INVITED PAPER

Where to Now? Welfare and Labour Market Regulation in Australia

Bob Gregory, Economics Program, Research School of Social Sciences, Australian National University

Introduction

Over the last decade and a half, Australia has been deregulating its labour market, with mixed results. One oft-quoted index of success is that, over the last decade, Australian GDP growth has been the second highest in the OECD. Over a similar period real wages have increased after a decade and a half of little change. These are good news stories.

At the same time, the Australian full-time employment-population ratio has remained near the historically low levels reached in the 1991 recession. Furthermore, over the 1990s, the proportion of welfare recipients to population of working age reached its highest level ever. The ratio of welfare recipients aged 15-64 years to the number of people in full-time employment is now a ratio one to two and a half. During the early 1970s, the ratio was one to sixteen. Labour under-utilisation affects all parts of Australian society. For example, one third of Australian children now live in households where no adult has a full-time job. These are bad news stories.

It is not surprising that Australians, given such mixed outcomes, have still to come to grips with the links between labour market deregulation and economic performance. How is it that the economy can do well in some dimensions and yet fail so badly in others? Is deregulation of the labour market responsible for both?

This paper focuses mainly on the bad news stories and our inability to solve the deep-seated structural problem of low rates of labour utilisation and high rates of welfare take up. It discusses where policy should move to now and attempts to draw lessons from our labour market deregulation experience. To do this, it is necessary to traverse briefly the history of labour market policy and outcomes since 1974-1975. The mid 1970s was a turning point for the Australian labour market, as it was for many other OECD labour markets, especially those in Europe.[1]

Some key Australian facts to be explained

The Australian structural problems revolve around low rates of labour utilisation. These problems are illustrated by three key facts.

First, Australian unemployment was very low during the fifties and sixties, rarely nudging two per cent, but between 1974 and 1982 unemployment increased to ten per cent of the labour force and since then has remained high. Even after a decade of strong GDP growth, unemployment is currently around six per cent - more than three times the levels prevailing before 1973 (Figure 1).

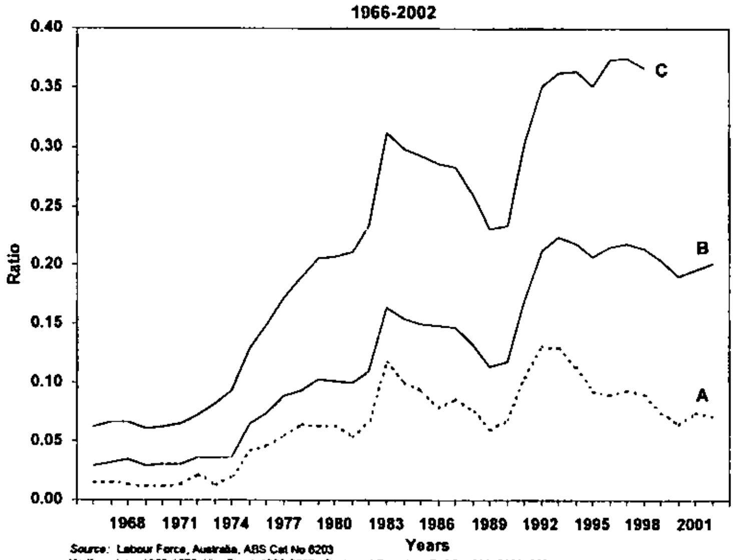
Second, unemployment increases have been accompanied by a substantial loss of full-time employment. The dramatic character of this change is emphasized if we compare the Australian full-time employment history with that of the United States (Figure 2). From the mid 1960s through to the early 1970s, the Australian full-time employment-population ratio was approximately 14 per cent above that of the US. It fell by 16 per cent between 1970 and 1983, and by the latter date it was below that of the US. The ratio then recovered slightly, but since 1990 has fallen again. The cumulative fall since 1970 is 17 per cent. The increase in the US full-time employment-population ratio over the same period was 18 per cent. [2] This difference has occurred even though GDP per capita has grown at similar rates in both countries (Figure 3).[3]

If Figure 1 and Figure 2 are considered together, a third key fact emerges: Australia's full-time job loss did not translate one-to-one into unemployment increases. After allowance is made for population changes, the full-time job loss since 1970 is 1,351 thousand. The unemployment increase is 420 thousand.[4] There is a gap of 931 thousand. Where did all these people go? How are they supporting themselves?

Many of the young have withdrawn from full-time employment and increased their education participation rates, but the overwhelming adjustment has been borne by workers who, failing to find full-time employment, have sought income support from the government, usually on a welfare program other than unemployment benefits. One major form of adjustment has been an increased take-up of disability pensions.

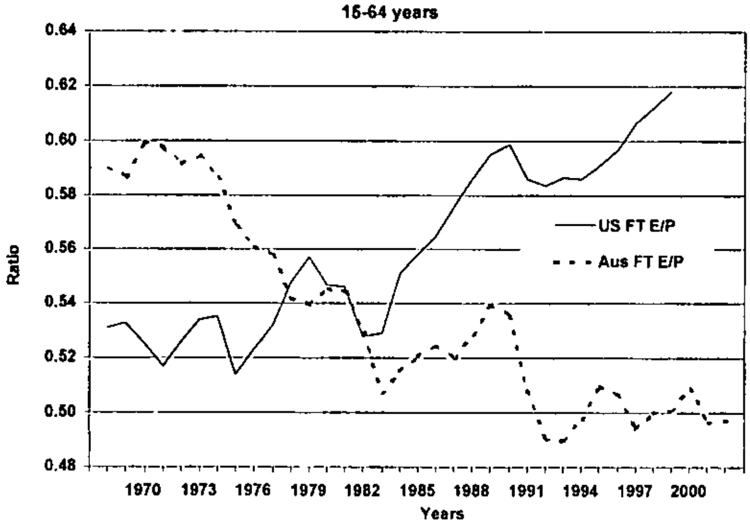
The rapid growth of unemployed and disabled welfare recipients, relative to the official measure of unemployment among those seeking full-time work, is evident in Figure 1. All data are expressed as fractions of full-time employment. Line A shows the ratio of those seeking full-time work to full-time employment. (The data are derived from the Labour Force Survey, which uses standard OECD definitions of unemployment) Line B shows the sum of those receiving unemployment benefits and those receiving disability pensions as a ratio of the number in full-time employment. Line C adds other groups of welfare recipients: lone mothers and the partners of the unemployed.

Figure 1 Ratio of Labour Utilization Measures to Full Time Employment 1966-2002



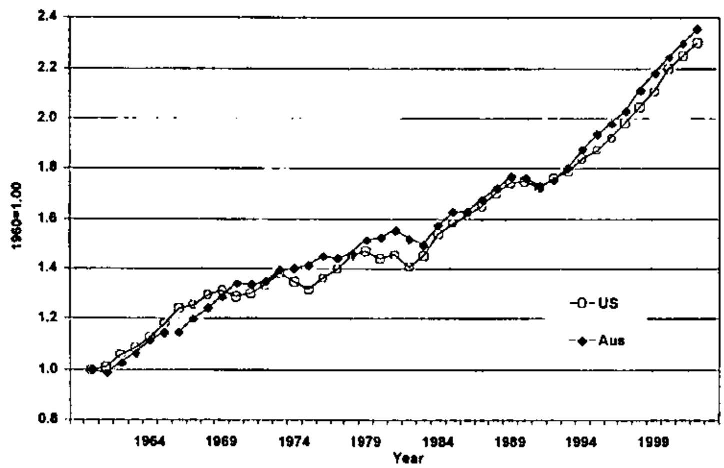
Source: Labour Force, Australia, ABS Cat No 6203
Welfare data- 1966-1979, Kim Bond 1980-2002, Statistical Overview, FaCS, 1996, 2000, 2001.

Figure 2 Australia and US Full-time Employment to Population Ratio 15-64 years



Source: Australia: Labour Force, August, ABS Catalogue No 6203.0, US: Current Population Survey, US Department of Labor.

Figure 3 GDP to Population Indices 1960-2002



Source: Economic Outlook, OECD, DX Database, March 2003.

The gap between line A and line B has continually widened since the mid-1970s, and the fall in unemployment over the last decade seems to have been due largely to people moving from unemployment to disability support. On the basis of line B - the wider definition of unutilised labour resources - there has been no recovery in the Australian economy over the last three decades. There is much more congruence between the loss of full-time jobs and wider concepts of unutilised labour resources – line B and line C - than between the loss of full-time jobs and unemployment as officially measured.

The major Australian policy puzzle relates to the *persistence* of our three key facts – higher levels of unemployment, the lower full-time employment-population ratio and the increased welfare take-up - and their general unresponsiveness to a wide range of policy changes. Over three decades, Australia has moved towards more centralised wage fixing, then away from it toward a more deregulated labour market and enterprise bargaining. Immigration programs have been adjusted to focus more on labour skills. Education policy has increased education levels. Policies have assisted a growth in the profit share of GDP. But the three key facts persist.

This invites a number of questions. Is it the problem that the right policies have been adopted but have not gone far enough? Is it that our persistent problems could not have been expected to respond to the policies adopted? Perhaps labour market deregulation was not the right policy response and we should look elsewhere?

Most policies in response to the falling utilisation rates of labour have been directed towards increasing wage and labour market flexibility. The policies primarily focussed on labour demand. But it could be that the problems relate significantly to labour supply and require policies that impact directly on the growing number of welfare recipients. Given the failure of existing policies, with their emphasis on labour market flexibility, it is likely that welfare provisions and labour supply will be the new frontier of policy reform.

Australian wage regulation since the 1970s: a brief history

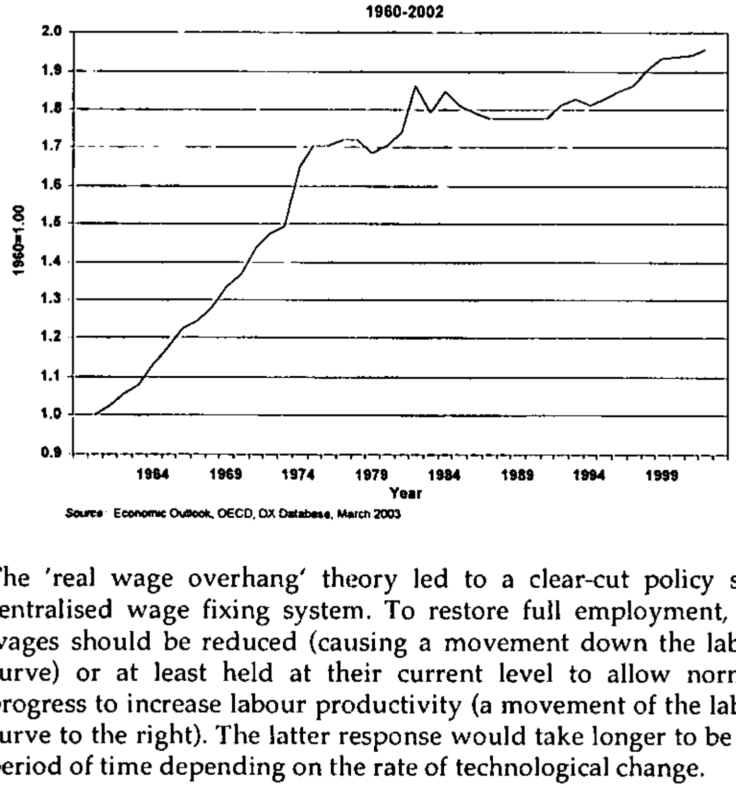
Before 1975, the Australian wage system could be characterised as a centralised one, with strong unions arguing for wage increases before an arbitration tribunal.[5] Employers and government also appeared before the tribunal, which handed down binding decisions that extended to almost all workers. The decisions usually applied nation-wide to all parties to awards, whether they were unionists or not. They extended through the wage structure and effectively set most peoples' pay. The tribunal also regulated many other aspects of employment – for example, annual leave, hours of work, classifications and promotion criteria. The list of regulations varied by awards and was extensive.

The central policy focus in the tribunal's work was the national wage case that considered the average wage Australia could afford. Because of the importance of the national wage case, policy advisers, employers and unionists were used to thinking about wages in a macro context. National economic outcomes were thought of as being generated by the balance between economy-wide average real wages and average productivity

It was natural, therefore, that the 'real wage overhang' theory, generated in response to the 1975 crisis and adopted widely by the OECD during the 1970s, should have been developed in Australia. A simple version of the theory proceeds as follows. At full employment there is a natural balance between average real wages and average labour productivity. Full employment is maintained if real wages grow at the same rate as productivity. If suddenly, at full employment, there is a large real wage increase, *unmatched by a productivity increase*, unemployment will ensue. The real wage increase will reduce profits and firms will attempt to offset this by reducing employment.[6]

The Australian real wage history over the period 1964-2004 is shown in Figure 4. During the 1950s and 1960s the balance between real wages and average labour productivity was maintained, so that unemployment was low. Then, during the early 1970s, real wage growth suddenly accelerated above the average of the previous two decades, without an accompanying change in the underlying rate of productivity growth. In response, firms reduced employment and unemployment was created.

Figure 4 Australia, Real Total Compensation Per Employee Indices 1960-2002



Source: Economic Outlook, OECD, OX Database, March 2003

The 'real wage overhang' theory led to a clear-cut policy solution in a centralised wage fixing system. To restore full employment, average real wages should be reduced (causing a movement down the labour demand curve) or at least held at their current level to allow normal technical progress to increase labour productivity (a movement of the labour demand curve to the right). The latter response would take longer to be effective, the period of time depending on the rate of technological change.

The Australian system reacted in the predictable way. The first response was to attempt to avoid further real wage increases and to move towards more centralised wage fixing. In April 1975, the tribunal introduced a real wage indexation policy to insure employees against real wage falls and, in this way, to encourage unions not to seek additional nominal wage increases. This occurred in an inflationary environment that was generating considerable uncertainty about future real wages. The system remained in place until the late 1970s, when it broke down. Further real wage increases were followed by the 1981-82 recession. After the recession, a focus on real wage moderation through the centralised system was adopted as the centrepiece of the Accord between the trade unions and the Australian Labor Party and introduced upon the Labor Party's electoral victory in 1983. All major political parties, therefore, more or less accepted that excessive nation wide real wage increases were the source of the unemployment problem and that there should be some form of macro wage intervention into the labour market. [7]

In retrospect, this emphasis on the real wage increase as the major explanation of the unemployment increase seems inadequate. On the basis of past trends, it should have taken only about three years of real wage constancy for the trend rate of technical change to restore the real wage-labour productivity balance compatible with full employment. But, although average real wages hardly increased at all for fifteen years after 1975 (Figure 4), unemployment remained high. For example, by 1990, real wages were about 30 per cent below a trend projection based on the 1950s and 1960s experience, and yet there was no evidence that the underlying rate of unemployment had fallen in response. The persistence of labour under-utilisation remained remarkably insensitive to the moderation of real wage growth.

The Accord process, with its emphasis on centralised wage fixing and real wage maintenance, carried within it political tensions that increased through time and eventually led to its abandonment. Centralised wage fixing effectively robbed union officials of one of their most important functions - fighting for wage increases for their members. As a result, the trade union movement became increasingly disillusioned. In addition, although there was evidence of an improvement in employment growth during the mid to late 1980s, the underlying national productivity growth appeared to slow, and many policy advisers became concerned at the failure of the labour market to make efficiency gains.

In response to these pressures, policy began to move away from the centralised wage fixing system. Dismantlement began under the Labor government in the early 1990s and continued during the Liberal and National Coalition government later in the 1990s. The new policy emphasis began to shift wage bargaining to the enterprise level, to weaken the role of trade unions and to deregulate the labour market.

It is apparent from Figure 4 that as the new labour market policy became increasingly effective, average real wages began to increase again. Over the last eight or so years real wages have increased by an average of 2 per cent per annum. Firms have been able to use enterprise bargaining to increase productivity and wages, and employees are now better off than before. But the increasingly deregulated labour market seems to have done nothing to increase full-time employment growth.

What can be done to address the problem of labour under-utilisation and the failure of labour market deregulation to impact on this problem? Should there be a move back towards centralised wage fixing or further movement towards labour market deregulation?

In practice, a significant move in either direction will be difficult. After so much dismantling of the old system, and in an environment where unions are weaker, it would be difficult to reverse current policy and move back to a centralised system. Furthermore, there seems to be little desire to attempt to contain real wage increases. There is probably more support for further deregulation, but the adjustments to labour market laws and regulations being discussed seem fairly trivial, and it appears that labour market deregulation policy has run its course. Are there any other significant deregulation ideas that might adequately address the labour under-utilisation problem and the growth of welfare recipients? I turn now to policy initiatives that stress the interrelationships between low wages and the welfare system.

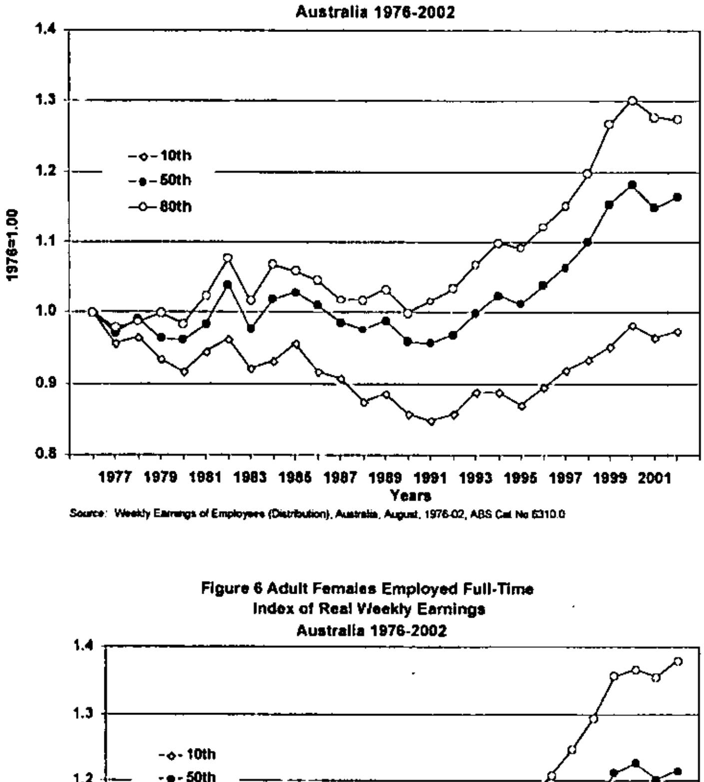
Interrelationships between low wages and the Australian welfare system

One possible way out of Australia's poor labour utilisation performance has been suggested by a group of five economists?[8] They argue that unemployment is not so much the outcome of the relation between average wages employment and labour productivity discussed earlier as a response to the wages prevailing in individual labour markets where there is significant unemployment. That is, the real wage focus should shift towards micro markets.

The five economists, however, also believe that the centralised wage system has an important role to play in bringing about a fall in real wages of the low paid and those facing high rates of unemployment. Within the current pay setting framework, the low paid who fail to obtain wage gains in the market place can still access across-the-board safety net wage increases through the tribunal. The five economists argue that this access should cease and that wage increases should be denied to the low paid. In return, the low paid would receive compensation in the form of an earned income tax credit or tax concession. The idea is that the real wage reduction would stimulate employment by lowering the real wage faced by the employer, but the tax concession would maintain the real income of the low paid. Would such a policy work?

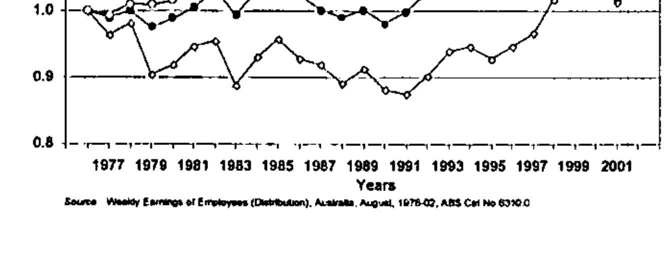
The five economists have suggested that a five per cent real wage reduction would substantially reduce unemployment. To achieve this, the Australian Industrial Relations Commission would withhold 'safety net' wage increases until the real value of award wages (on which many of the low paid are dependent) was reduced by 12 per cent. One way to develop a feel for the adequacy of a wage cut of this magnitude is to look at what has been happening to the wages of the low paid. Figure 5 and Figure 6 plot earnings from full-time work at the 80th, 50th and 10th percentile of the male and female earnings distributions. Over the period of high unemployment, the dispersion of earnings from full-time employment has widened significantly for men and women, both before and after the Accord period. Since 1975, there has been a two per cent reduction in real earnings from full-time work for men at the 10th percentile and an increase of 30 per cent at the 80th percentile. For women, real earnings at the 10th percentile have increased by five per cent, while real wages at the 80th percentile have increased by 38 per cent.

Figure 5 Adult Males Employed Full-Time
Index of Real Weekly Earnings
Australia 1976-2002



Source: Weekly Earnings of Employees (Distribution), Australia, August, 1976-02, ABS Cat No 6310.0

Figure 6 Adult Females Employed Full-Time
Index of Real Weekly Earnings
Australia 1976-2002



Source: Weekly Earnings of Employees (Distribution), Australia, August, 1976-02, ABS Cat No 6310.0

Would a five (or even 12) per cent reduction of real wages at the bottom of the distribution be successful as a job creating strategy? It seems unlikely. After all, relative to median earnings from full-time work, earnings at the 10th percentile have fallen by about 15 per cent and yet the under-utilisation of labour has increased substantially. If the policy is to work, it seems, a very large real wage fall is needed. A five per cent wage reduction would only put real wages back to the 1997 level, when the number of welfare recipients was at record levels and still increasing.

This inevitably highlights the interconnectedness of the wage and welfare system. Large wage reductions at the bottom of the pay distribution make welfare support more attractive. A wage reduction strategy may therefore be ineffective as a way of reducing the number of welfare recipients.

The Australian welfare system

On the surface, Australian welfare payments appear not to be particularly generous, but they have two important characteristics that impact on job finding, job acceptance and leaving welfare support.

First, welfare payments are not subject to time limits. The unemployed can access welfare support for as long as they satisfy income and asset tests and job search conditions. There is some evidence that this feature of the system matters, as most of the unemployed spend very long periods on income support. There is no substantial support for changing this characteristic of the system.

Second, the system allows welfare recipients to combine welfare support with employment income, subject to welfare tapers that withdraw welfare payments as private income increases. In addition, there are substantial allowances, also subject to tapers, for children. Table 1 lists a number of typical examples.

Each column refers to a particular level of private income. The entries in each cell show disposable income and (in brackets) the effective marginal tax rates of receiving an extra dollar of private income. Each row lists the outcomes for different groups of people. Row 1 shows the unemployment benefits for a single adult. The base payment is $190 per week. If this person leaves unemployment benefit to accept employment at $502 per week – the 10th percentile of the male full-time wage distribution - he would receive an income of $418, an increase of $228 relative to the initial level of unemployment benefits. He faces an average effective tax rate of 55 per cent, (502-228)/502. High tax rates apply also to other groups. For example, an unemployed couple with two children would receive income support of $488 per week. If one of the adults accepted a full-time job that paid $587 a week – the 20th percentile of the male full-time wage distribution - the family income would increase by $181 - an average effective tax rate of 73 per cent. Thus the combination of income tax and welfare tapers produces very high marginal and average effective tax rates in response to private income increases. It is widely believed that these high effective tax rates discourage employment.

There is one other important feature of Table 1 which is most striking for a disabled adult with a partner and two children. The wage increase from the 10^{th} to the 20^{th} percentile of the male full-time wage distribution is $85 gross. If a person employed at the 10^{th} percentile were to move to the 20^{th} percentile, the weekly disposable income would increase by $6 - a very low reward for accepting a job that pays an extra $85. The government is effectively receiving $79 from tax increases and welfare reductions. There is a very large wedge between the labour demand wage, $85, and the labour supply wage, $6.[9] It is in response to these outcomes that it is argued that the low paid are better off receiving a tax concession from the government than a wage increase in the labour market. A tax concession avoids the wage increase for employers and narrows the gap between the labour demand and the labour supply wage.

Table 1: Disposable income by Family Type and Private Income July 2003

	Private Income $ per week					
Family type:	*0*	*100*	*502**	*587**	*660**	*800*
Unemployed Single	190	237 (87)**	418 (35)	475 (31)	525 (31)	621 (31)
Couple, no children	342	390 (87)	466 (93)	505 (31)	555 (31)	651 (31)
Couple with children, 1 child < 5 yrs and 1 child 5-12 years (one parent on unemployment pension)	488	535 (87)	633 (21)	669 (50)	696 (61)	750 (61)
Couple with children, 1 child < 5 years and 1 child 5-12 years (one parent on disability pension)	502	595 (17)	763 (78)	769 (127)	796 (82)	864 (54)

Note:
* 10^{th}, 20^{th} and 30^{th} percentile of the male full-time weekly earnings distribution, August 2002
** () is Effective Marginal Tax Rate

There has been considerable discussion of welfare taper reform, but reform is an extremely complex and difficult issue. As welfare tapers are reduced, access to welfare payments is further extended up the income scale and therefore the employment response to taper changes is not clearcut. Although some adjustments have been made to reduce the wedge and to make employment more attractive, government policy has basically turned away from change in this area and proceeded in a different direction.

A less radical policy

First, over the last two decades, access to income support has been made more difficult. Many asset and income tests applied to those seeking welfare support are now more stringent. Longer waiting times have been introduced before people can gain access to particular programs.

Second, more emphasis has been placed on the welfare-to-work transition. One aspect of this policy has been to increase the degree of individual case management and to attempt to tailor the welfare system more closely to the job-finding needs of each person. Job-finding agencies have been privatised, and training and job placement activities subject to tender.

Third, more financial assistance has been offered to the low paid to accept jobs and to remain in employment. As low wages fall, in relative terms, the incentive structure is changing to make welfare support more attractive relative to low paid employment. To offset this, government is increasing the rewards from employment by allowing people to keep more welfare income while in low paying jobs. There is considerable interest in extending these *de facto* wage subsidies to the working poor.

Fourth, the indexation procedure for some welfare payments has been changed. Unemployment benefits, for example, are now indexed to the CPI and not wages. As a result, unemployment benefits are falling relative to average wages.

From an economist's viewpoint, Australian policy seems 'boxed in'. Real wages of the low paid cannot fall substantially because of the welfare floor, and yet there is no sign that the community will accept a lowering of the floor. In addition, minimum wages as a cost to employers are being increased, but the increases in real wages received are quite small because of the high effective tax rates. There is considerable discussion of the problem of labour utilisation, but little policy action.

Concluding comments

It is disturbing that Australia does not seem to have a good grip on what is going wrong with our labour utilisation outcomes and that we are being diverted from the task because other aspects of the economy are doing well. It could be argued, perhaps, that labour market deregulation will take some time to work and that we shall see an employment pay-off soon. But the fact that so much of the productivity growth seems to have gone into wage increases, especially for those who earn above average wages, does suggest pessimism. If Australia continues to turn away from direct job creation for the unskilled, further increases in inequality of wages are likely to occur over the next decade. Yet the employment response to a widening wage distribution in the past makes it difficult to foresee a substantial turnaround in the rate of full-time job creation.

Deregulating the labour market achieved many of the intermediate targets - unions are weaker, enterprise bargaining is more common and centralised wage fixing has been abandoned, except for safety net wage adjustments for the low paid. But success in increasing the low rate of labour utilisation has been limited. Australia is developing a dual labour market, wherein a significant group of individuals are spending increasing amounts of time on welfare support at the same time as the employed are gaining real wage increases.

Endnotes

[1] It is extremely difficult to isolate macro changes that can be attributed directly to labour market deregulation. The empirical evidence inevitably is ad hoc and broad brush. The facts presented should not be in doubt, but their interpretation as evidence of outcomes attributable to deregulation will inevitably be subject to debate.
[2] In contrast to the full-time employment loss, part-time employment has grown substantially. This growth, however, has been mainly focussed on young students and women, with little impact on the number seeking full time employment.
[3] Australian per capita GDP growth has not been as exceptional as is often suggested. In this respect, Australia's performance has been similar to that of the US.
[4] The calculations apply 1970 full-time employment and unemployment ratios to the 2003 population levels.
[5] I use the generic term 'tribunal', because the major authority in 1988 underwent a statutory restructure and a change of name. The Australian Industrial Relations Commission replaced the Australian Conciliation and Arbitration Commission.
[6] If the real wage remains above the full employment level, labour productivity will adjust as low productivity workers are laid off. The new balance reached between real wages and labour productivity will not occur at full employment.
[7] There was some divergence of opinion within the conservative parties as to whether the better policy was the pursuit of wage restraint through the centralised system or the dismantling of the system.
[8] The five economists are Professor P Dawkins, Professor J. Freebairn, Professor R. Garnaut, Dr M Keating and Dr C. Richardson. The basic ideas are found in Dawkins, P. and Freebairn J. (1997), "Towards Full Employment", *Australian Economic Review*, 30,4.405-17.
[9] To move from the 20th to the 30th percentile, the gross income of this person increases by $73, but net income by only $27.