

**WORKPLACE RELATIONS REFORM:
EXAMINING THE ECONOMIC DATA**

Address to a conference sponsored by

The Australian Financial Review

Tuesday 25th October 2005

Sofitel Hotel, Melbourne

by

Saul Eslake

Chief Economist,
Australia & New Zealand Banking Group Ltd

Mine is perhaps the only presentation on today's agenda which is not expected to argue a case either for or against the Government's proposed changes to Australia's industrial relations system(s). Rather, my task is to see what light (if any) the economic data sheds on the arguments for or against those changes. That may be an Herculean task. As Mark Latham noted in his *Diaries*, 'wages ... are such an emotional issue it is impossible to shift opinions, even based on sound empirical research'¹.

However, just so that people know where I'm coming from, I should indicate that I am a lukewarm supporter of the Government's proposed agenda, except for a couple of points which I'll address later on. I should also acknowledge, since this will in a sense be a recurring theme in my comments, that my support for the Government's agenda is more the result of my own *a priori* reasoning than being unequivocally grounded in economic theory or empirical data.

For most of my allotted time I want to focus on what economic theory and evidence tells us about two of the more important aspects of the Government's proposals: the changes to what is commonly referred to overseas as 'employment protection regulation', but which in this country is captured by the term 'unfair dismissal laws', and the changes to the procedures for setting the minimum wage.

Before I do that, however, I should note that there has been a significant amount of change in the direction of 'greater flexibility' in the Australian labour market over the past decade, largely as a result of the reforms introduced by the Keating Government in 1993, and by the Howard Government in 1996. In particular:

- the proportion of employees whose pay is set by awards only has dropped to 20%, from an estimated 68% in 1990²;
- fewer people are members of a trade union than at any time since 1958. The proportion of employees who are trade union members has dropped from 37.6% in 1993 to 22.7% in 2004. Only 17.4% of private sector employees are members of a trade union, down from 27.5% in 1993³;
- more people are now self-employed (as owner-managers of incorporated or unincorporated enterprises) than are members of trade unions⁴; and
- more people now directly own shares than are members of trade unions⁵.

Having had one of the most highly centralized and co-ordinate set of wage-setting institutions in the OECD until the early 1990s, Australia now sits towards the lower end of the OECD spectrum on both these scores⁶. Australia's wage-fixing arrangements are still more centralized than in other English-speaking nations (other than Ireland) or the Asian members of the OECD, Japan and Korea.

¹ Mark Latham, *The Latham Diaries* (Melbourne University Press, 2005), p. 98. It's not clear from the context whether this is Latham's own opinion, or that of David Card (co-author with Alan Krueger of the well-known study which argued that lifting minimum wages does not lead to higher unemployment), a discussion with whom is the basis of this entry.

² ABS, *Employee Earnings and Hours* (6306.0), May 2004, and Mark Wooden, *Australia's Industrial Reform Agenda*, Paper presented at the 34th Conference of Economists (September 2005), p. 3.

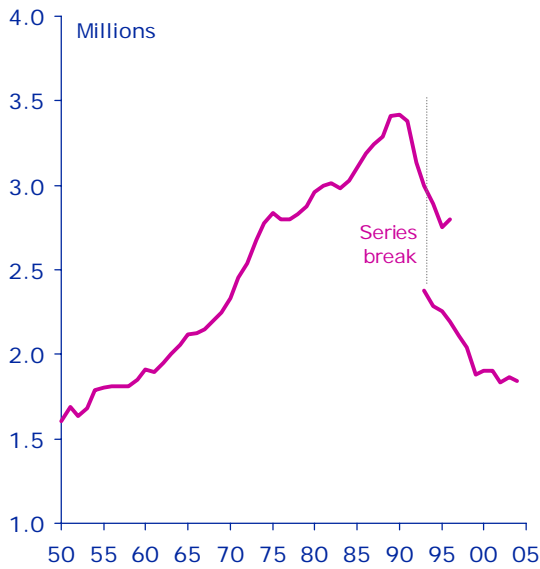
³ ABS, *Employee Earnings, Benefits and Trade Union Membership* (6310.0), August 2004.

⁴ As for footnote 3, and ABS, *Australian Labour Market Statistics* (6105.), October 2005.

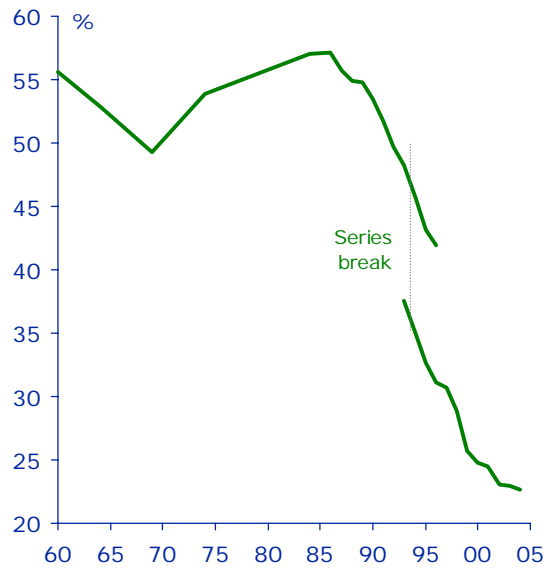
⁵ As for footnote 3, and ASX, *Australia's Share Owners* (2005).

⁶ OECD *Employment Outlook 2004* (Paris, 2004) p. 151.

Number of union members

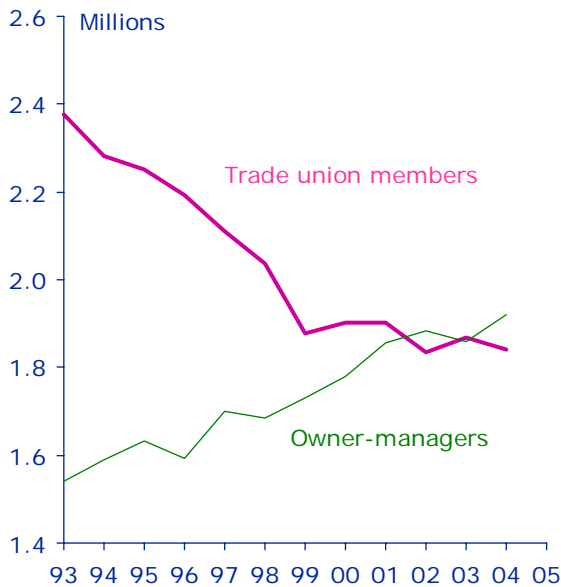


Union membership as a p.c. of total employees

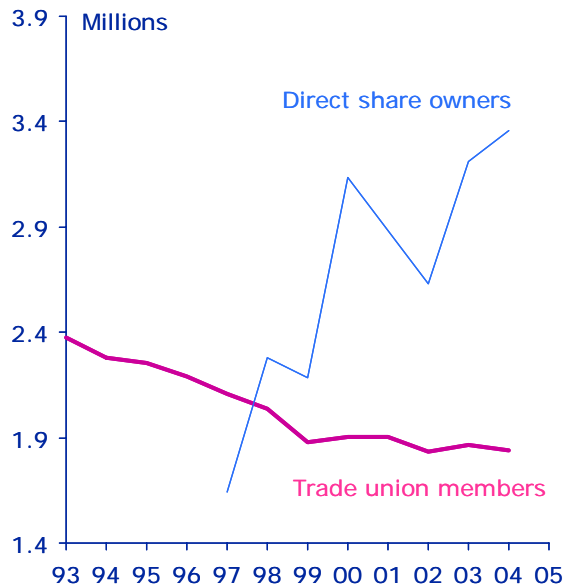


Data up to 1984 are as at 31 December; from 1984 to 1996 (old series) are as at 30 June; from 1984 (new series) are as at 31 August. *Source: ABS, Employee Earnings, Benefits and Trade Union Membership (6310.0).*

Union members and owner-managers of businesses



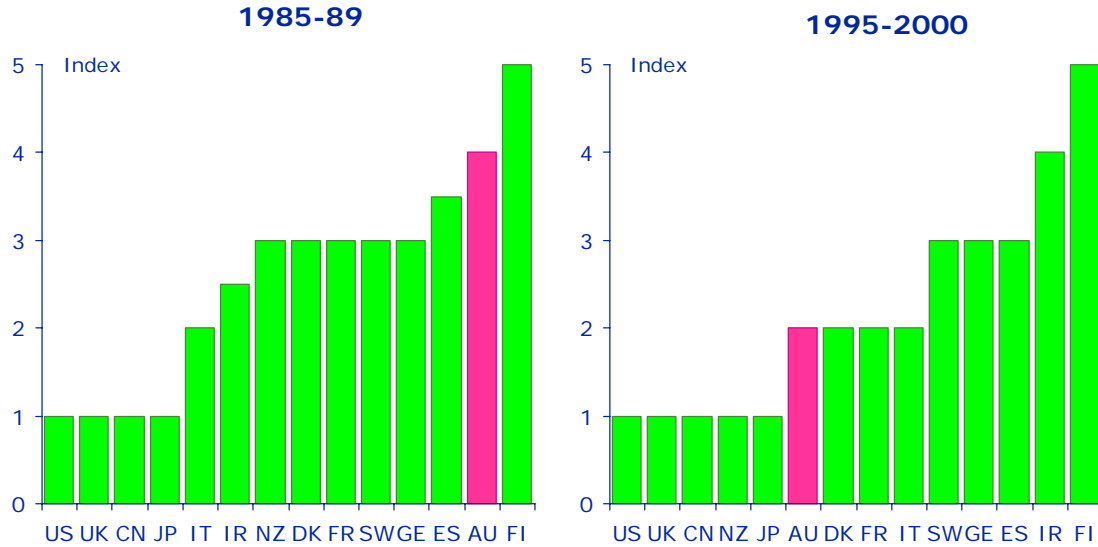
Union members and direct share owners



Sources: ABS, Employee Earnings, Benefits and Trade Union Membership (6310.0) and Labour Market Statistics (6105.0); Australian Stock Exchange, Australia's Share Owners 2004.

Since the 1993 Keating Government reforms, Australia's labour market has delivered strong jobs growth (albeit at a slightly lower rate than during the previous twelve years); falling unemployment and under-employment; rising productivity (at least until the end of 2003, since when productivity growth has gone into reverse) and real wages; well-behaved real unit labour costs (rising by 1.3% pa, on average, over the past 12 years), and (at least by Australian standards) low levels of industrial disputation.

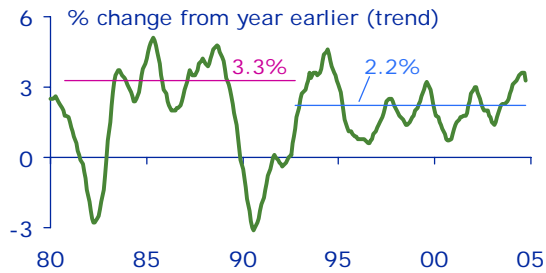
Degree of centralization of wage-setting institutions



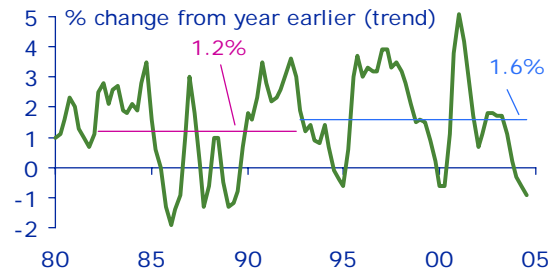
1 = company/plant level predominant 5 = central-level agreements predominant

Sources: OECD *Employment Outlook 2004*, Table 3.5 p.151.

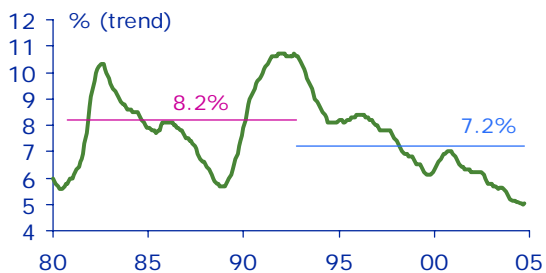
Employment growth



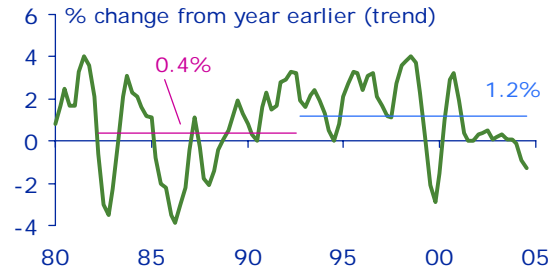
Labour productivity growth*



Unemployment rate



Real wages†



* Treasury measure. † Non-farm average earnings deflated by non-farm product deflator.

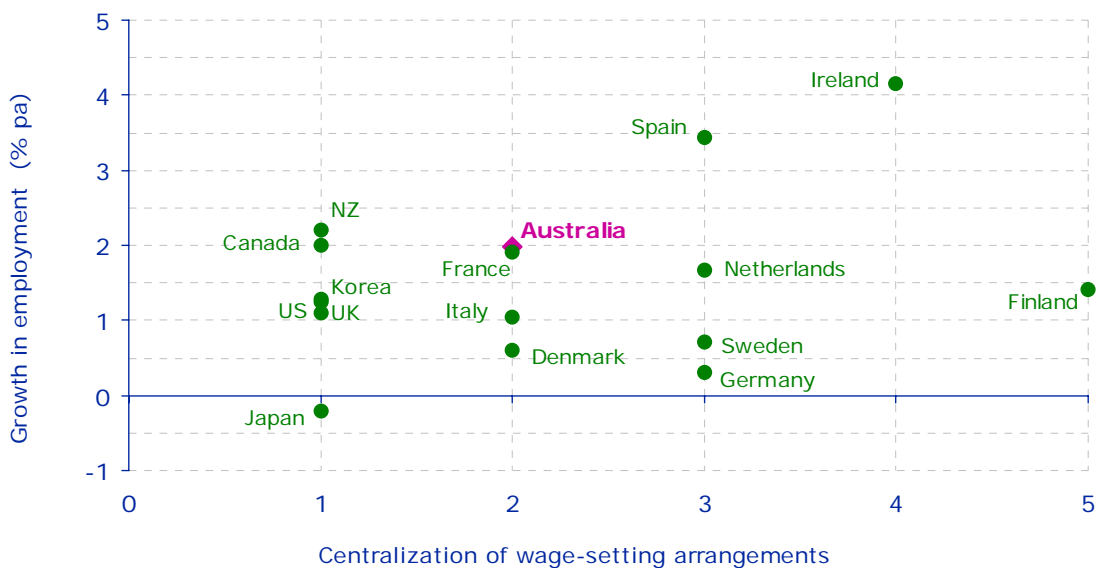
Source: ABS, *The Labour Force* (6202.0); Commonwealth Treasury website; Economics@ANZ.

How much of this is due to changes in industrial relations arrangements, as opposed to 14 years of more or less continuous economic growth – the longest period unpunctuated by at least two consecutive quarters of negative growth in Australia's history – is difficult to ascertain. Indeed to the extent that changes in industrial relations arrangements have lessened the probability of a 'wages break-out' as the economy has approached 'full employment' over the past year – as has occurred at the same stage of each of the three previous business cycles – then they may have contributed to prolonging the current expansion.

International data on the impact of industrial relations arrangements on labour market performance is not entirely unambiguous. For example there is no obvious correlation between the degree of centralization of wage-setting arrangements (as measured by the OECD) and employment growth over the past decade.

Indeed a simple regression of the latter on the former produces a co-efficient with the 'wrong' sign from the perspective of those expecting to find an inverse correlation between these two variables (although the co-efficient is not statistically significant). The co-efficient becomes negative if the two apparent 'outliers' of Spain and Ireland are excluded; but it is even less statistically significant and the R^2 is just 6%.

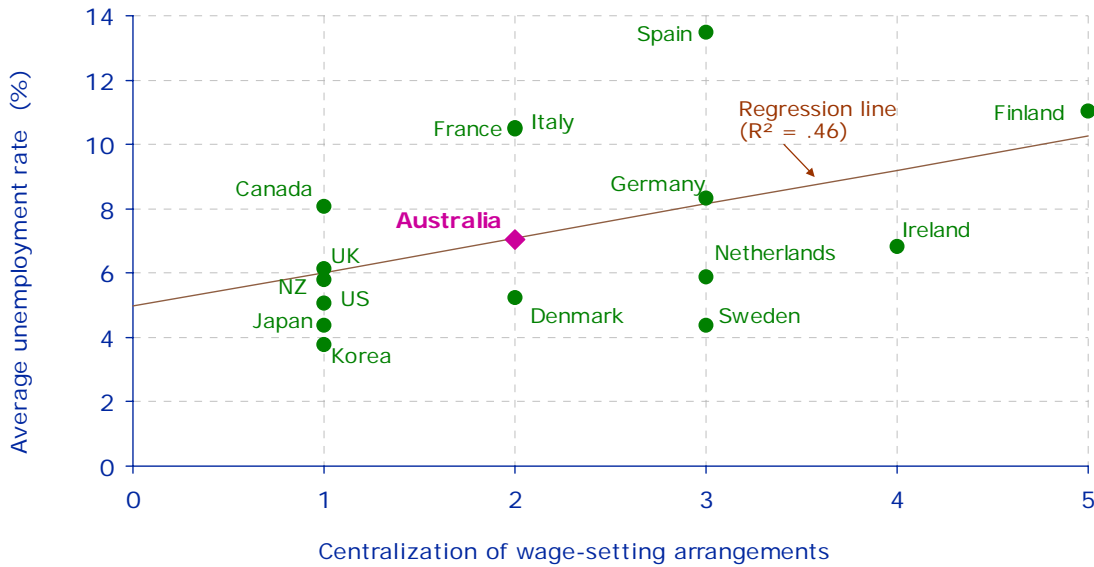
Centralization of wage-setting arrangements 1995-2000 and employment growth 1994-2004



Sources: OECD *Employment Outlook* 2004, Table 3.5;
OECD *Economic Outlook* database via Datastream.

There appears to be a stronger association between the degree of centralization of wage-fixing arrangements and average unemployment rates over the past decade (see chart on page 5). A simple regression of the latter on the former produces a (just) statistically significant co-efficient with the expected positive sign, and an R^2 of 0.46. However it is clear that some countries are able to combine relatively centralized wage setting arrangements with rapid employment growth and low unemployment.

Centralization of wage-setting arrangements 1995-2000 and average unemployment rate 1994-2004



Sources: OECD *Employment Outlook* 2004, Table 3.5;
OECD *Economic Outlook* database via Datastream.

Employment protection regulation and labour market outcomes

Australia's employment protection legislation is 'one of the least restrictive' in the OECD⁷. According to the OECD's 2004 *Employment Outlook* report, only the United States, Canada, the United Kingdom, Ireland and New Zealand had less strict employment protection legislation than Australia⁸ (see chart on p. 6).

The Government nonetheless argues that Australia's 'current unfair dismissal laws not only discourage job creation across businesses, but impose costs on businesses – small, medium and large alike'⁹. The Prime Minister said recently that the unfair dismissal laws have led to 'a culture of complaint and litigation that loads extra costs onto those who society relies on to create wealth and jobs by taking risks with their own livelihoods' and that they 'hurt the good staff, they discourage small firms from taking on more people and they are a prime example of where over-regulation has worked to the detriment of both business and also employees'¹⁰.

The Howard Government is not the only contemporary government which takes this view. Last Wednesday's *Financial Times* reported that the Socialist government of Spanish Prime Minister José Luis Rodríguez Zapatero is also seeking to relax rules regarding dismissal of workers¹¹.

⁷ OECD, *Economic Survey of Australia 2004* (Paris, February 2005), p. 191.

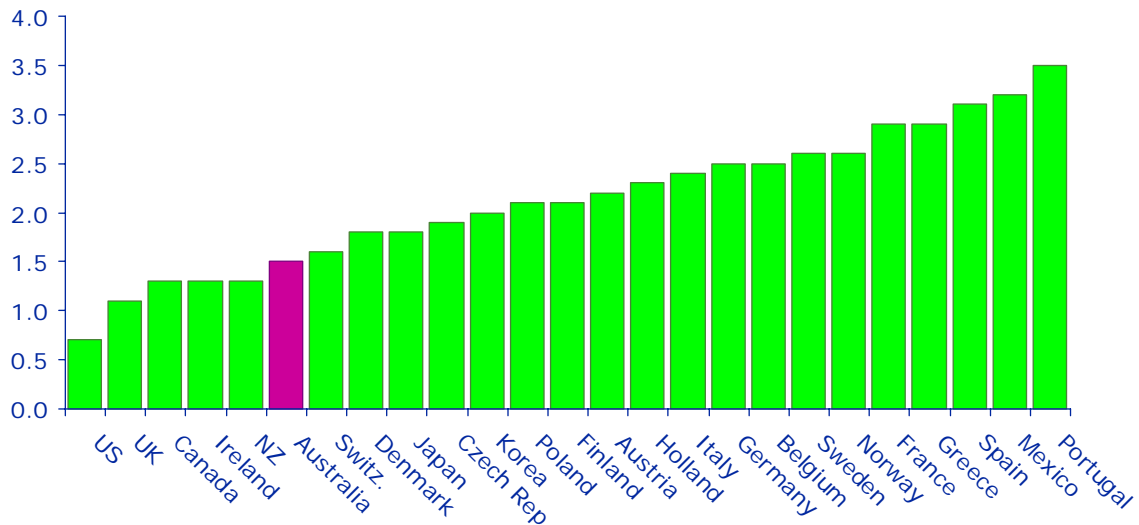
⁸ OECD, *Employment Outlook 2004* (Paris, 2004, p. 117).

⁹ Hon. Kevin Andrews MP, Minister for Employment and Workplace Relations, 'A Better Balance for Unfair Dismissal' (Media Release, 9 October 2005),

¹⁰ Hon. John Howard, MP, Prime Minister, 'Why Our Unfair Dismissal Laws Aren't Working', Address to the Chamber of Commerce and Industry of Western Australia (Perth, 29 September 2005).

¹¹ 'Zapatero's labour reforms spark anger among unions', *Financial Times* (19 October 2005), p. 4.

Overall strictness of employment protection legislation 2003 (0 = low; 4 = high)



Source: OECD, *Employment Outlook 2004*,
Table 2.A2.4, p. 117.

The idea that legislation which increases the costs (both pecuniary and in terms of management time) of dismissing employees has an adverse impact on hiring enjoys fairly widespread support among economists. Earlier this month the Chairman of the US Federal Reserve, Alan Greenspan, noted that:

'Many working people, regrettably, equate labour market flexibility with job insecurity. Despite that perception, flexible labour market policies appear to *promote* job creation, not destroy it. An increased capacity of management to discharge workers without excessive cost, for example, apparently increases companies' willingness to hire without fear of unremediable mistakes'¹².

Economic theory generally suggests that employment protection legislation tends to depress both hiring and firing, and this prediction is generally supported by empirical evidence¹³. That is, employment protection legislation does protect existing jobs to at least some extent, while also adversely affecting the creation of new jobs.

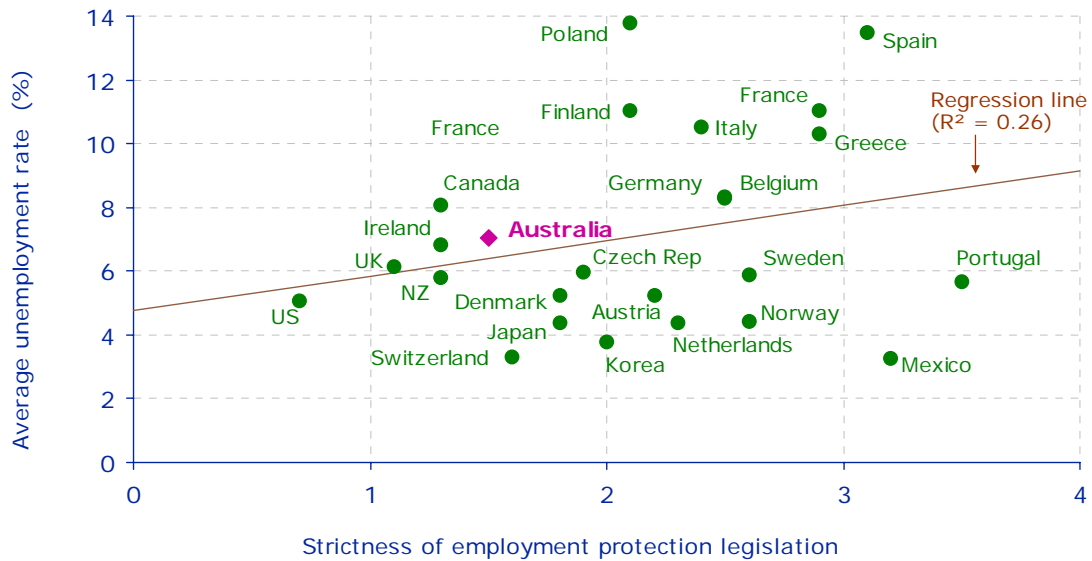
It seems reasonable to infer from this that employment protection legislation may inhibit the ability of businesses, and the economy more broadly, to respond to technological change (which may have to be accommodated through worker turnover); although it could also be argued that employment protection legislation may make workers less resistant to technological change and more willing to undergo re-training.

The finding that employment protection laws reduce both hiring and firing also means that their effect on unemployment is *a priori* ambiguous: it depends on whether the latter effect is greater than the former.

¹² Alan Greenspan, 'Economic Flexibility', Remarks before the National Italian American Foundation (Washington DC, 12 October 2005), p. 5.

¹³ OECD (2004), p. 76-79.

Strictness of employment protection legislation and average unemployment rate 1994-2004



Sources: OECD *Employment Outlook* 2004, Table 2.A2.4, p. 117;
 OECD *Economic Outlook* database via Datastream.

The empirical evidence on this is far from unequivocal. A simple regression of average unemployment rates in OECD countries over the past decade on the strictness of employment protection legislation (as measured by the OECD) produces a coefficient with a positive but statistically insignificant sign and an R^2 of only 26%.

Of nine recent empirical studies summarized by the OECD in its 2004 *Employment Outlook*, five found a statistically significant negative impact of employment protection legislation on unemployment, while four either found no impact, or an impact that was not statistically significant¹⁴.

However the studies reviewed by the OECD do provide some support for the notion that employment protection legislation may adversely affect the employment prospects of young people and women – who at any given time are more likely to be seeking to enter or re-enter the workforce – while positively impacting the stability of employment of prime-age men¹⁵.

It's worth noting that the Government proposes to retain the existing unfair dismissals laws for employers with more than 100 employees (who account for about 38% of employees¹⁶), whilst abolishing them for employers with fewer than this number – even though, as the Minister acknowledged in the press release from which I quoted earlier, these laws impose costs on large businesses as well as small ones.

There are two observations I'd like to make about this.

¹⁴ OECD (2004), pp. 82-84.

¹⁵ Ibid., pp. 85-86.

¹⁶ ABS, *Wage and Salary Earners, Australia* (6248.0), Table H20C. Data are for August 2001. This publication has since been discontinued. The ABS Business Register (details of which for June 2004 were published in 8161.0.55.001 on 7 October 2005) classifies employers into 0-19, 20-199 and 200 or more employees.

First, it would appear that if the Government accepts that there is a case for employees to be protected against unfair dismissal – which it presumably does since it is not abolishing the law for all employees – then it is a little strange that the employees who are to remain protected from unfair dismissal are actually those least likely to be unfairly or capriciously dismissed. That's because large corporations usually have HR departments whose functions include ensuring that their managers adhere to 'procedural fairness' when dismissing staff; and because large corporations are generally more conscious of the reputational risk involved in unfair dismissals cases.

That being so, a more creative response on the part of the Labor Party to this element of the Government's proposed reforms might have been to replace the word 'under' in the relevant section of the legislation with the word 'over': so that those working for employers with fewer than 100 employees continued to be protected against something that was more likely to happen to them, while larger employers were exempted from those provisions.

Second, it is interesting that some of those claiming to speak for small business have been assiduously pushing for amendments to the Trade Practices Act to allow them to 'bargain collectively' with large corporations, in order to redress the alleged imbalance of bargaining power between small and large businesses, whilst simultaneously being fervent proponents of changes to industrial relations legislation making it more difficult for employees to bargain collectively with them. There seems to be an element of inconsistency between these two positions.

New procedures for setting the minimum wage

Australia's minimum wage, most recently set at \$484.40 per week (or \$12.75 per hour for a 38-hour week) is high, relative to median wages, by international standards. According to the OECD, the Australian minimum wage (in 2002) was equivalent to 58% of the median earnings of full-time adult employees, a higher figure than for any other OECD country for which such a comparison is possible except France¹⁷ (see chart on page 9). In its 2005 National Minimum Wage Report, Britain's Low Pay Commission reported earlier this year that Australia's 2004 minimum wage was equivalent to 58.8% of median full-time adult earnings, higher than for any of the 13 other OECD economies covered¹⁸.

As the Melbourne Institute's Mark Wooden points out, 'for most economists, minimum wage to median earnings ratios of close to 60% are indicative of a system that prices many of the unemployed out of the labour market'¹⁹.

David Card and Andrew Krueger, authors of the now well-known study ten years ago which suggested that increases in the minimum wage did not have the adverse impact on employment traditionally ascribed to them, acknowledge that their findings only applied to levels of the minimum wage that existed in the United States (a little over 30% of median full-time adult earnings) and that, beyond some point, minimum wage increases must harm employment²⁰.

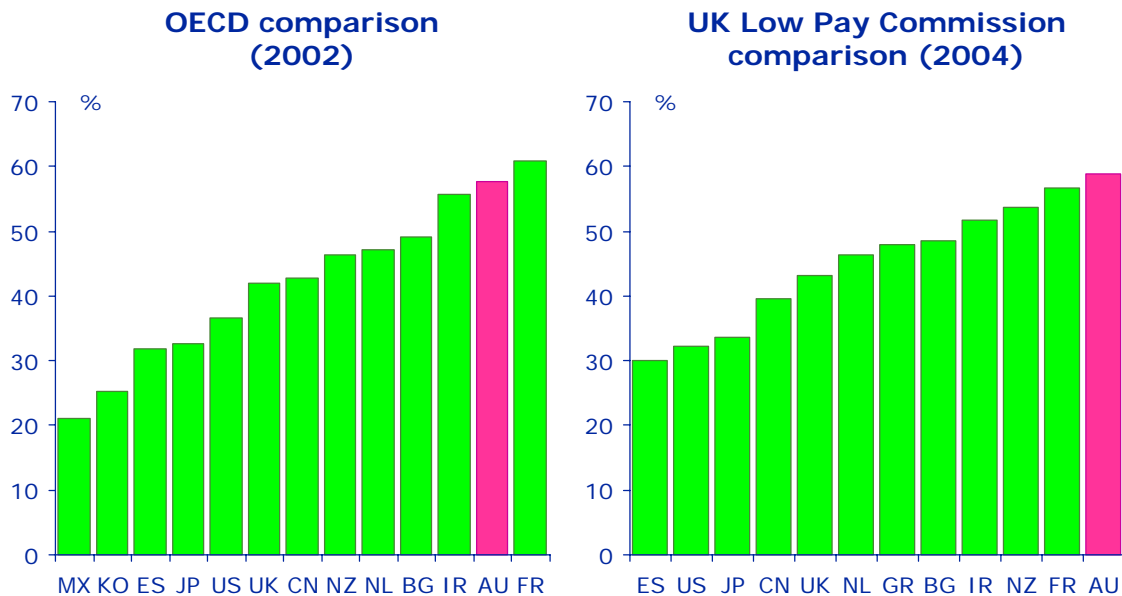
¹⁷ OECD, *Economic Survey of Australia 2004* (Paris, February 2005), p. 189.

¹⁸ UK Low Pay Commission, *National Minimum Wage: Low Pay Commission Report 2005* (HMSO, London, February 2005), Table A4.2 (<http://www.lowpay.gov.uk/lowpay/lowpay2005/appendix4.shtml>).

¹⁹ Mark Wooden, *op. cit.*, p. 8.

²⁰ David Card and Andrew Krueger, *Myth and Measurement: The New Economics of the Minimum Wage* (Princeton University Press, 1995), p. 393; quoted by Wooden, *ibid.*

Minimum wages as a p.c. of average earnings



Sources: OECD earnings structure database; UK Low Pay Commission, *National Minimum Wage Report 2005*, Table A4.2.

The UK Low Pay Commission believes that the British minimum wage – first introduced at £3.60 per hour (for persons aged 22 and over) in April 1999, and since increased by 35% to £4.85 per hour, equivalent to 43% of median full-time adult earnings – ‘does not seem to have had any significant negative impact on the labour market any significant negative impact on the labour market’, although two research projects which they commissioned found ‘small negative employment effects in those sectors and among those most affected by the minimum wage’. The Commission also found that the minimum wage has ‘had a major beneficial impact on the aggregate earnings of women’ without ‘harming women’s job prospects’²¹.

In the Australian context, there have been a number of recent studies suggesting that increases in the minimum wage have adversely affected employment.

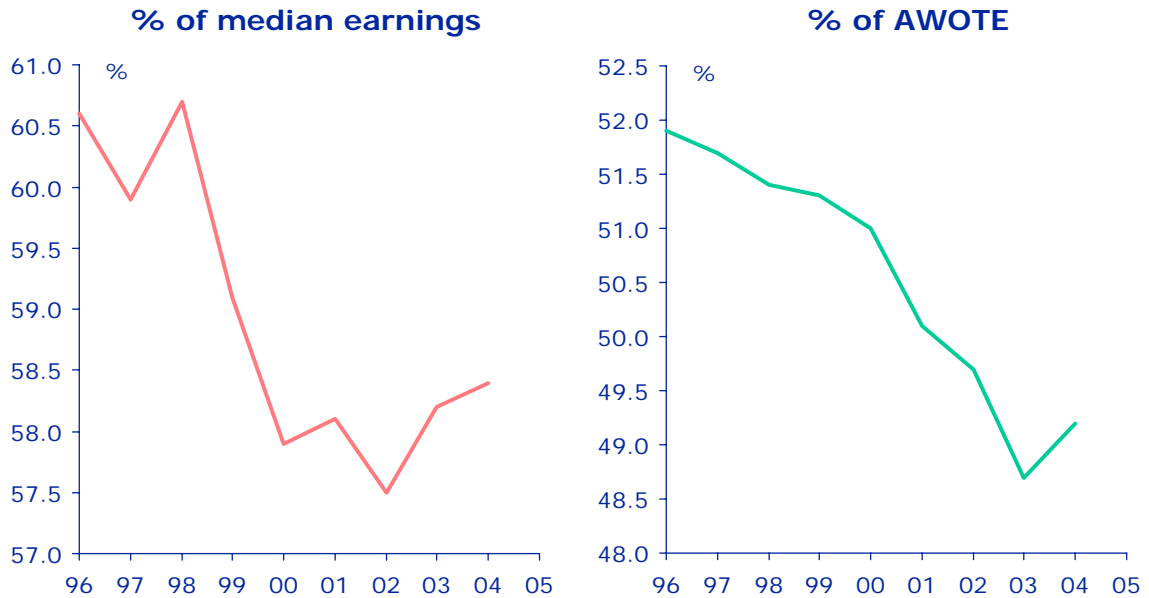
A 2003 study of the impact of six increases in the WA minimum wage between 1994 and 2001 by Andrew Leigh suggested that a 1% increase in the minimum wage leads to a 0.15 percentage point fall in employment²². Don and Glenys Harding, who were commissioned by the Commonwealth Government to conduct a survey of the impact of ‘safety net’ adjustments on small and medium businesses, found that a 1% increase in the minimum wage reduced employment by about 0.2%²³. Both of these studies were the subject of methodological criticisms and were given short shrift by the Australian Industrial Relations Commission in this year’s safety net review, as was most of the international evidence on this subject.

²¹ UK Low Pay Commission, *op. cit.*, paragraphs 2.90, 2.68 and 4.9.

²² Andrew Leigh, ‘Employment Effects from Minimum Wages: Evidence from a Quasi-Experiment’, *Australian Economic Review* Volume 36 No. 4 (December 2003), pp. 361-73.

²³ Don and Glenys Harding, *Minimum Wages in Australia: an Analysis of the Impact on Small and Medium Sized Businesses* (Turning Point Research Pty Ltd, 2004).

Australia's minimum wage as a p.c. of average earnings



Source: Australian Industrial Relations Commission, *Safety Net Review – Wages* (PR002005, 7 June 2005), Tables 22 and 23.

Nonetheless, the Commission has allowed the minimum wage to decline from 60.6% of median earnings in 1996 to 58.4% in 2004, or from 51.9% to 49.2% of full-time adult average weekly ordinary time earnings over the same period²⁴.

In some ways, the debate over whether the minimum wage should be set by the AIRC, or by the Fair Pay Commission envisaged by the Government, seems to be a cover for a debate about whether this trend should be accelerated or not.

Of course the Australian minimum wage has its origin, nearly a century ago, in the notion of an income sufficient to allow a man to support his wife and three children in 'frugal comfort', which may explain why the Australian minimum wage has historically been higher relative to median earnings than in other countries.

(Incidentally, the 1907 Harvester Judgement was premised on a creative extension of the Commonwealth's excise power, just as the Howard Government's *WorkChoices* package is partly grounded on an extension of the corporations power.)

However, the labour market is no longer comprised predominantly of married men supporting stay-at-home wives and dependent children. In reality, more than half of low-wage earners are located in households in the top half of the income distribution²⁵, while the bottom quintile is dominated by those in receipt of social security payments. Hence, many economists (myself included) believe that support for low-income earners is more appropriately provided through the income tax and social security systems than via the industrial relations system. In that context, I think it is unfortunate that the Government's *WorkChoices* proposals haven't been accompanied by reforms in these areas.

²⁴ Australian Industrial Relations Commission, *Safety Net Review – Wages* (PR002005, 7 June 2005), p. 108.

²⁵ A. Harding and S. Richardson, 'The Lowly Paid, the Unemployed and Family Incomes', *Australian Journal of Labour Economics* Volume 3 (March 1999), pp. 23-46.

Conclusion

My interpretation of the economic data is that it lends some support to the Howard Government's proposed reforms, but that support is neither unequivocal nor incontestable. I would add that the economic evidence also suggests that goals of increasing participation in the labour force, reducing long-term unemployment and reducing poverty require reforms in other areas in addition to workplace relations, including tax, social security, and education and training.

In the end, attitudes to the Government's proposed reforms are probably informed more by politics than by economics, and I doubt that there is anything any economist can say which will alter that.