow and reduced potential for profits, firms may be more hesitant in investing in plant and equipment, so reducing employment opportunities in the future.

Thus, some of the economic costs of a system of partial indexing of incomes may be higher unemployment and lower business investment than would otherwise be the case.

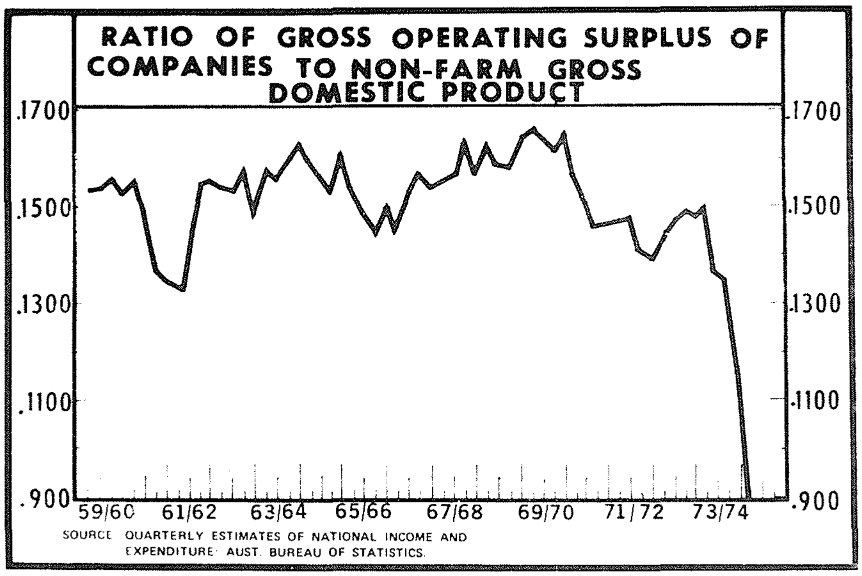
## Some extra costs in doing it NOW

The economic costs of the previous section are inherent in any system of partially indexing incomes. This section points to the slightly different and quantitatively much larger and more serious cost that could arise if a system of wage indexation were to be introduced in the current economic situation. It is precisely this cost that has not been included in the various assessments of indexation schemes so far put before the Conciliation and Arbitration Commission.

There are two main features of the present situation that make it a particularly unfortunate time at which to introduce a system of indexation. They are:

(i) the wages share of national income and the profits share of national income have moved sharply, over the past year or so, from their historical levels. The following graph indicates the extent of the recent decline in the profits share. In particular, it is seen to have declined more rapidly and further than during the 1960-61 decline in economic activity. Many factors have contributed towards this fall in the profits share including, on the one hand, Australian Government support of claims for increased wages, longer leave provisions, holiday loadings, etc. and, on the other, the activities of the Prices Justification Tribunal;

(ii) the current trends in prices, earnings and output that offer little prospect for a sharp upward movement in the profits share in the immediate future.




The additional costs of introducing wage indexation at this time arise from the assertion that the current incomes shares are in disequilibrium. On ideological grounds, some may dispute this assertion but on economic grounds it can be argued that the current profits share is not sufficient to provide a level of capital formation consistent with the historical growth and full employment aspirations of the Australian economy; that profits are insufficient to generate the cash flow for many firms to be able to maintain their investment programs. This situation is exacerbated by some company taxation provisions, particularly those relating to the valuation of stocks, and high yields available on competing assets but nevertheless the rapid recent decline in private business investment, curtailed building programs, corporate failures etc. and the sharp increase in the level of unemployment lend support to the assertion that the current profits share is in disequilibrium.

The Australian economy has traditionally proven to be fairly resilient and major disequilibria tend to be corrected, generally at some cost. What then are likely to be the main adjustment mechanisms through which the profits shares in national income might be expected to return towards equilibrium? Two of the main mechanisms include the following. The first is an adjustment in the comparative rates of return in labour inputs and on output. One of the factors underlying the decline in profits has been the price of labour increasing more rapidly than prices generally. To restore the profits share towards its previous levels one might expect a catching up period during which prices generally move ahead of, or closer to, wage rate increases. The second adjustment mechanism is that of productivity which typically increases rapidly in the earlier stages of an economic recovery.

An important effect of quarterly wage indexation would be to negate the first of these two adjustment mechanisms and so appreciably prolong the period over which the income shares might be expected to return to more normal levels. Indexation of wages may prolong the economic recovery and during this period some additional costs of quarterly indexation of wages would become apparent. These costs would be in the form of markedly lower prospects for investment and employment opportunities, and of markedly higher unemployment than would otherwise be the case.

These effects of wage indexation could be expected to be the worse:

(a) the more general is the concept of wages that is being indexed. That is, the impact of indexing average weekly earnings could be more damaging than the impact of indexing minimum wages - even after allowing for an increase in industrial unrest that may follow the greater compression of relativities that would follow an indexation based on minimum wages, and

(b) the more the profits share is in disequilibrium at the introduction of indexation.

## Conclusion

One of the main costs of introducing wage indexation in the first half of 1975, as is the proposition, is that it seems likely to prolong the recovery in economic activity. It may lead to lower levels of business investment and employment than would otherwise be the case and to higher levels of unemployment than would otherwise be the case. These effects could be severe.

In summary, at first glance wage indexation looks appealing as a means of maintaining real living standards in the face of rising prices. But in the current state of economic disequilibrium, the inflexibility of indexation, the impracticability of full indexation and the consequences of partial indexation appear to diminish the prospects for its successful implementation.

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(1) This note was intially written in late November 1974 and some issues have subsequently received wider attention: the study is not a comprehensive examination of the wage indexation proposals but looks at only one of the many issues involved. The opinions reflect the personal views of the author and are not necessarily shared by his employer or his colleagues.

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## INFLATION AND FULL EMPLOYMENT

The 1970 proceedings of the Per Jacobsson Foundation were on the topic "Towards a World Central Bank". In introducing his written paper the American W. McC. Martin, a former President of the New York Stock Exchange and recently retired as Chairman of the Board of Governors of the Federal Reserve System, commented on the inflation problem.

Unfortunately the problem has become much worse since he spoke. The following brief extract is worth repetition four years later as it expresses an informed conviction whose truth is at last becoming widely accepted:

> "There are two schools of thought that have developed since the full employment concept was accepted generally by governments. One school was that you can only have high levels of employment with inflation; that there is a trade-off between unemployment and inflation. The other school of thought - to which I happen to belong, and, while they aren't here to defend themselves, I think that both Per Jacobsson and Lord Keynes would also be in that school - is that it is not possible to have high levels of employment on a semi-permanent basis with inflation. Inflation disrupts and undermines and dislocates in such a way that whatever employment is created by it is only temporary. Therefore, if we do not find means of resisting this inflation and keeping it under control, we are not ever going to attain the full employment goal that all of us are striving for. I state this as my conviction.



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