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2 Can Government Create Employment?

Introduction
This chapter attempts to answer the following question. Can government use economic policies to influence significantly the levels of private sector employment and unemployment in a relatively small open economy such as Ireland? It should be noted that the question differentiates between the concepts of employment and unemployment. If the total labour force were constant then this distinction would be trivial as a rise in employment would imply a fall in unemployment. However, an important feature of the Irish economy is that the labour force may not be independent of the level
spend it so sparingly that opportunities of national development are missed or national efficiency is lost instead of being increased.3

3Quoted in Fanning, p. 196.

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REFERENCES


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Introduction
This chapter attempts to answer the following question. Can government use economic policies to influence significantly the levels of private sector employment and unemployment in a relatively small open economy such as Ireland? It should be noted that the question differentiates between the concepts of employment and unemployment. If the total labour force were constant then this distinction would be trivial as a rise in employment would imply a fall in unemployment. However, an important feature of the Irish economy is that the labour force may not be independent of the level of economic activity. If the numbers seeking work increase with job availability then policies designed to create employment may not necessarily lead to significant reductions in unemployment as new jobs may be filled by additions to the labour force rather than by the existing pool of unemployed. A second point to note is that the question specifically refers to a small open economy; that is, an economy whose total output is small relative to that of its major trading partners and in which international trade accounts for a large proportion of its economic activity. As we shall argue below, the relative size and openness of the economy may be significant in determining the effectiveness of government policies.

Causes of Unemployment
An analysis of the causes of unemployment is an important prerequisite to any discussion of government’s ability to create employment. Two approaches to unemployment may be identified – a Keynesian approach and a monetarist approach.1

(i) Keynesian The Keynesian analysis starts from the hypothesis that the level of employment is closely related to the economy’s aggregate output of goods and services. Aggregate output is produced by utilising factors of production such as labour, land and capital equipment. When the level of output is low then the demand for labour will be low and unemployment will be relatively high. Hence government policy should be directed towards stimulating domestic production in order to increase the use of productive resources. In the Keynesian model this objective is best achieved by boosting demand for the economy’s output. Hence unemployment is caused by a deficiency of aggregate demand and can be reduced by appropriate demand management policies. In other words, a particular employment target implies a rise in output which can be most readily achieved by stimulating demand.

(ii) Monetarist The monetarist approach to unemployment does not deny a close relationship between employment and output. Nor does it deny that demand management policies can successfully reduce unemployment for given periods of time. The point of contrast between monetarist and Keynesian approaches is that the former puts stronger emphasis on the real wage as a determinant of the levels of unemployment and employment. The real wage is the money wage relative to the

price of output. To make increases in output and employment profitable it is necessary that the real wage should fall. That is, the rate of wage inflation should be less than the rate of price inflation. In monetarist models such a state of affairs is only possible for relatively short periods of time. Monetarists assume that labour (i.e., unions) is primarily concerned with real wages and once they realise that purchasing power is being eroded by higher prices they will force an increase in money wages even though this may mean a rise in unemployment.

An alternative way of specifying the differences between the two approaches is to regard the Keynesian model as one in which output and employment are demand constrained and the monetarist model as one in which supply, or cost, conditions play a key role. In the following section we shall consider the effectiveness of monetary and fiscal policies as means of increasing employment in a Keynesian model. Later sections consider the significance of the openness of the economy and the question of employment and wages in the context of incomes policy.

**Demand Management Policies**

Demand management policies may be classified into monetary policy and fiscal policy. Monetary policy is concerned with changes in the nominal money supply while fiscal policy is concerned with discretionary changes in the government’s fiscal deficit, i.e., the excess of government expenditure over revenue.

(i) **Monetary Policy** The causal relationship between monetary policy and employment can be illustrated as follows:

- Increase in money supply → fall in interest rates → rise in consumption and investment demand → rise in output and employment, i.e., an increase in the quantity of money initially reduces interest rates. Consumption (households') and investment (firms') expenditures are inversely related to interest rates so that a reduction in 'the cost of credit' stimulates demand. To meet the increase in demand output must rise, thereby increasing employment. Given this line of causation it is obvious that the effectiveness of monetary policy is crucially dependent upon the Central Bank's ability to influence domestic interest rates. Most economists agree that a small economy which maintains a fixed exchange rate with the currencies of larger countries (such as Ireland's membership of the EMS) cannot pursue an independent monetary policy.² For example, if the Irish pound is fixed in value against major European currencies then given the relative size of Ireland's financial sector, domestic financial conditions (including interest rates) will be strongly influenced by external developments with the consequence that the Irish Central Bank has limited ability to establish monetary conditions which differ significantly from those prevailing on the major European markets. It follows that monetary policy cannot be considered as a useful means of promoting employment in an economy such as Ireland.

(ii) **Fiscal Policy** Fiscal policy can be measured by the government deficit or the difference between government spending and taxation. The causal relationship between this deficit and employment may be illustrated as follows:

- Increase in fiscal deficit → increase in disposable incomes → increase in demand → increase in output and employment. To illustrate the way in which fiscal policy works consider an increase in the deficit caused by a rise in government expenditure (e.g., building new roads, increasing social security benefits etc.) or by a reduction in tax rates. In either case the general level of disposable (net of tax) incomes will be increased. As incomes rise the demand for goods and services will also rise with the consequence that the economy moves to higher levels of output and employment.

For example, suppose the government decides to expand the public sector housing programme. The direct effect of this rise in government expenditure will be to stimulate the building industry. More building workers will be employed and construction firms will increase orders for building materials. This direct stimulus increases the incomes of those employed in the construction industry and related trades with the consequence that these groups may increase their consumption of goods and services generally, thereby stimulating production and employment in other sectors of the economy. As the increased expenditure of construction firms and workers raises the incomes of those who produce the goods they buy, aggregate demand is again stimulated as these recipients respond to larger incomes by increasing their consumption. Hence the direct stimulus given by increased government demand increases the incomes and expenditures of other sectors, and the combination of these direct and indirect effects means that each £1 increase in government expenditure results in a greater increase in aggregate demand. This process is known as the expenditure multiplier.

The Open Economy
The expenditure multiplier explains the link between fiscal policy and aggregate demand. Its strength depends upon the community’s marginal propensity to consume, the proportion of an increase in disposable income which goes to consumption expenditure. The higher the marginal propensity to consume, the greater the stimulus to demand from a given rise in the government deficit. However, a large boost to aggregate demand does not necessarily imply an equally large increase in domestic output and employment.

The link between demand and output depends upon the proportions of total expenditure going to domestically produced goods and to imports. If the economy tends to spend a high proportion of its disposable income on imports then the stimulus to domestic output and employment will be relatively weak. Whereas the expenditure multiplier depends upon the marginal propensity to consume, the output multiplier depends upon the marginal propensity to import, defined as the proportion of an increase in disposable income which is spent on imports. For example, if the marginal propensity to import is 0.6 then an increase in disposable income of £1m will raise expenditure on imports by £600,000 with the remaining £400,000 being saved or spent on domestically produced goods and services. Hence a high marginal propensity to import implies a relatively small output multiplier. Put another way, when the propensity to import is high, large increases in the government deficit are required to achieve significant increases in domestic output. Given Ireland’s high dependency on imports a boost to domestic demand will do as much, if not more, for the output of other countries as it will for domestic output and employment.

A second important feature of the Irish economy is the relation between labour force participation and the level of economic activity. Traditionally Ireland has ‘exported’ part of its unemployment to the U.K. in the sense that some of these unable to find work at home have migrated to Britain. Hence the domestic labour force (those in work plus those seeking work) depends, in part, on job availability in Ireland relative to the U.K. labour market. Increased employment opportunities in Ireland may therefore lead to a decline in the numbers who would otherwise leave the country and may also induce those working in the U.K. to return home. In short, creating more jobs at home may induce an increase in the labour force rather than a significant decline in existing unemployment.3


Incomes Policy
In recent years many governments (including Ireland’s) have resorted to incomes policies, or wage controls, as a means of influencing the level of employment. In this context incomes policy means that the government attempts to control the rate of money wages either by voluntary agreement or by direct legislation. The principal argument in favour of incomes policy, or wage controls, is that reducing the rate of wage inflation has a direct impact on production costs and thereby provides a stimulus to output and employment. In Ireland this argument is reinforced by the fact that about 50 per cent of manufactured output is exported. Hence reducing the rate of increase of money wages improves our international competitiveness and encourages exports.

For an incomes policy to affect employment significantly it is necessary that the rate of wage inflation is reduced relative to the rate of price inflation. That is, real wages must fall in order to make increased output and employment profitable. It follows that the cost of lower unemployment is a reduction in the real living standards of those employed. At given levels of productivity this means that the existing workforce (or their representatives) must be prepared to accept a trade-off between real wages and employment. The experience of countries such as Ireland and Britain is that labour is generally not prepared to accept this trade-off and that labour unions consistently put the real wages objective above employment levels in their order of priorities.

Conclusions
The above analysis suggests that government policies do not significantly affect the levels of private sector employment/unemployment in small economies such as Ireland. If we take the Keynesian view that unemployment results from a deficiency of aggregate demand then governments should attack unemployment by appropriate demand management policies. In a small economy fiscal policy may significantly affect demand but boosts to demand may not be transmitted to domestic output and employment because of a relatively high propensity to import.

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