The Commonwealth Government.

The views expressed in this paper do not necessarily reflect

Melbourne September 1989

Preliminary Working Paper No. 6-92

Industries Assistance Commission

By

Phillippa Dee

MARKET FLEXIBILITY
REDUCTION: A STRATEGIC ROLE FOR LABOUR
ECONOMIC EFFECTS OF PUBLIC EXPENDITURE

30-31 March 1989
Monash University

Issues in Public Expenditure Analysis
Paper presented to conference on
ABSTRACT
Contents

1. Introduction
2. Literature Review
  2.1 Literature Budget Proposal
3. Analytical Framework
4. The Long-run Effects of Government
  4.1 Long-run Effects of Government
  4.2 Spending Cycle
  4.3 Additional Framework
5. Short-run Effects of Government
  5.1 Short-run effects of Government
  5.2 Spending Cycle
6. The Short-run Effects of Government
7. Summary
8. References

Tables

1. Primary, Prefer; Budget, Spending
2. (1980-87, Period)
3. Long-run Microeconomic Effects of
4. Government Spending Cycle
5. Short-run Microeconomic Effects of
6. Government Spending Cycle
7. an Employment, Rate by Occupation
8. Short-run Effects of Spending Cycle
9. Government Spending Cycle
10. Government Spending Cycle
11. Fiscal, Wage, Flexibility
13. Fiscal, Wage, Flexibility
Our principal problem is then not so much the benefits of government from reducing government's claim on resources.

competing private property will suffer. Over the longer term, Australia would gain productive sector, benefits because they are shielded from price signals of market resources. If government provides, do not use resources as efficiently as the productive sector then. If this is the ultimate by competing away real government spending on goods and services will be crowded out to some extent.

Whatever the reasons for this growth (and they are probably many), one effect of the growth of government spending is to reduce the amount of the 1970s and 1980s for people to support their customary economic sectors. The student of structural adjustment in Australia can call to notice, as they search...

1. Introduction

by

Philippa Dee

Economic Effects of Public Expenditure Reduction.
Attention has been given elsewhere to the groups that benefit currently from free provision of the goods and services paid for by government - both identifying them and proposing ways to compensate deserving cases when government spending is cut.\(^1\) The purpose of this paper is to focus instead on those employed in activities where government spending is cut.

An earlier paper modelled the macroeconomic impact of government budget cuts, including the short-term impact on aggregate demand and unemployment.\(^2\) The results suggested that the benefits of budget cuts would take time to accrue and that significant adjustment costs would be borne by those employed in the government sector. This paper investigates the point further in the context of a particular budget proposal, and looks at strategies to alleviate the short-term labour adjustment problems.

### 2. An Illustrative Budget Proposal

#### 2.1 Spending

The scenario for government spending examined in this paper is the proposal put forward by the National Economic Priorities Project in 1987.\(^3\) This was a comprehensive package that included spending proposals in four main areas:

- health
- education
- labour market programs
- social security and welfare

---

1. For example, ABS (1987) and Freebairn, Porter and Walsh (1987).

References


Types of intergovernmental mandates would be reduced or eliminated. The effect of the spending on goods and services would occur, and which
are the expected benefits. This is shown in Table 1. The table also shows in which
government spending by economic transactions framework, the Poirot Project
With the assistance of ABS publications. The Commonwealth, State and local
government spending and resource use is important to make this distinction.
According to demand and resource use, it is important to make the distinction
between how much of the money spent was used to fund goods and services and
resources. The purpose of this framework is to improve the modeling of the impact
on services and resources. For the purpose of modeling, the impact on
services and resources. For the purpose of modeling, the impact on
goods and services. The budget scores, estimates provided by the National Economic
Profile, reflect the amount of competitiveness for resources.

Goods and services are a public
when government no longer provides the
in terms of transactions to determine the
spending on goods and services in the economy and a direct reduction in
government spending on resources. They need to be accompanied by: A
ordering of economic transactions framework to ensure that the spending
government is better informed of
reduction. This is the first stage towards a significant reduction in government
spending and net spending in the economy. This framework is to improve the
modeling of government spending and resource use, and which
are the expected benefits. This is shown in Table 1. The table also shows in which
government spending and resource use is important to make this distinction.
According to demand and resource use, it is important to make the distinction
between how much of the money spent was used to fund goods and services and
resources. The purpose of this framework is to improve the modeling of the impact
on services and resources. For the purpose of modeling, the impact on
goods and services. The budget scores, estimates provided by the National Economic
Profile, reflect the amount of competitiveness for resources.
The spending cuts outlined in Table 1 provide a useful basis for analysing the impact of several types of spending cuts which fall on goods and services. They also include a pure cut in transfer payments which can serve as a useful comparison.

2.2 Taxation

An important aspect of the Priorities Project spending proposals was that they be packaged together with tax cuts. Tax cuts would have their own beneficial impact on economic activity, even in the short term, and among those earning enough to benefit from them, would help to offset the withdrawal of free goods and services arising from the spending cuts.

<table>
<thead>
<tr>
<th>TABLE 1: PRIORITY PROJECT BUDGET SAVINGS (1986-87 values)</th>
<th>$m</th>
</tr>
</thead>
</table>
| Health
  Saving on goods and services - health and pharmaceuticals | 926.0 |
  Less increase in transfer payments - means-tested benefits | 2576.0 |
  | 7000.0 |
| Education
  Saving on goods and services - education | 2192.0 |
  Saving in transfer payments - non-means-tested benefits | 498.0 |
  | 2580.0 |
| Labour Market Programs
  Saving on goods and services - public administration | 500.0 |
| Social Security and Welfare
  Saving in transfer payments - unemployment benefits | 400.0 |
  - means-tested benefits | 1340.0 |
  - non-means-tested benefits | 450.0 |
  | 2190.0 |

Given credence. Furthermore, when spending cuts are undertaken in a short-term environment of real and relative wage flexibility, the outcomes in the rest of the economy are less adverse.

There would obviously also be strong advantages in targeting spending cuts so that adjustment problems were not so heavily concentrated in a few occupations, requiring very much larger cuts in real wages relative to the rest of the economy to keep employment rates from falling. As the second column of Table 6 shows, the Priorities Project spending cuts are projected to require significant real wage reductions for the professional and para-professional occupational groups even in the long term (although once again, the reductions may be exaggerated).

7. Summary

This paper has looked at the macroeconomic impact of government spending proposals in health, education, labour market programs and social security in order to highlight some of the short-term adjustment problems likely to be experienced with any sort of spending cut.

An important adjustment problem is in deploying the labour released by the government sector elsewhere in the economy. This paper has argued that since productivity gains in the government sector are unlikely to solve this problem, there is an important strategic role for real and relative wage flexibility in assisting the adjustment. There are also economic gains from this flexibility.

The analysis also suggests an important area for further research. One of the factors contributing to the apparent severity of the short-term adjustment problems is the assumption that although household demand for privately supplied health and education responds via conventional price and income signals, there is no additional direct dependence of private demand on the
Your opposition to spending cuts is likely to be less when the problems are at least real while more acceptable than a significant increase in unemployment. Workers in the security occupations may find a significant short-term drop in spending cuts if they are so heavily concentrated in a region of the economy.

were predictions that could be made then shown.

income tax rises.

in a budget-neutral environment.

income tax rises.

Income tax rises.

positive experience.

a budget-neutral environment.

positive experience.

positive experience.

positive experience.

income tax rises.

positive experience.
The model extensions firstly introduce income taxes and transfer payments and combine these, together with the commodity taxes and government spending items from standard ORANI, into an integrated set of government accounts.

Income taxes on labour income are treated as progressive, with average tax rates rising along with taxable labour incomes. These taxes correspond closely in concept to personal income taxes, the difference being that for the self-employed they cover taxes on an imputed return to labour rather than on all business income. In the analysis which follows, these tax rates on labour income are also assumed to be fully indexed. Income taxes on non-labour income are modelled as proportional, with average tax rates constant.

On the outlays side, transfer payments are divided into three categories. Unemployment benefits are paid only to the unemployed, means-tested benefits are paid only to those not in the workforce, while non-means-tested benefits are payable to everyone. In practice, most wage earners earn sufficient to exclude them from means-tested benefits and only about 5 per cent of these benefits are paid to those who are employed.

The extended version of ORANI also models labour supplies in order, among other things, to explain the number of people in each of these employment status categories. Labour supply decisions are modelled as a multi-step process.

---

5 Indexation of personal income taxes was an important part of the Priorities Project tax proposals. More pragmatically, if income taxes were not treated as indexed, the extended ORANI model would lose the property of being homogeneous of degree zero in the nominal exchange rate and domestic prices. Some explanation would then be required for the way in which changes in competitiveness were divided between changes in the nominal exchange rate and domestic prices.

---

**TABLE 5: SHORT-TERM MACROECONOMIC EFFECTS OF GOVERNMENT SPENDING CUTS WITH WAGE FLEXIBILITY**

<table>
<thead>
<tr>
<th>Variable, $</th>
<th>Health ($7.6b saving)</th>
<th>Education ($2.9b saving)</th>
<th>Labour Programs ($5.2b saving)</th>
<th>Social Security ($2.7b saving)</th>
<th>Total ($12.4b saving)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real GDP</td>
<td>0.0</td>
<td>0.2</td>
<td>-0.0</td>
<td>0.2</td>
<td>0.4</td>
</tr>
<tr>
<td>Consumer price index</td>
<td>-9.1</td>
<td>-5.5</td>
<td>-0.4</td>
<td>-5.1</td>
<td>-20.1</td>
</tr>
<tr>
<td>Real private consumption</td>
<td>1.8</td>
<td>-0.4</td>
<td>0.1</td>
<td>-1.6</td>
<td>0.2</td>
</tr>
<tr>
<td>Real investment</td>
<td>0.0d</td>
<td>0.0d</td>
<td>0.0d</td>
<td>0.0d</td>
<td>0.0d</td>
</tr>
<tr>
<td>Real government consumption</td>
<td>-18.2</td>
<td>-5.9</td>
<td>-1.2</td>
<td>0.0d</td>
<td>-25.3</td>
</tr>
<tr>
<td>Exports (volume index)</td>
<td>8.4</td>
<td>5.1</td>
<td>0.4</td>
<td>4.3</td>
<td>18.2</td>
</tr>
<tr>
<td>Imports (volume index)</td>
<td>-3.7</td>
<td>-2.6</td>
<td>-0.2</td>
<td>-2.9</td>
<td>-9.5</td>
</tr>
<tr>
<td>Trade balance</td>
<td>1.4</td>
<td>0.9</td>
<td>0.1</td>
<td>0.9</td>
<td>3.3</td>
</tr>
<tr>
<td>Persons in workforce</td>
<td>-0.6</td>
<td>-0.2</td>
<td>-0.0</td>
<td>0.1</td>
<td>-0.7</td>
</tr>
<tr>
<td>Persons employed</td>
<td>-0.1</td>
<td>0.2</td>
<td>-0.0</td>
<td>0.2</td>
<td>0.3</td>
</tr>
<tr>
<td>Persons unemployed</td>
<td>-8.4</td>
<td>-5.8</td>
<td>-0.0</td>
<td>-1.0</td>
<td>-15.3</td>
</tr>
<tr>
<td>Real capital stock (domestically and foreign owned)</td>
<td>0.0d</td>
<td>0.0d</td>
<td>0.0d</td>
<td>0.0d</td>
<td>0.0d</td>
</tr>
<tr>
<td>Real domestic (private and govt) saving</td>
<td>6.8</td>
<td>4.5</td>
<td>0.3</td>
<td>4.4</td>
<td>15.9</td>
</tr>
<tr>
<td>Real per capita disposable income</td>
<td>- employed</td>
<td>0.8</td>
<td>0.1</td>
<td>0.6</td>
<td>1.5</td>
</tr>
<tr>
<td>- others</td>
<td>6.7</td>
<td>-0.8</td>
<td>0.1</td>
<td>-10.2</td>
<td>-4.2</td>
</tr>
<tr>
<td>Income tax rates</td>
<td>-16.6</td>
<td>-7.7</td>
<td>-1.1</td>
<td>-6.3</td>
<td>-31.6</td>
</tr>
<tr>
<td>Real PSBR</td>
<td>0.0d</td>
<td>0.0d</td>
<td>0.0d</td>
<td>0.0d</td>
<td>0.0d</td>
</tr>
</tbody>
</table>

---

a The important assumptions underpinning these projections are that industry capital stocks are fixed, while after-tax rates of return adjust, and real wages vary by occupation to keep occupational employment rates fixed. A full technical specification of the short-term environment is given in Dee (1990a).

b All results, with the exception of the trade balance, are percentage deviations from the value the variable in question would have taken in the short term in the absence of the spending cuts. The trade balance, while also a deviation from control, is expressed in percentage points worth of base-period GDP.

c Because of rounding, individual row entries may not add to totals.

d Held fixed by assumption.

---

price and income effects, but there is no additional direct substitution arising from direct dependence of private health and education expenditure on the amounts being provided free by government. With an element of direct dependence, households would end up purchasing more of their own health and
The relative wage advantage implied by these professions are likely to be

The required qualifications for the occupations of the 6 shown

The second decision is which occupation to pursue. Again, valuable
capital

determination participation rates. They are assumed to be constant over the time

The first decision is whether or not to participate in the workforce.

hours worked are taken from Table (1980) and participants for

The required qualifications for the occupations of the 6 shown

The relative wage advantage implied by these professions are likely to be

The required qualifications for the occupations of the 6 shown

The relative wage advantage implied by these professions are likely to be

The required qualifications for the occupations of the 6 shown

The relative wage advantage implied by these professions are likely to be

The required qualifications for the occupations of the 6 shown

The relative wage advantage implied by these professions are likely to be

The required qualifications for the occupations of the 6 shown

The relative wage advantage implied by these professions are likely to be

The required qualifications for the occupations of the 6 shown

The relative wage advantage implied by these professions are likely to be

The required qualifications for the occupations of the 6 shown

The relative wage advantage implied by these professions are likely to be

The required qualifications for the occupations of the 6 shown

The relative wage advantage implied by these professions are likely to be
Whether all persons of a given occupation succeed in finding a job depends on whether relative occupational wages are assumed to be flexible. In ORANI, much of the model’s flexibility comes from being able to choose which subset of variables will be exogenous. For example, relative occupational wage rates can be endogenous and can vary to meet particular exogenous targets for occupational employment rates. Alternatively, occupational wage relativities can be fixed exogenously, perhaps along with the economy-wide real wage, while occupational employment rates can vary in response to changes in economic conditions.\(^7\)

A further feature of the extended version of ORANI is that aggregate investment, whether financed domestically or by foreigners, is allocated among industries according to after-tax rates of return, rather than the pre-tax returns used in the standard ORANI model. This gives an important channel by which both spending cuts and their accompanying tax cuts can affect economic activity. By affecting after-tax returns, they will in the longer term affect industry capital stocks.

Net foreign investment is defined in turn as the difference between total investment and national (i.e., private plus government) saving. The disposable income available to households for consumption or saving is not only net of tax, but also net of the capital rentals earned by foreigners on the share of the Australian capital stock they own.

\(^7\) Industry labour demands in ORANI are expressed in terms of person-hours, but industries are usually assumed to be indifferent between whether additional person-hours are met by additional persons or additional hours from existing employees. This, together with the assumption that employed workers can always work their desired number of hours (i.e., the model abstracts from under-employment or unfilled overtime), ensures that any mismatch between the supply and demand for person-hours in the face of real or relative wage rigidity appears as a mismatch for persons.

large workforces and if significant savings are to be made by streamlining their operations, many workers are likely to be laid off.

Some thought therefore needs to be given to devising packaging for government spending cuts so as to mitigate the opposition by the labour that is shed in the process. The longer-term gains from government spending cuts appear to be substantial so the effort is worthwhile. As both the model results and recent experience with microeconomic reform in New Zealand indicate, however, the adjustment problems can be large enough to threaten the entire reform package, especially when insufficient thought is given to facilitating adjustment by those most directly disadvantaged in the short run.

The short-term labour adjustment problems may be mitigated if changes to work and management practices which improve productivity can be negotiated quickly in affected industries. However, there is no guarantee that such productivity improvements would keep unemployment rates from increasing in the short term. They are likely to allow affected industries to economise on the labour they require to produce a given amount of output, so that employment levels would be maintained in absolute terms only if output expanded sufficiently. It is hard to see how this can happen, even in the long term, in the face of reductions in demand by government.

What is required is not just a strategy to achieve productivity improvements, but also strategies to help surplus labour be redeployed quickly. These strategies may vary. In some industries, the age structure of the workforce may be skewed towards the older age groups. If a significant number of workers are nearing retirement age, the cheapest strategy for easing labour market adjustment problems may be to assist some of these workers into early retirement.
Imagined as a period of about ten years, the OPEAN model operationally the long term in these projections can be the other condition specified by projections from the economic version of the The significantly increasing long-term effects of spending cuts in all three under some occupation / from the government sector and will allow increases in real wages at least in the long run. This will help the rest of the economy to absorb shocks / productivity challenges. The operation of the government in order to absorb shocks long term industries is expected to play a role in creating in the long run. The long-term cuts in will lead to improve industry profitability and in the long term.

4. The Long-term Effects of Government Spending Cuts

4. The Long-term Effects of Government Spending Cuts

<table>
<thead>
<tr>
<th>Occupation</th>
<th>0.10</th>
<th>0.11</th>
<th>0.12</th>
<th>0.13</th>
<th>0.14</th>
<th>0.15</th>
<th>0.16</th>
<th>0.17</th>
<th>0.18</th>
<th>0.19</th>
<th>0.20</th>
</tr>
</thead>
<tbody>
<tr>
<td>Health worker (social)</td>
<td>0.10</td>
<td>0.11</td>
<td>0.12</td>
<td>0.13</td>
<td>0.14</td>
<td>0.15</td>
<td>0.16</td>
<td>0.17</td>
<td>0.18</td>
<td>0.19</td>
<td>0.20</td>
</tr>
<tr>
<td>Education program administrator</td>
<td>0.10</td>
<td>0.11</td>
<td>0.12</td>
<td>0.13</td>
<td>0.14</td>
<td>0.15</td>
<td>0.16</td>
<td>0.17</td>
<td>0.18</td>
<td>0.19</td>
<td>0.20</td>
</tr>
<tr>
<td>Social worker (social)</td>
<td>0.10</td>
<td>0.11</td>
<td>0.12</td>
<td>0.13</td>
<td>0.14</td>
<td>0.15</td>
<td>0.16</td>
<td>0.17</td>
<td>0.18</td>
<td>0.19</td>
<td>0.20</td>
</tr>
<tr>
<td>Field interviewer</td>
<td>0.10</td>
<td>0.11</td>
<td>0.12</td>
<td>0.13</td>
<td>0.14</td>
<td>0.15</td>
<td>0.16</td>
<td>0.17</td>
<td>0.18</td>
<td>0.19</td>
<td>0.20</td>
</tr>
<tr>
<td>Process manager</td>
<td>0.10</td>
<td>0.11</td>
<td>0.12</td>
<td>0.13</td>
<td>0.14</td>
<td>0.15</td>
<td>0.16</td>
<td>0.17</td>
<td>0.18</td>
<td>0.19</td>
<td>0.20</td>
</tr>
</tbody>
</table>

5. The short-run effects of government spending cuts

6. A strong role for labor market flexibility

Because of the non-binding labor contracts and high exit costs, the restrictions on the ability of labor markets to adjust to changes could be employed in other industries as well, including those with high unemployment rates. All efforts to improve these functions, especially in government spending, can contribute to improving the long-term economic conditions and the economy to improve.
One important effect which has not been included in the model analysis is the impact that lower government involvement in health and education would have on work and management practices in these industries. The Priorities Project argued that a more competitive environment would induce significant improvements in productivity. The model projections throughout this paper assume that the production technology in the affected industries is the same after as before the budget cuts. If the productivity improvements could be quantified, they could be imposed exogenously as technological changes along with the budget cuts, but the extent of the productivity improvements is hard to gauge.

One implication of this omission is that while the model does project a small increase in private sector provision of health and education following the government spending cuts, the increase is not as great as would be the case if productivity improved. Furthermore, it is not nearly sufficient to offset the loss of government provision, even in the long term.

Nevertheless, the various kinds of spending cut, each with its matching tax cut, are projected to improve most macroeconomic aggregates. This is shown in Table 2. With each type of spending cut, real GDP increases. This follows from an expansion in real capital stocks in many industries, generally accompanied by an expansion in overall employment.

The trade account improves in most cases as resources are reallocated from the non-traded to the traded sector of the economy. The real exchange rate generally also strengthens. This is indicated in the model results by an increase in the consumer price index, showing an increase in domestic relative to foreign prices.

| Table 3: Short-term Macroeconomic Effects of Government Spending Cuts |
|-------------------------|-----------------|----------------|-----------------|
| Variable               | Health ($7.0b saving) | Education ($2.5b saving) | Labour Programs ($0.5b saving) | Social Security ($2.2b saving) |
| Real GDP               | -2.1             | -0.9            | -0.2            | 0.2             |
| Consumer price index   | 0.5              | 0.5             | 0.1             | -2.9            |
| Real private consumption | 1.5             | -0.2            | 0.1             | -1.6            | -0.2 |
| Real investment        | 0.0d             | 0.0d            | 0.0d            | 0.0d            | 0.0d |
| Real government consumption | -18.2           | -5.9            | -1.2            | 0.0d            | -25.2 |
| Exports (volume index) | -0.3             | 0.5             | -0.0            | 2.7             | 2.8  |
| Trade balance          | -0.0             | 0.1             | -0.0            | 0.6             | 0.7  |
| Persons in workforce   | -0.5             | -0.2            | -0.0            | 0.1             | -0.6 |
| Persons employed       | -2.8             | -1.2            | -0.2            | -0.3            | -4.5 |
| Persons unemployed     | 36.7             | 16.6            | 2.2             | 7.2             | 65.6 |
| Real capital stock (domestically and foreign owned) | 0.0d | 0.0d | 0.0d | 0.0d | 0.0d |
| Real domestic (private and govt) saving | -0.4 | 0.7 | -0.1 | 3.1 | 3.3 |
| Real per capita disposable income | 2.5 | 0.9 | 0.2 | 1.0 | 4.5 |
| - employed             | 5.6             | -1.3            | 0.1             | -10.4           | -6.0 |
| Income tax rates       | 9.8             | -4.3            | -0.8            | -5.3            | -20.2 |
| Real PSBR              | 0.0d             | 0.0d            | 0.0d            | 0.0d            | 0.0d |

a The important assumptions underpinning the short-term nature of the projections are that industry capital stocks are fixed, while after-tax rates of return adjust (affecting the allocation of investment), and real wages in all occupations are fixed while occupational employment rates adjust. A full technical specification of the short-term environment is given in Dee (1989a).
b All results, with the exception of the trade balance, are percentage deviations from the value the variable in question would have taken in the short term in the absence of the spending cuts. The trade balance, while also a deviation from control, is expressed in percentage points worth of base-period GDP.
c Because of rounding, individual row entries may not add to totals.
d Held fixed by assumption.

Table 4 gives the projected short-term impact on employment rates broken down by occupation, and shows in more detail where the adjustment problems occur. Declines in employment are concentrated in the professional occupational group, which includes medical practitioners and pharmacists, and the para-professional occupational group, which includes nurses and teachers. The total
The increases inINTERVENTIONS that accompany the health sector.

The short-term impact of the spending cuts shown in Table 2 is counteracted by increases in government spending in most cases, as illustrated by Table 2. The additional spending increases in most cases are not offset by decreases in target programs, so the overall fiscal impact of these programs is minimally offset by spending decreases in other programs. The increases in health sector spending are not counteracted by decreases in target programs, so the overall fiscal impact of these programs is minimally offset by spending decreases in other programs.
spending. As a consequence, however, the increase in capital stocks is not fully financed domestically, so that foreign investors' stake in Australia expands and real GNP (the income accruing to Australians) grows less than real GDP (the income generated in Australia).

The long-term benefits tend to be greater, the bigger is the reduction in government's claim on resources. This can be seen by comparing the impact of the spending cuts in health, education and labour market programs.

The long-term benefits of cuts in transfer payments do not seem to be as great as an equivalent cut in spending on goods and services. This can be seen by comparing the impact of the cut in social security with the cut in education. Cuts in transfer payments do not reduce government's claim on resources, but rather the purchasing power of welfare recipients. Some of these recipients are encouraged to re-enter the workforce, but in keeping with available econometric evidence this impact is not particularly strong. The main impact of the social security cuts is to reduce real per capita income for recipients. Because a substantial number remain unemployed or out of the workforce, the result is a projected decline in overall real private consumption spending.

5. Short-term Adjustment Pressures
The long-term benefits from government spending cuts depend to a large extent on the economy's ability to reallocate the resources released by government into alternative uses. In the short term, reallocation will tend to be a sticky process.

One reason is the gestation lags required for new investment projects. Even if industries adjust investment plans immediately in response to changes in profitability, new equipment will take time to install. Industries are also likely to wait to see if the conditions leading to changes in profitability are likely to be permanent. Investment plans may not be adjusted at all if the government spending cuts are not seen as being credible. Policy makers may not be able to influence the gestation lags involved in installing new capital, but they will certainly have an important role in establishing the credibility of the spending cuts.

The wage setting environment will also be an important influence on short-term adjustment pressures. In the past, this environment has tended to make changes in both real wages and in wage relativities extremely difficult. Reallocation of labour released by the government sector will obviously be more difficult when neither employers nor employees receive signals through relative wage changes. Reallocation of labour towards the traded sector would tend to be brought about instead by general deflation which improved the international competitiveness of the traded sector.

Deflationary pressure is a very blunt instrument for reallocating those with the particular skills and qualifications used in hospitals, schools and employment offices. It is likely that in the short term a significant number of these people will remain unemployed. If this is the case, they are likely to form a vociferous and effective lobby group against government spending cuts. After all, it is cold comfort to a group of trained and dedicated professionals to know that, in a wider economic sense, their hard work has been wasted.

To gauge the importance of these considerations, the impact of the various kinds of spending cuts has been projected in a short-term environment where industry capital stocks, real wages and wage relativities are all fixed.