

STATEMENT 4: MAINTAINING LOW UNEMPLOYMENT IN AUSTRALIA

Statement 1 outlines the need to take early action to increase productivity and labour force participation in order to boost Australia's medium-term growth potential and address the ageing of the population already underway.

The rise in unemployment in Australia, commencing in the 1970s, meant that the contribution of labour force participation to real growth in GDP per capita fell over the past 40 years.

Over recent years, Australia's unemployment has been on a steady downward trend. Now below 6 per cent, it is around 23 year lows and is expected to remain low over the forecast period. Unemployment sustained around these levels marks an important breakthrough against the poor unemployment outcomes recorded from the mid-1970s.

Policy reforms have helped to create the circumstances where unemployment has fallen steadily and sustainably. The labour market is now more flexible, and the economy is less prone to the boom-bust cycles of the past as a result of product market reforms and steadier macroeconomic policy settings.

Further reform is announced in the 2004-05 Budget, which puts in place a package of major initiatives that address directly the objective of increasing economic growth by increasing participation and productivity. The package will assist with reducing welfare traps for those receiving family tax benefits and deliver tax cuts that will increase the reward from working. The Budget also contains initiatives that increase investment in education, health, innovation and infrastructure that will assist participation and productivity.

These initiatives, together with the current solid macroeconomic environment, will enable Australia to achieve lower unemployment and higher labour force participation, provide a higher level of social wellbeing and help deal effectively and sustainably with the ageing of the population.

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MAINTAINING LOW UNEMPLOYMENT IN AUSTRALIA

INTRODUCTION

The unemployment rate is one of the most widely monitored partial indicators of a country's economic performance and the wellbeing of its society. Australia's unemployment rate has been sustained at around 23 year lows since late 2003, below 6 per cent, and there is scope for it to fall further over the medium term with appropriate policy settings.

Economic and social outcomes are enhanced when low unemployment is combined with high productivity in an environment where people can make sound decisions about participation in the labour force. This is evident in a number of ways. Average household incomes are likely to be higher and more stable than otherwise; income is likely to be more evenly distributed across the community, given that unemployment or non-participation in the labour force is a key contributor to relative poverty in the community; employed individuals and households tend to be more actively engaged in society and social activities; and a steady stream of income from regular employment provides individuals and households with greater opportunity to save, borrow and invest for their future and to contribute to the education of their children.

Unemployment sustained at around or below 6 per cent marks a major break from the past. Unemployment has averaged around 7½ per cent over the period since the late 1970s, but had only dipped to around 6 per cent briefly on two occasions prior to 2002. In the late 1980s, the decline in unemployment to around 6 per cent was accompanied by concerns about excessive strength in demand, a widening current account deficit and the prospect of rising inflationary pressure. A subsequent sharp slowdown in the economy saw unemployment rebounding to nearly 11 per cent over the next few years. In 2000, the decline to around 6 per cent saw only a modest push up in wage and price pressures, with unemployment rising to around 7 per cent for a short time as the economy slowed in line with weakening world growth and high oil prices, before resuming a downward trend.

The circumstances surrounding Australia's current economic performance are quite different to those earlier episodes and point to unemployment rates of 6 per cent or less now being much more sustainable. Economic and employment growth has been steadier, avoiding a build-up of inflationary pressure, as evidenced from a wide range of indicators such as wage costs, participation rates, hours worked, and a more even regional distribution of employment growth and falls in unemployment.

The improving performance of the labour market reflects a payoff from the wide range of macroeconomic and microeconomic reforms implemented over the last decade. Consistent macro policy settings, in a medium-term framework, since the mid-1990s are contributing to steadier economic and employment growth. Coupled with the

increased flexibility of the economy flowing from the long-term programme of microeconomic reform, this is making the economy less prone to the booms and busts of the past, which made it difficult to achieve a steady and sustainable approach to low unemployment levels. Flexible workplace relations and active labour market programmes, along with increased participation in education and training, have contributed to a more flexible, adaptable and responsive labour market. Better incentives to participate in the labour force and for the unemployed to actively seek employment have come through reductions in income tax rates and reforms to income support arrangements.

Australia's current unemployment rate is not only low relative to the experience of recent decades, unemployment in Australia has been below the OECD average since late 2001, the first time it has been lower than the OECD average for a sustained period since the late 1980s. But there are several developed economies with unemployment rates below Australia's, for example New Zealand and Ireland. Structural unemployment rates in the United States also seem likely to be lower than in Australia. This suggests there is scope to sustainably lower unemployment further in Australia over the medium term, with ongoing steady growth and further policy reform.

The first section of the Statement reviews the performance of the labour market in recent decades with a focus on unemployment. An emphasis in this section is placed on a comparison of the circumstances surrounding the decline in unemployment to around 6 per cent in the late 1980s, 2000 and the most recent period since 2002. The second section of the Statement surveys the changes in policy settings which have contributed to the improved labour market performance in recent years and considers where there may be scope for policy settings to be tuned to further reduce unemployment.

TRENDS IN THE UNEMPLOYMENT RATE OVER RECENT DECADES

Unemployment in Australia since the Second World War

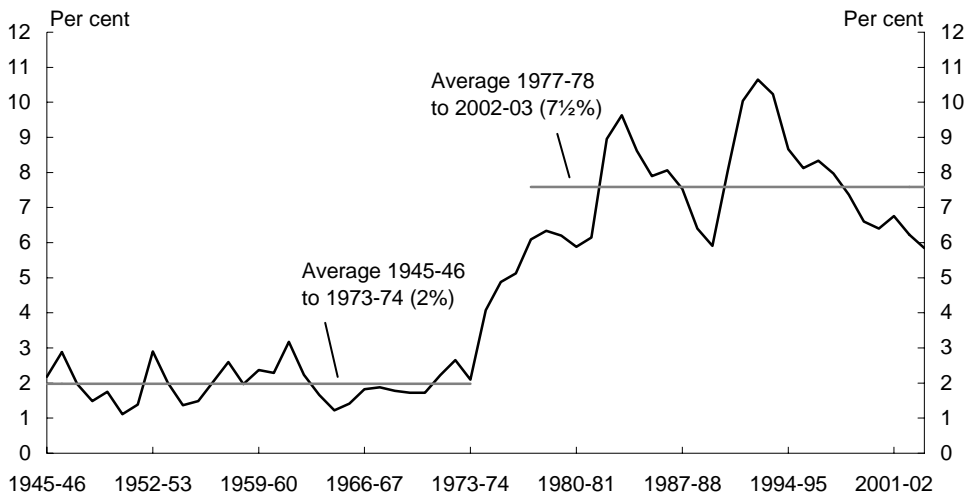
The unemployment rate is influenced by a range of factors. These include the prevailing economic environment, the institutional and policy framework for the labour market, and a range of social factors such as attitudes towards desired hours of work and willingness to move locations or undertake further training in order to secure employment.

Chart 1 illustrates Australia's measured unemployment rate over the period from the end of the Second World War to 2003-04 (Box 1 briefly reviews the trends in unemployment in Australia between Federation and the Second World War). It is evident from the chart that unemployment rates have traditionally been subject to significant short-term fluctuations. It is also evident that there was a substantial increase in the average unemployment rate from the mid to late 1970s, compared with earlier decades.

In the period from the Second World War to the mid-1970s, the unemployment rate fluctuated around a longer-term average of 2 per cent, reaching as high as around 3 per cent, with a low point of around 1 per cent. In contrast, in the period from the mid-1970s to the early 2000s, the unemployment rate fluctuated around a longer-term average of 7½ per cent, reaching as high as 10.9 per cent in 1992, with a low point currently below 6 per cent.

These longer-term average rates of unemployment are sometimes referred to as structural unemployment rates, on the assumption that they are more likely to reflect the longer-term economic, institutional and social factors driving the labour market. These factors can change over time, and when they change the structural rate of unemployment will change. However, most moves in the unemployment rate are not structural, but rather reflect only short run or cyclical swings in economic activity.

Chart 1: Australia's unemployment rate, 1945-46 to 2003-04

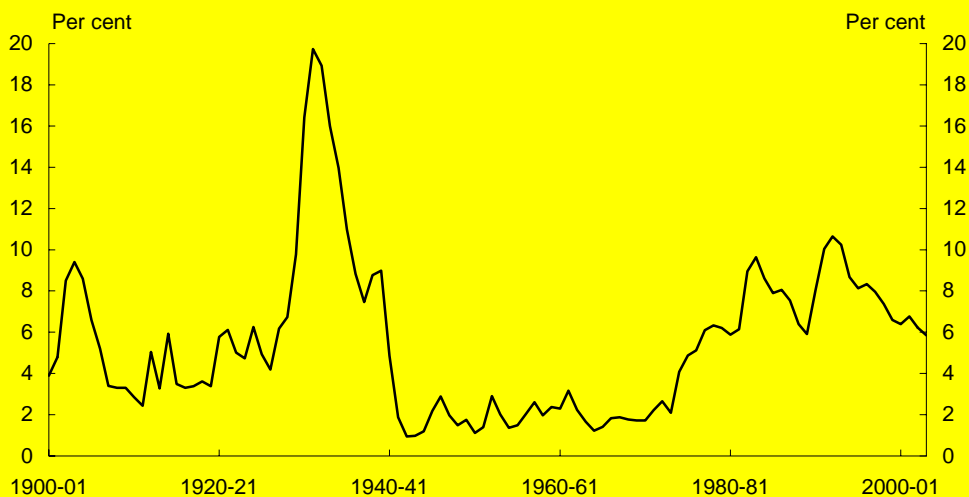


Source: Data to 1965-66 from *Preliminary Annual Database 1900-01 to 1973-74* (Reserve Bank of Australia Research Discussion Paper 7701). Data from 1966-67 to the present is from *Labour Force, Australia* (ABS Cat. No. 6202.0). 2003-04 figure is the average for the nine months to March 2004.

The increase in the structural rate of unemployment since the mid-1970s likely reflected a range of factors. In the 1970s, poor macroeconomic policy management (especially in the face of the first oil price shock), combined with rigid institutional arrangements in the labour market and strong union influence, resulted in much higher inflation and a sharp increase in real wages relative to underlying trends in productivity. The resultant real wage 'overhang' resulted in a reduction in employment opportunities and rising unemployment as businesses reacted to the increased cost of labour.

Box 1: Australia's unemployment rate since Federation

Chart 2: Unemployment rate, Australia, 1900-01 to 2003-04



Source: Data to 1973-74: *Preliminary Annual Database 1900-01 to 1973-74* (Reserve Bank of Australia Research Discussion Paper 7701). Data from 1974-75: *Labour Force, Australia* (ABS Cat. No. 6202.0). 2003-04 figure is the average for the nine months to March 2004.

Chart 2 shows the level and variability of Australia's unemployment rate since Federation.¹ Australia's unemployment rate prior to the Great Depression in the early 1930s generally varied in a range between 3 and 6 per cent. The Great Depression was associated with a very large increase in unemployment, rising from just over 4 per cent in 1926-27 to over 19 per cent in 1931-32.

It then took a further 9 years, and the outbreak of the Second World War in 1939, for the unemployment rate to return to under 4 per cent. During the war, the labour market was distorted by the demand for military personnel, and so called 'manpower planning' in many key sectors of the economy.

Through the late 1970s productivity growth also slowed, prolonging and intensifying the effect the real wage overhang had on the unemployment rate. The existing centralised wage fixing system meant that wages were generally tied to inflation, so the real wage overhang could not be quickly removed over time. The early 1970s also saw a range of reforms to the social welfare system specifically aimed at providing a more generous and comprehensive welfare safety net. However, a consequence of

1 Care should be taken in interpreting this chart. The definition of unemployment has changed over time, and the estimates prior to the Second World War are relatively unreliable.

some of these reforms is likely to have been a reduced incentive for some unemployed people to actively seek work.²

The pattern of a substantial increase in both unemployment and inflation (often referred to as 'stagflation') was seen in many countries during the period of the late 1970s, and Australia's experience was not unique. Although starting from a higher base, the average unemployment rate jumped by around 2 percentage points in the less regulated labour market of the United States, and by an average of over 4 percentage points in the larger European countries with more regulated labour markets. The increase in average unemployment rates in Australia was one of the largest at around 5 percentage points (comparing 1960-1973 with 1973-1990), with Australia moving from having one of the lowest unemployment rates in the world to a relatively high rate. Box 2 provides further detail on longer-term trends in unemployment and inflation for Australia and some other OECD countries.

Chart 1 also shows that, since the sharp increase in unemployment in the 1970s, previous episodes of low unemployment have generally not been sustainable. They were often associated with an overheating economy, with the unemployment rate rebounding to higher levels shortly after reaching historical lows. The factors which drove these rebounds in unemployment are complex and likely to have varied from episode to episode. In broad terms, emerging tightness in labour markets as the unemployment rate declined towards the lower point is likely to have put increased pressure on wages (especially in the early 1980s), at least in some industries and regions, particularly if output and employment had been increasing rapidly.

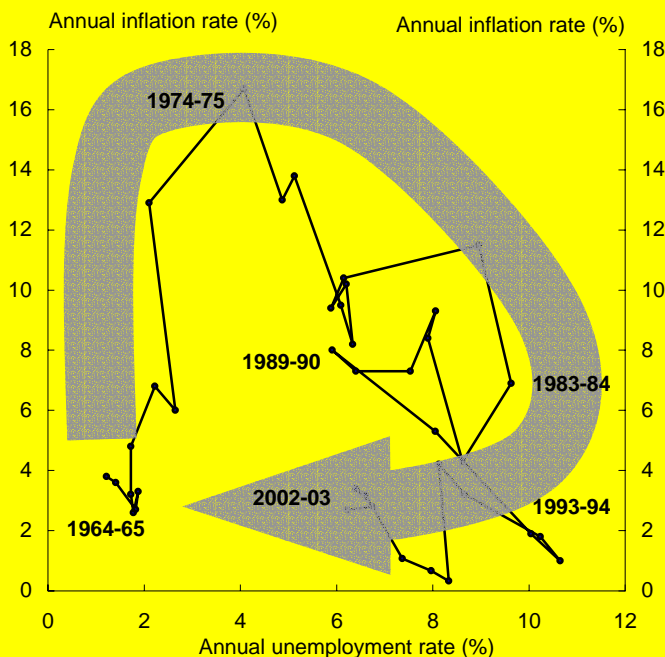
With centralised wage fixing, which Australia has had in some form over most of the period, wage pressures in one sector or region would quickly flow into other parts of the economy, even where labour demand pressures were less apparent. This, in turn, tended to raise concerns about increased inflationary pressure as higher wage costs were passed on in the form of higher prices, a process exacerbated by limited or restricted competition in the market for many goods and services. Put another way, whatever 'impulse' to the economy generated pressure for higher wages in one sector or region, the centralised wage system helped 'propagate' this to the broader economy. Limited competition in product markets then allowed this first-round inflationary effect to be embedded into the economy.

2 Further discussion of this structural increase can be found in J. Borland and S. Kennedy (1998), 'Dimensions, Structure and History of Australian Unemployment', in G. Debelle and J. Borland (eds), *Unemployment and the Australian Labour Market*, proceedings of a conference held by the Reserve Bank of Australia and the Australian National University, Sydney.

Box 2: Unemployment and inflation — the Phillips Curve

One way to measure the change in Australia’s economic performance over time is to trace out the combination of inflation rates and unemployment rates recorded over a period of years. The result is sometimes referred to as a ‘Phillips Curve’.³

Chart 3: The Australian Phillips Curve



Source: *Labour Force, Australia* (ABS Cat. No. 6202.0) and *Consumer Price Index, Australia* (ABS Cat. No. 6401.0), Treasury calculations.

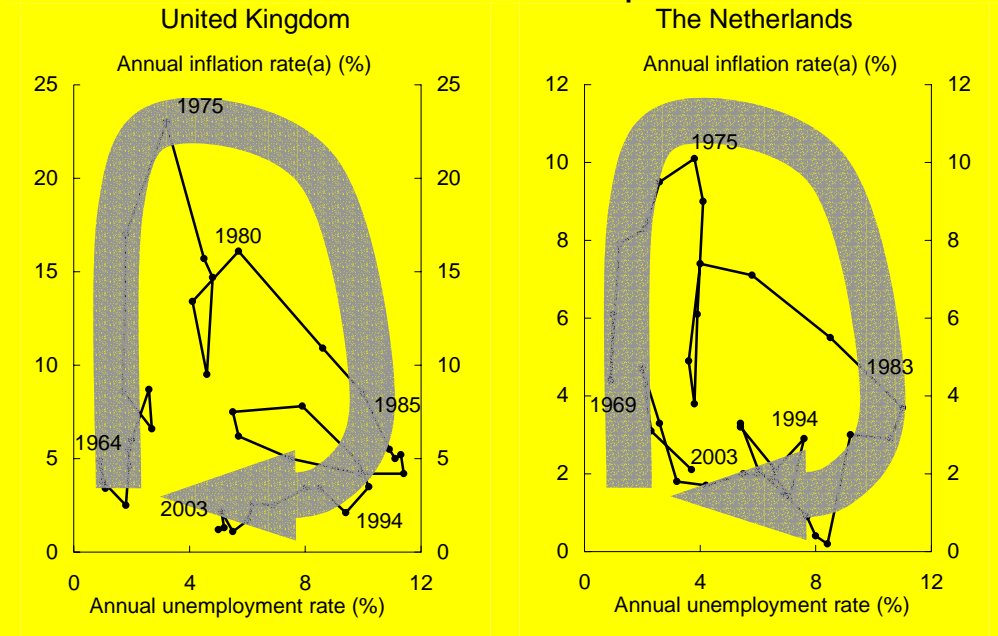
Australia recorded a combination of low inflation and low unemployment in the 1960s. In the 1970s, in response to poor macroeconomic policy settings and rising pressure for higher wages, inflation increased sharply and there was some increase in unemployment. Inflation moderated somewhat in the 1980s, but unemployment continued to rise on average. Since the early to mid-1990s, inflation has been sustained at much lower levels, and unemployment has been trending down. This more recent experience reflects the benefits of more stable and coherent macroeconomic policy settings and the impact of the longer-term programme of microeconomic reforms, which has made the economy much more adaptable and flexible.

3 Further discussion of the ‘Phillips Curve’ in Australia is contained in D. Gruen, A. Pagan and C. Thompson (1999), ‘The Phillips Curve in Australia’, *Journal of Monetary Economics* 44(2), pp. 223-258.

Box 2: Unemployment and inflation — the Phillips Curve (continued)

Chart 4 shows that the United Kingdom (UK) and the Netherlands' Phillips Curves over a similar time period display many of the features revealed in the Australian curve. Like Australia, both these countries undertook broad structural reform programmes during the 1980s and 1990s which have recently enabled their economies to simultaneously demonstrate low inflation and moderately low unemployment rates.

Chart 4: Other nations' Phillips Curves



(a) Private consumption deflator growth rate.
Source: OECD Economic Outlook database.

Governments and monetary authorities tended to respond to these inflationary pressures by tightening fiscal and monetary policy (either through 'credit rationing' in earlier periods when financial markets were highly regulated, or higher interest rates in more recent decades) to slow the economy and reduce inflationary pressure, thereby exacerbating (or magnifying) the negative consequences for employment of the original shock.

Once inflationary pressures had emerged, it often required a period of much slower economic and employment growth, and hence a sustained period of higher unemployment, to reverse the process, particularly in the absence of a coherent and credible medium-term macroeconomic strategy and framework in earlier decades, and the absence of flexible labour markets. Further, it usually proved difficult for policy

makers to judge the required extent of tightening of fiscal and monetary policy to quell the emerging inflationary pressure.

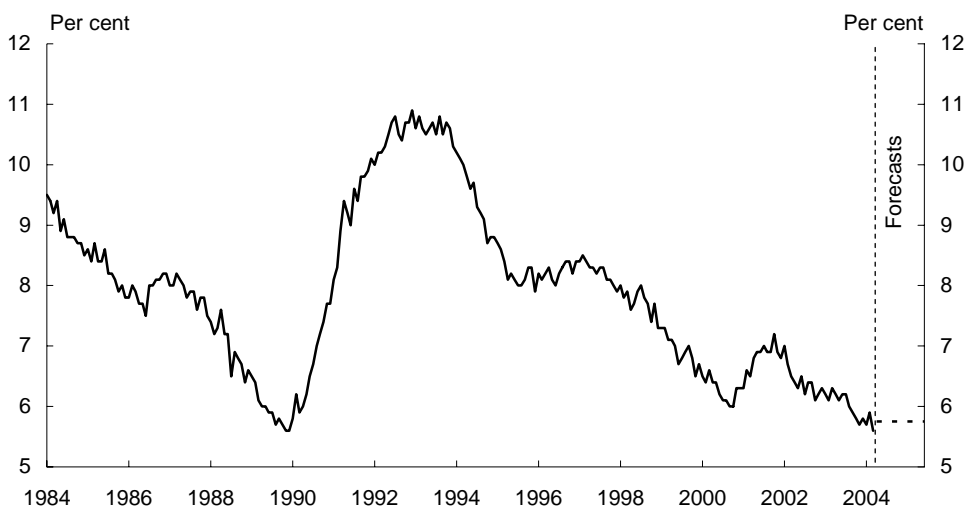
This created the risk that either too little would be done initially and inflationary pressure would continue to build, followed by an excessive tightening of policy and a very sharp slowdown in growth and rise in unemployment, or policy would be tightened excessively in the initial response.

As discussed in more detail in the next section, Australia's unemployment experience since 2002 stands in contrast with these earlier outcomes. Unemployment has declined steadily to below 6 per cent and is expected to remain below 6 per cent on average over the forecast horizon, in the context of steady economic growth and minimal wage and price pressures.

The labour market in the 1980s, 1990s and 2000s

Chart 5 shows Australia's unemployment rate for the past 20 years in more detail, including the Budget forecasts out to mid-2005. Following the structural upward shift in the unemployment rate in the late 1970s Australia's unemployment rate has declined to levels around 6 per cent on only three occasions: 1989 to 1990, late 2000, and late 2002 to the present.

Chart 5: Unemployment rate, Australia, 1984 to 2005



Source: *Labour Force, Australia* (ABS Cat. No. 6202.0), Treasury forecasts.

These three episodes have had quite different aftermaths. In the case of the 1989 episode, the unemployment rate subsequently rose sharply, reaching almost 11 per cent by 1992. Following the 2000 episode the unemployment rate rebounded modestly, but only to slightly over 7 per cent, before resuming a downward trend. In contrast, in the current episode, the unemployment rate has been around 6 per cent for

an extended period since October 2002, and has been below 6 per cent since September 2003. The unemployment rate is expected to remain below 6 per cent on average over the forecast horizon. Statement 3 in this Budget Paper contains more detail about the forecasts for the labour market.

While the unemployment rate declined to around 6 per cent in each case, there are significant differences in the overall performance of the labour market in the three periods, particularly with respect to employment growth, wage pressures, hours worked and regional variability in unemployment. As discussed below, these various indicators point to the current decline in unemployment to below 6 per cent being much more sustainable than previously.

Employment growth

In the 1989 episode the overall annual rate of employment growth was very high, at around 4 per cent. In fact, the through-the-year growth of 5 per cent experienced in the year to May 1989 has only been exceeded during one three-month period (in 1986) since monthly data collection commenced in 1978. This period of strong growth in employment was largely a reflection of very strong growth in output. The economy grew by around 5½ per cent in the year to the September quarter 1989 (when some of the lowest rates of unemployment for the episode were reached).

The period between May 1989 and November 1989 includes four of the ten highest through-the-year growth rates in total employment on record. Between June 1988 and April 1989, when the unemployment rate declined from over 7 per cent to 6 per cent, employment grew at an annualised rate of 4½ per cent.

In comparison, between September 1999 and September 2000, when the unemployment rate declined from 7 per cent to 6 per cent, employment growth was steadier but still above trend at just over 3 per cent (in annualised terms). The more subdued employment growth reflected the overall growth of the economy, which reached 4 per cent through-the-year to the June quarter 2000, and was 3½ per cent through-the-year to the September quarter.

During the most recent episode, the unemployment rate declined from 7 per cent in January 2002 to 6 per cent in August 2003. During that period, employment grew at an annualised rate of 2 per cent, broadly in line with the longer-term average growth rate of employment in Australia. Growth in the overall economy was also relatively steady, at 2.7 per cent through-the-year to September 2003 (although this growth rate was below trend due to the continued impact of drought on the agricultural sector and the global slowdown).

The annual growth rate of employment did reach 3 per cent briefly in this period, but returned to trend rates soon after. Employment growth has been maintained at around trend rates since then as the unemployment rate has trended down further to below

6 per cent in recent months. These sustainable rates of employment growth have helped to contain wage and price pressures as the unemployment rate has declined.

The steadier and more stable growth in employment in the two most recent episodes reflects the more stable growth in overall GDP.⁴ And this in turn reflects the improvements to overall macroeconomic policy frameworks, and the long-term programme of microeconomic reform, which have helped to provide greater stability to the overall economy. These issues are discussed in more detail in the second section of this paper.

Other indicators of labour market tightness

While the unemployment rate is the most commonly used summary measure of the state of the labour market, it does not capture the full story of what is happening within the market. Movements in the unemployment rate are, in fact, the result of large flows into and out of employment, and into and out of the labour force, and the unemployment rate captures only the net impact of these flows (Box 3). Over time these flows will also have an impact on the industry distribution of employment (see Box 4).

Movements in other labour market indicators, discussed below, can also provide useful additional information about the possible emergence of excessive tightness or imbalances in the labour market, and hence how sustainable the unemployment rate may be over the medium term.

Growth in labour costs

One such indicator to assess the relative tightness of the labour market, and hence the sustainability of the unemployment rate, is the trend in the growth rate of labour costs. A very tight labour market is likely to be associated with accelerating wages growth relative to growth in productivity and hence rising labour costs. One measure which captures such changes in wage growth relative to productivity trends is Nominal Unit Labour Costs (NULCs).⁵

Chart 6 shows that NULCs grew by nearly 8 per cent in the year to the March quarter 1989. The average growth rate of NULCs was above 7 per cent for 7 of the 8 quarters between December 1988 and September 1990, which is the longest period above 7 per cent since the early 1980s (when NULCs growth reached as high as 18 per cent in 1982). This reflected both relatively high growth in wages, but also very poor growth in productivity, with labour productivity actually falling by 1½ per cent in the year to the March quarter 1990.

4 See Budget Paper No. 1, *Budget Strategy and Outlook 2002-03*, Statement 4, pp. 4-10 to 4-11.

5 Real Unit Labour Costs can also be used to assess changes in labour costs taking into account the effects of inflation, although the trends are broadly similar to those for NULCs.

Box 3: The dynamics of the labour market

An increase in unemployment is often considered to be a reflection simply of a loss of jobs, while a decrease in unemployment is interpreted simply as people finding jobs. However, the reality of the labour force is that jobs are both lost and gained in large numbers during any given month. There are also people moving in and out of the labour force, as well as growth in the potential labour force as the population increases. These movements in and out of employment and the labour force can occur for a variety of reasons, of which losing a job is only one. Other examples include people taking the opportunity for a holiday between contracts, occupations where employment is seasonal, or leaving the labour force to care for children.

During 2003 the number of unemployed persons in Australia fell from a seasonally adjusted level of 632,000 in January 2003 to 584,000 by the end of the year. Taken simply, this suggests that 50,000 people moved from unemployment to work. But breaking down these figures shows that in fact, in every month around 130,000 people move from unemployment to work, and around 92,000 move from employment to unemployment. All together there were 1.6 million movements from unemployment to work (either part-time or full-time), and 1.1 million movements from work to unemployment. The final change in unemployment further depends on flows between unemployment and those not in the labour force, and the growth in the population aged over 15.

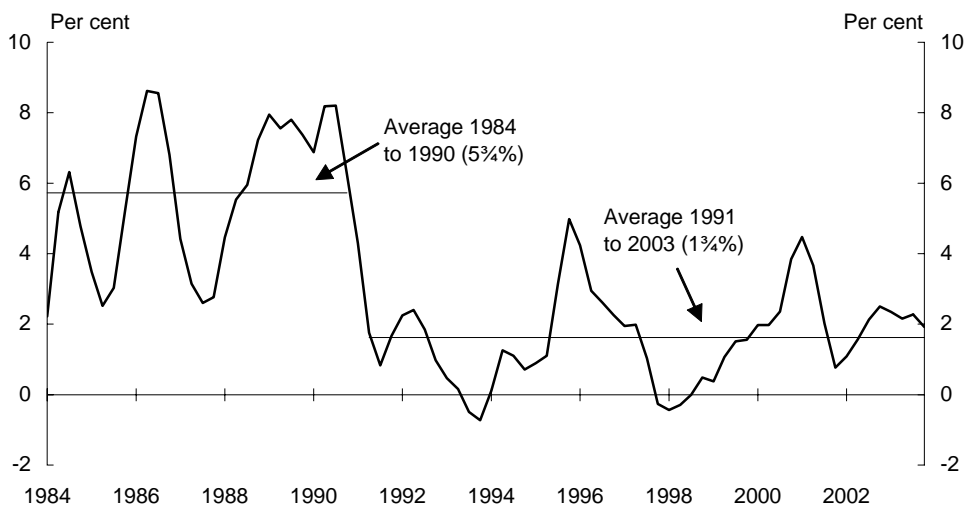
It is clear that it is these flows, and the factors behind them, that are the most important force in determining the unemployment rate. In particular, small changes to these flows can have large impacts on the overall movement in the measured unemployment rate. Small disincentives to work or create jobs can have large consequences, as over time even small differences in flows can be reflected in large numbers of people being recorded as unemployed at given points in time.

While around 50 per cent of those currently unemployed were unemployed for less than 3 months in 2003, there was a significant group who had been unemployed for longer, with a fifth of people unemployed having been so for a year or more. So while these flows show that there are people constantly moving in and out of unemployment, there is also a group of long-term unemployed for whom re-entry into employment can be particularly difficult.

In contrast, the episode in 2000 saw a more modest increase in labour costs, and the period since 2002 has seen minimal pressure on labour costs to date. Between June 2000 and March 2001 NULCs growth increased from 2 per cent to 4½ per cent. However, part of this acceleration was a return to more normal rates of growth, from the low and even negative rates experienced in 1998 through early 2000. Productivity growth also slowed somewhat, from the relatively high annual rates of 3 to 4 per cent through the late 1990s to an average annual growth rate of less than 1 per cent through 2000.

In 2002 and 2003 growth in NULCs was very modest at around 2 per cent per annum, only slightly above the average for the 1990s, and trending downwards slightly in recent quarters. This is indicative of the combination of steady employment growth, a gradual downward movement in unemployment and a more flexible labour market helping to prevent excessive tightness in the labour market and the associated increases in labour costs. Another contributing factor was a strong productivity performance, with through-the-year growth rates averaging around 2 per cent over 2002 and 2003.

Chart 6: Growth in nominal unit labour costs (through-the-year), 1984 to 2003



Source: *Unit Labour Costs*, Australian Government Treasury.

The lower and more stable growth in unit labour costs over recent years is another dividend from the improvement to the macroeconomic framework and labour markets, especially the lower inflation rates that have been sustained over the last decade or so compared to the inflation rates in the 1980s. Lower inflation, and lower inflation expectations, improves the wage bargaining process as both employers and employees can be more certain of the future path of prices.

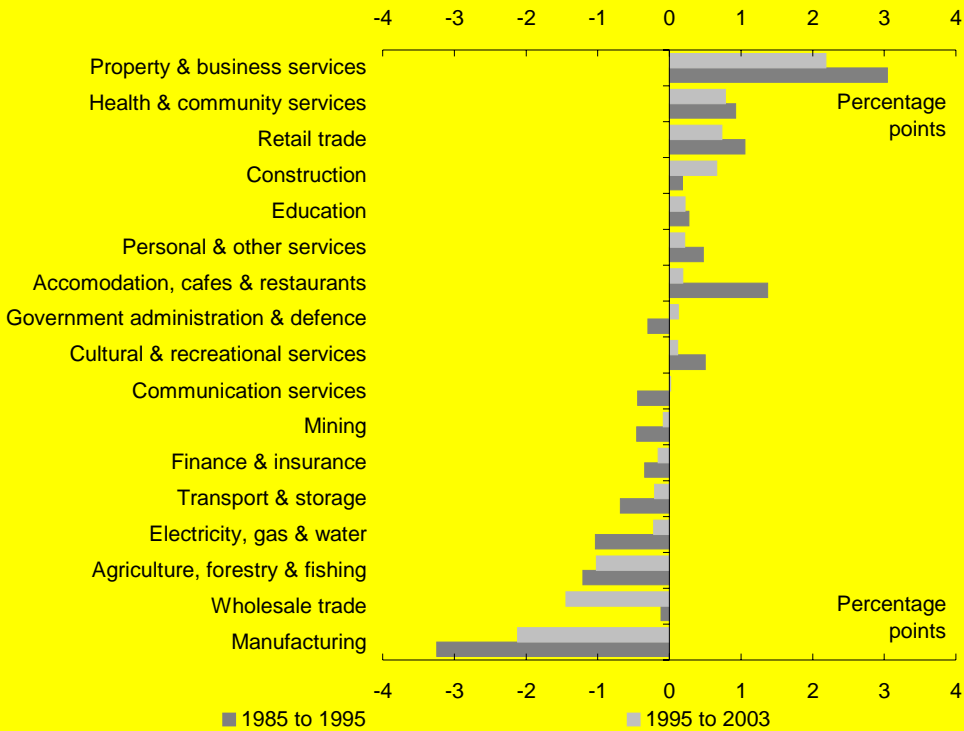
Participation rates

Another indicator of emerging labour market tightness is rapid increases in the participation rate in the short term. The participation rate measures how many people in the working age population (defined in Australia as those 15 years of age or older) are looking for or have a job. When the participation rate rises rapidly in the short term, in the context of strong employment growth, it often indicates that the labour market is tightening.

Box 4: Industry distributions of employment

A decline in employment in one industry or sector, in relative or absolute terms, does not necessarily represent a decline in employment for the economy as a whole. In a flexible, adaptable economy, lower employment in one sector is generally offset by increasing employment in other sectors.

Chart 7: Change in share of total employment by industry



Source: *Labour Force, Australia, Detailed* (ABS Cat. No. 6291.0.55.001).

Chart 7 shows how the industry by industry shares of total employment have changed over the past 18 years. Some industries that have traditionally been large in Australia have declined relatively, such as manufacturing. And in their place employment has grown more strongly in the services sector.

One important note on these shifts is that they occur within the context of a growing labour market – between 1985 and 2003 the total level of employment grew by over 40 per cent. Most of the declines shown in Chart 7 are purely relative declines, and do not reflect levels of employment, only that the industry is not growing as fast as others. For example, while the share of total employment in wholesale trade has fallen by 1.6 percentage points between 1985 and 2003, total employment in that sector has grown by around 22,000 jobs over the same period.

When the unemployment rate fell from 7 per cent to 6 per cent in 1989, the participation rate rose by around $\frac{1}{2}$ of a percentage point. The episode in 2000 saw a similar increase in the participation rate over the period where the unemployment rate fell from 7 per cent to 6 per cent. But this fall in unemployment occurred over a longer period, suggesting that there may have been less tightness in the labour market.

In contrast, when the same decline in unemployment occurred in 2002 the participation rate was lower at the end of the period (although it did fluctuate upwards for 6 of the 18 months in question). This is partly a result of a steadier approach to low unemployment levels than in previous episodes.

The longer-term trends in Australia's participation rates are largely driven by structural factors, rather than short-term labour market fluctuations. The most significant driver of the Australian participation rate over the past four decades or so has been the increasing participation of women in the labour force. Looking forward, participation rates will be strongly influenced by the ageing of the population, as discussed in the *Intergenerational Report* contained in the 2002-03 Budget Papers.⁶

Other important structural factors include the incentive that individuals on welfare and other benefits have to enter employment, the education and skills attainment of those entering the labour force, and the options for retraining and further education available to those who have become unemployed. The influence of these factors is discussed in more detail later in this paper.

Part-time employment

Another dimension to the issue of possible increasing tightness in the labour market, and hence the sustainability of the unemployment rate, is the impact of part-time work. The growing importance of part-time work reflects a significant structural change in the labour market in Australia. Australia has one of the highest rates of part-time work in the world, reflecting a relatively flexible labour market that allows many people to choose the number of hours of work that best suits their individual circumstances.

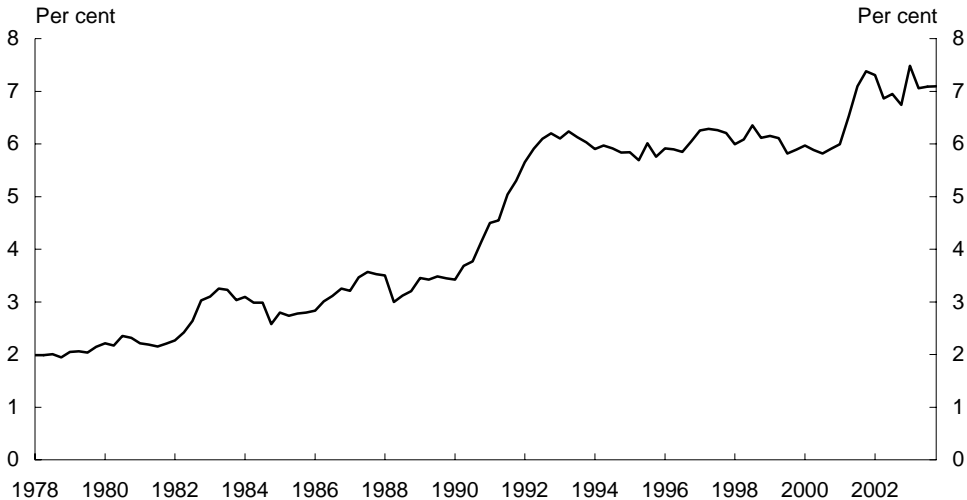
Since the mid-1960s the proportion of employees working part-time (that is, working less than 35 hours per week) has grown from around 9 per cent to around 30 per cent today. This increase reflects a long-term improvement in the ability of people to choose how they will participate in the labour force, and how many hours they will work.

Survey data indicate that around three quarters of part-time workers are not actively seeking more hours. The fact that the majority of part-time workers are satisfied with their existing hours of work is testament to the flexibility of Australia's labour market, and its ability to deliver employment arrangements which are satisfactory for both employees and employers. Nevertheless, there is still a pool of part-time workers who

6 Australian Government (2002), Budget Paper No. 5, *Intergenerational Report 2002-03*.

would work more hours if such employment opportunities became available (about one quarter of part-time workers, and hence around 7 per cent of the total labour force). This could provide an additional 'buffer' against emerging wage and price pressures when there is rapid growth in employment.

Chart 8: Proportion of labour force working part-time and available for more hours of work, 1978-2003



Source: Treasury calculations based on *Labour Force, Australia* (ABS Cat. No. 6202.0) and *Underemployed Workers, Australia* (ABS Cat. No. 6265.0).

Chart 8 shows that the proportion of the total workforce that wish to work more hours has grown over the past 20 years, but is a comparatively small proportion of the workforce.

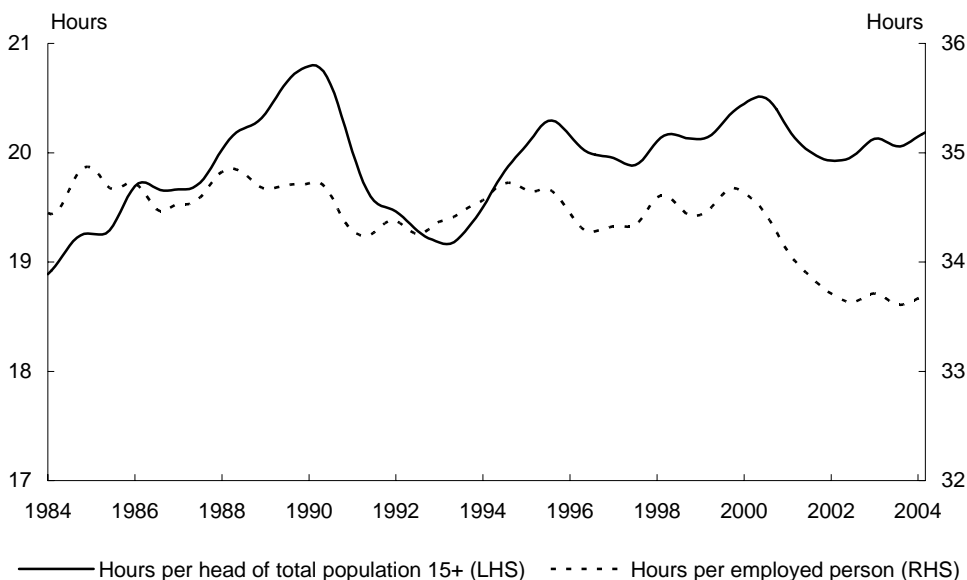
Average hours worked

Chart 9 shows an alternative summary indicator of the overall level of tightness in the labour market, namely the average number of hours worked per week per person aged over 15 (including those not employed or not in the labour force). This measure captures the net effect of not just the unemployment rate per se, but also employment growth, the participation rate, average hours of work for both full-time and part-time employees, and the relative proportions of full-time and part-time employment. Although the series is much more volatile than the unemployment rate, the overall trends are similar to the unemployment rate (Chart 5). In particular, on this measure, there are peaks of greater than average tightness in the labour market in 1989 and 2000. In contrast, there is less evidence of tightness in the current episode of low unemployment, with the hours measure peaking at a lower level than in the earlier episodes and subsequently trending down.

Chart 9 also shows the movements in average hours per employed person. The broad trends are similar, although the peaks in 1989 and 2000 are more moderate relative to

trend than in the overall population. During these peaks, the additional demand for labour was met more by additional employment than changes in the hours worked by existing employees.

Chart 9: Average hours worked, Australia



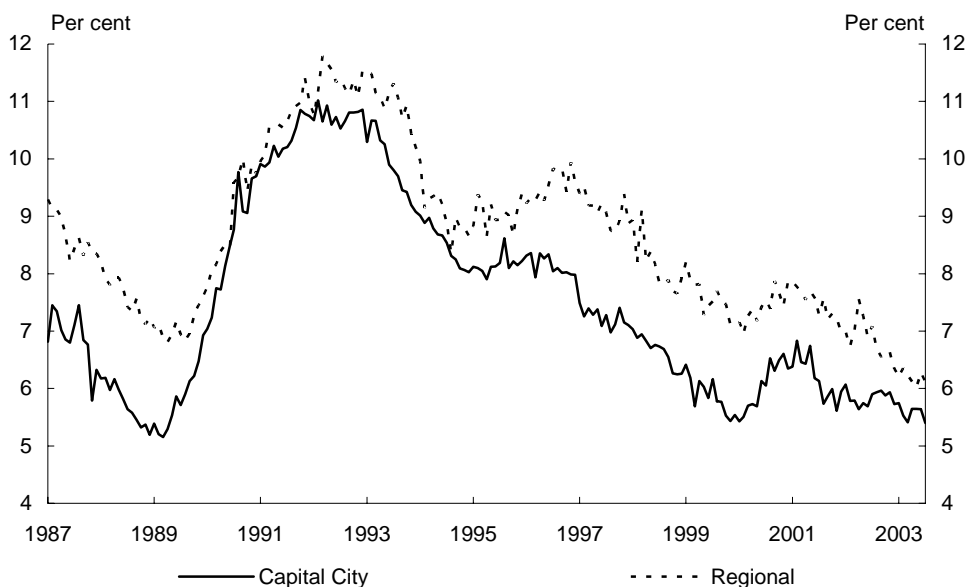
Source: Treasury calculations based on *Labour Force, Australia* (ABS Cat. No. 6202.0).

Regional unemployment rates

Labour market trends in particular capital cities might not reflect the labour market experience in other capitals or in more regional areas. For example, a period of labour market tightness, as measured by some of the overall national indicators, might reflect a very low unemployment rate in a few areas, such as Sydney and Melbourne, and higher unemployment elsewhere. In contrast, when the falls in the national unemployment rate reflect a relatively uniform fall in unemployment across most regions, there is less risk of bottlenecks and the associated price and wage pressures in particular areas or markets.

Historically, the capital cities have had a lower unemployment rate than regional areas. Chart 10 shows how these two unemployment rates have varied over the past decade and a half. The falling unemployment rate in 1989 and 2000 was relatively uniform across these two groups, and hence the gap between capital city and regional unemployment rates remained constant in both of these episodes. In contrast, during the most recent episode the most significant falls in unemployment have occurred in regional areas (notwithstanding the impact of the drought on farm employment), which has resulted in a closing gap between the capital city and regional areas. While unemployment rates in capital cities are currently somewhat above the lows of around 5¼ per cent reached in 1989, regional unemployment rates of just above 6 per cent are well below the rates of around 7 per cent reached in 1989 and 2000.

Chart 10: Unemployment rates for capital city and regional areas, 1987-2004



Source: Treasury calculations based on *Labour Force, Australia, Detailed — Electronic Delivery* (ABS Cat. No. 6291.0.55.001). Capital cities includes all State and Territory capitals except for Darwin, Regional includes the balance of Australia.

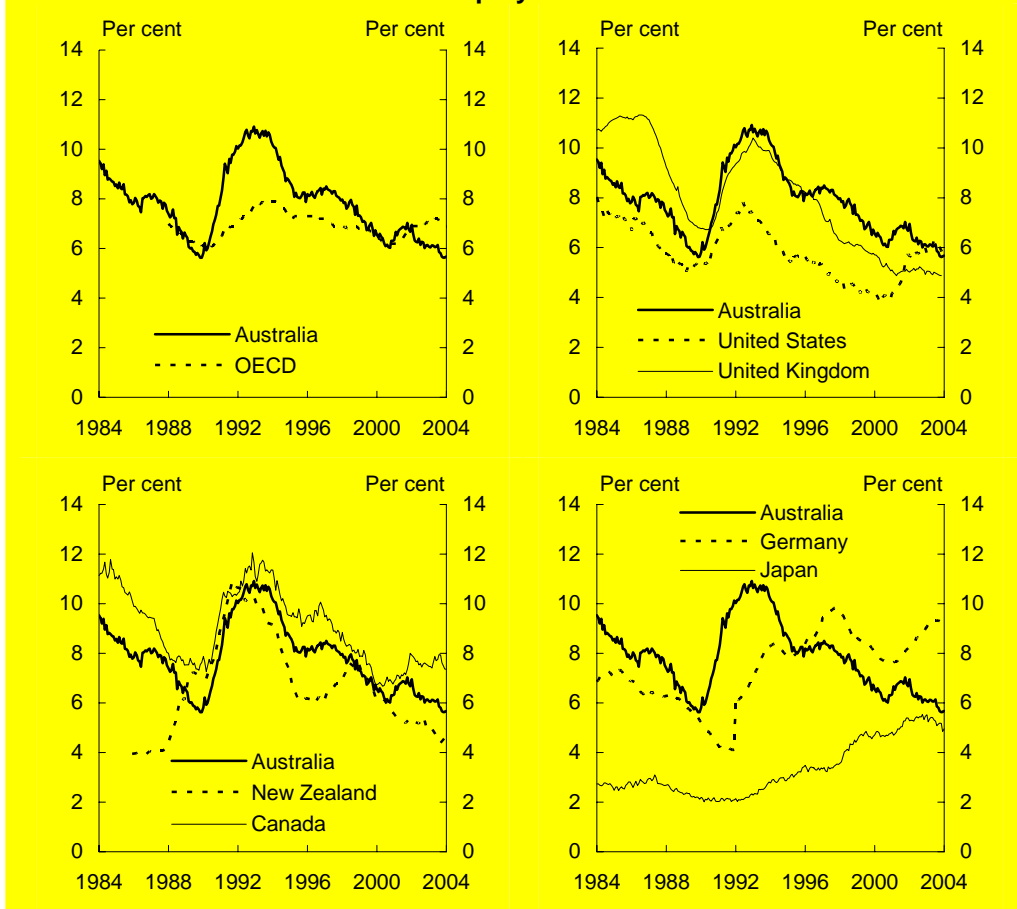
International trends in unemployment rates

Australia's current unemployment rate is not only low relative to the experience of recent decades, but also well below many other members of the OECD. The Euro area had an average unemployment rate of 8.8 per cent in 2003, with countries such as France and Germany experiencing unemployment rates above 9 per cent. Australia's unemployment rate is currently over 1 percentage point below the OECD average (in standardised terms), and has been below the OECD average since late 2001. This is a significant turn around since the mid-1990s, when Australia's unemployment rate was as much as 3 percentage points above the OECD average. Box 5 provides further detail on movements in unemployment rates in other key economies over recent decades.

That said, there are some countries with lower current unemployment rates than in Australia, such as New Zealand (averaging 4.7 per cent in 2003) and Ireland (averaging 4.6 per cent in 2003). The unemployment rate in the United States in 2003 was comparable to Australia, at around 6 per cent. However, this probably represented a cyclical peak for the unemployment rate in the United States reflecting the weak United States economy, while as discussed above, it represented a 23 year low in Australia. This suggests that the longer term or structural unemployment rates in the United States may still be below those for Australia.

Box 5: International trends in unemployment rates

Chart 11: Standardised unemployment rates in selected countries



Source: *OECD Main Economic Indicators*.

The extent to which unemployment rates fell in the 1990s differed across countries. While the UK unemployment rate fell from over 10 per cent in 1992 to less than 5 per cent in 2003, the German unemployment rate has stayed between 7 and 10 per cent since January 1993. Moreover, the long-term unemployed account for as much as one third of the total unemployed in Germany, reflecting structural problems in the German labour market.

Japan has been an exception to the general trend of falling unemployment rates during the 1990s. Prolonged weaknesses in aggregate demand has resulted in a doubling of Japan's unemployment rate from the 1980s average of 2½ per cent to the current 5 per cent.

Box 5: International trends in unemployment rates (continued)

A low unemployment rate may not always present a true picture of the labour market. While the rise in the US unemployment rate during the recent downturn has been modest by historic standards, the US labour market has weakened significantly, shedding 1.95 million jobs since March 2001 with the participation rate falling markedly. Similarly, the sustained fall in the Dutch unemployment rate during the 1980s and the 1990s happened in conjunction with a falling participation rate, which suggests that there may have been an increase in the number of 'discouraged' workers.

More generally, the fact that unemployment rates are lower in some other developed economies than in Australia suggests that there is scope to lower unemployment further in Australia over the medium term, given appropriate policy settings. This is discussed in more detail in the following section.

THE CONTRIBUTION OF POLICY REFORMS TO IMPROVED LABOUR MARKET PERFORMANCE

The first section of the Statement discussed how Australia's labour market performance has improved over time. Particular attention was drawn to the experience of the late 1980s, 2000, and the period since 2002. While the unemployment rate was around the low points of recent decades in each case, at around 6 per cent, the most recent period has been characterised by a structurally more sound economy, with steadier employment growth and low inflationary pressure. This suggests that low unemployment is now more sustainable and raises the prospect that unemployment can fall further.

The improved performance of the economy over recent years, of which the lower unemployment rate is an important dimension, has been achieved through a long-term and comprehensive package of reform measures. These measures have been complementary and reinforcing, and have been aimed at improving the microeconomic efficiency of the economy, its ability to grow steadily and consistently and to respond to change. An important characteristic of the reforms has been to ensure that the institutions affecting our social and economic activities are better suited to meeting contemporary and future needs.

The reforms have been extremely diverse and broad based, including: trade reform; deregulation of financial markets; wide-ranging tax reform; enhancing competition across many areas of the economy; increasing the flexibility of the labour market; the development of skills and capacities; reforms to welfare arrangements; and creating a transparent medium-term framework for fiscal and monetary policy in order to enhance economic stability. But there is scope to do more in some of these areas, to

produce further gains in productivity, labour force participation, employment and overall wellbeing.

Lower unemployment brings valuable economic and social benefits. Higher income levels and a more equal distribution of income lower household poverty. Better access to income-earning activities provides greater opportunities for people to engage in economic and social activities, thus allowing the development of social capital. As a result of a more inclusive and connected society, with a greater capacity to support those who are disadvantaged, the risks faced by an individual in the modern economy are reduced. It is for these reasons that policies have been developed and refined in a balanced way to promote lower unemployment.

Policies to reduce unemployment from its current levels are needed to address the medium-term challenges which the Australian economy faces as a result of demographic change. In the 2002-03 Budget, the Government published the first *Intergenerational Report* in which it outlined the scale of these challenges, such as the effects on the potential labour force and living standards. In February 2004, the Treasurer released a discussion paper, *Australia's Demographic Challenges*, to promote community debate on these longer-term issues.⁷

In this context, this section surveys the changes in policy settings which have contributed to the improved labour market performance in recent years and considers where there may be scope for policy settings to be tuned to further reduce unemployment, including by removing the impediments to job creation and participation.

A framework for policy

The OECD has undertaken extensive cross-country research into the factors that drive employment and economic growth, culminating in the OECD Jobs Strategy⁸ (see Box 6) and the related OECD Growth Study.⁹ These strategies were in part developed in response to the stubbornly high rates of unemployment that many OECD nations have had since the 1970s.

The major elements of the OECD Jobs Strategy are to: increase the flexibility of working time and labour costs; reform employment security provisions; deliver active and effective labour market programmes; improve skills and competencies; and reform unemployment and related benefit systems and their interaction with the tax system.

7 Australian Government (2004), *Australia's Demographic Challenges*, February (<http://demographics.treasury.gov.au>).

8 OECD (1994), *The OECD Jobs Strategy*, Paris.

9 OECD (2003a), *The Policy Agenda for Growth*, Paris; OECD (2003b), *The Sources of Economic Growth in OECD Countries*, Paris.

The major elements of the overarching OECD Growth Study relate to: strengthening economic and social fundamentals; facilitating the diffusion of information and communications technologies; fostering innovation; investing in human capital; and stimulating the creation of firms.

Importantly, these strategies are complementary and need to be implemented together to have greatest effect on labour market performance. For example, reforms to welfare policies will not be as effective in improving employment and community wellbeing in the absence of steady macroeconomic management.

The elements of the OECD Jobs Strategy can be classified into three broad groups: general economic policies, labour policies and welfare policies. This provides a useful framework in which to survey the policy settings in Australia and how those settings have changed over time to address unemployment more effectively.

Recent policy reforms and areas for further development

Australian governments have made substantial progress in their general economic policies, labour and welfare policies over past years to achieve lower unemployment, consistent with the directions of the OECD Jobs and Growth strategies.

General economic policies

Critical to achieving low unemployment are: stable and well-tuned macroeconomic policies; well-functioning and competitive markets; innovation and a climate of entrepreneurialism; and the diffusion of new technologies. Policy developments in these areas and their contributions to wellbeing have been extensively discussed in previous budget papers.¹⁰

Since the 1970s, many reforms have been designed to improve the competitiveness of the Australian economy domestically and internationally. Greater competition and depth in Australia's product and financial markets has been fostered through mechanisms such as National Competition Policy, an agenda agreed by the Australian Government and State governments in the mid-1990s. Reforms have been implemented in the communications, energy and transport sectors, and by commercialising and privatising government businesses, removing anti-competitive regulation and broadening the scope of competition. Similarly, the reduction of barriers to trade and reduced support for export activity has opened the Australian economy to international competition, markets and cultures.

¹⁰ For example, Australian Government (2003), 'Sustaining Growth in Australia's Living Standards', Budget Paper No. 1, *Budget Strategy and Outlook 2003-04*, Statement 4.

Box 6: Summary of the OECD Jobs Strategy¹¹

1. Set macroeconomic policy such that it will both encourage growth and, in conjunction with good structural policies, make it sustainable, that is, non-inflationary.
2. Enhance the creation and diffusion of technological know-how by improving frameworks for its development.
3. Increase flexibility of working time (both short-term and lifetime) voluntarily sought by workers and employers.
4. Nurture an entrepreneurial climate by eliminating impediments to, and restrictions on, the creation and expansion of enterprises.
5. Make wage and labour costs more flexible by removing restrictions that prevent wages from reflecting local conditions and individual skill levels, in particular of younger workers.
6. Reform employment security provisions that inhibit the expansion of employment in the private sector.
7. Strengthen the emphasis on active labour market policies and reinforce their effectiveness.
8. Improve labour force skills and competencies through wide-ranging changes in education and training systems.
9. Reform unemployment and related benefit systems – and their interactions with the tax system – such that societies' fundamental equity goals are achieved in ways that impinge far less on the efficient functioning of the labour markets.
10. Enhance product market competition so as to reduce monopolistic tendencies and weaken insider-outsider mechanisms while also contributing to a more innovative and dynamic economy.

11 J. Elmeskov (2000), *Implementing the OECD Jobs Strategy – assessing performance and policy*, remarks at the Conference on Jobs, Helsinki, January.

These improvements in competitiveness, combined with more strategic support by government for education, research and development, have gradually infused the economy with greater innovative capacities. Improvements in governance frameworks and corporate law have also played their role by ensuring transparency in economic activity, thereby enhancing the underlying confidence in the economy.

While many gains have been made under Competition Policy in a wide range of industries so far, there is scope to achieve further gains in efficiency, quality and resilience of the major infrastructure industries that provide critical inputs into many other economic sectors. Australian and State governments are looking to identify areas of opportunity for significant gain to be made through further competition reform, and the recently announced Productivity Commission inquiry is important in this regard.

The microeconomic foundations of the Australian economy are important to promoting lower unemployment. However, it is also worth highlighting the role that macroeconomic management plays in reducing unemployment. A medium-term framework for monetary and fiscal policies has been found to best contribute to steady and sustainable economic growth, helping to minimise the episodes of boom and bust due to poor macroeconomic policy that were a feature of Australia's past economic performance.

After the recession of the early 1990s Australian monetary policy started to focus around a medium-term inflation-targeting regime. In August 1996 in a *Statement on the Conduct of Monetary Policy* (the 'Statement') by the Treasurer and the Reserve Bank Governor a formal targeting regime was put in place and set out a target of 2 to 3 per cent on average over the course of the economic cycle. This Statement was reaffirmed and updated for current practice in July 2003. The Statement formalises the operational independence of the Reserve Bank in implementing monetary policy to achieve the Government's inflation goal. The inflation target provides discipline for monetary policy decision-making and serves as an anchor for inflation expectations in the community.

Australian fiscal policy was also placed by the Government into a medium-term framework from 1996. The *Charter of Budget Honesty Act 1998* (the 'Charter') states that fiscal policy should be directed at maintaining the ongoing economic prosperity and welfare of the people of Australia, and therefore should be set in a sustainable medium-term framework. The purpose of the Charter is to improve fiscal policy outcomes. It provides for this by requiring that fiscal strategy be based on principles of sound fiscal management and by facilitating public scrutiny of fiscal policy and performance. This transparency is important for the credibility of fiscal policy. The primary objective of the Government's fiscal strategy is to maintain budget balance, on average, over the course of the economic cycle.

A continuation of general microeconomic reform and sound macroeconomic policy settings will be important for assisting labour and welfare policies to maintain low levels of unemployment and to achieve further reductions in unemployment.

Labour policies

The first section of this Statement indicated that Australia's unemployment rate has averaged 7½ per cent since the late 1970s. A belief that lower unemployment was an integral component of a better Australia, plus the desire for a higher rate of sustainable economic growth, led to the pursuit of labour policies which have fostered productivity, participation and lower unemployment. Labour and welfare reforms have been particularly important for addressing the various disadvantages that many people face in the labour market and whose employment prospects are less responsive to general increases in labour demand.

Employment arrangements, wages and conditions

Flexible employment arrangements and conditions are more able to promote productivity at the workplace level and to better match employer and employee preferences, a key to good labour market performance and community wellbeing. These more flexible arrangements tend to reduce unemployment, as more people who are unemployed are able to find suitable work.

The Australian workplace relations system has evolved to reflect contemporary economic and social factors. In the early part of the twentieth century, a complex system of awards developed through industrial courts with the objective of equity and justice in wages and working conditions. Unfortunately, over time these complex and rigid institutional arrangements came to inhibit employment outcomes.

Significant reforms were achieved with the *Workplace Relations Act (Cth) 1996*. The Act set primary responsibility for determining matters affecting the relationship between employers and employees with the employer and employees at the workplace level, taking into account the specific circumstances of the individual firm and employees involved. The Act also provided a framework of rights and responsibilities for employers and employees, and their organisations, to support fair and effective agreement-making; ensured freedom of association; and enabled employers and employees to choose the most appropriate form of agreement for their particular circumstances. This included the creation of Australian Workplace Agreements, individual agreements between an employer and employee which would be recognised as legally binding by the Australian Industrial Relations Commission.

These reforms were to significantly redefine the role of awards, with increases in award rates of pay to be modest and focused on the low paid, consistent with the intention that awards operate as a safety net of minimum standards.

As a result of these policy developments, the percentage of workers reliant on arbitrated awards for pay rises has fallen from 67 per cent of employees in 1990 to around 21 per cent in 2002. Around 38 per cent of employees now have their terms and conditions determined through collective agreements between employers and their employees, while another 41 per cent rely on individual agreements reached between

an employer and an employee, the latter predominantly being informal arrangements or common law contracts.¹²

While these reforms have focused on encouraging productivity and a more direct relationship between employers and employees, they have had a significant effect on the incentive for employers to hire workers and to boost output, thereby reducing unemployment. The Productivity Commission, for example, has attributed Australia's improved productivity performance in the 1990s in part to better management practices and work arrangements.¹³ This has allowed structural reform in product markets to encourage 'the adoption of new production processes and firm organisation, for example through multi-skilling, performance-based remuneration, the introduction of split shifts and the reduced rigidity of job demarcations.'¹⁴ These innovations led to increased competitiveness and a greater capacity for the economy to create employment.

These improvements in flexibility and reduced complexity have also had a supply side effect by creating greater opportunities for people to find jobs, increase their incomes, and respond positively to structural change.

While an improvement in productivity growth was achieved over the 1990s, international comparisons suggest that further improvements in productivity can be made in Australia. As discussed in Statement 4 last year, Australia's productivity level is still below some other major developed nations, particularly the United States.¹⁵ There are a number of aspects to the labour market where further reforms could be made to improve productivity and reduce unemployment.

Workplace agreements, including collective and individual agreements, are considered to be more effective tools for promoting productivity improvements than are awards. However, around 21 per cent of employees remain reliant on awards for determining their conditions of work rather than workplace agreements of some kind. This is one sign that there may be significant potential for the community to further draw on the flexibilities provided by the Workplace Relations Act to achieve higher productivity and employment. While it will be necessary to retain a safety net for many employees, the attractiveness of workplace agreements may increase as the community learns from others' experience in developing agreements and as employers compete for higher quality employees.

Similarly, workplace relations law remains complex and the role of labour law in reducing unemployment could be improved. The Australian Government has over ten bills presently before the Parliament which are designed to increase flexibility, reduce

12 *Employee Earnings and Hours* (ABS Cat. No. 6306.0).

13 Cited in OECD (2001), *OECD Economic Surveys – Australia*, Paris, p. 75.

14 OECD (2003), *OECD Economic Surveys – Australia*, p. 84.

15 Australian Government (2003), 'Sustaining Growth in Australia's Living Standards', Budget Paper No. 1, *Budget Strategy and Outlook 2003-04*, Statement 4.

employment transaction costs and achieve a closer link between wages and productivity. More specifically, the proposed amendments to the Workplace Relations Act aim to reduce the degree of regulation around the termination of employment; address pattern bargaining; streamline agreement-making processes; and further simplify awards to promote workplace agreements.

It is important to minimise the employment transaction costs and other on-costs to improve the demand for labour and hence raise employment and reduce unemployment. While employment protection legislation in Australia is generally more refined and less stringent than in other OECD nations,¹⁶ there is scope to improve employment protection law, particularly in relation to small businesses, as existing regulations can be an impediment to these employers taking on additional workers.

Wages are, of course, a key influence on the level of employment. The award system which operates in Australia provides a menu of minimum wages that can significantly affect the employment prospects for unskilled as well as more highly skilled people.

Adult minimum wages in Australia, as a proportion of median earnings, are the second highest in the OECD at around 58 per cent of median earnings. In the United Kingdom and United States, by contrast, minimum wages are around 45 and 34 per cent of median earnings respectively.¹⁷ Australia's award system also provides minimum wages for a range of individual jobs and levels, rather than the single statutory minimum wages that are present in the UK and US jurisdictions. There are around 4,500 industrial awards in operation in Australia, with around 2,000 in the State jurisdictions. These high minimum wages could 'price out' many people from employment and hence result in higher unemployment than otherwise. The rigidities in the wage structure reduce the capacity for wages to adjust to meet labour demand and supply over time.

Governments now intervene more effectively to achieve equity objectives through the tax and welfare systems. By comparison, the award system is a blunt and ineffective mechanism for promoting equity. There may be scope to further refine the award system, including through reductions in its complexity and breadth as well as changes in the responsibilities of the Australian Government and State government jurisdictions.

There will be an ongoing need to review the workplace relations system more broadly to ensure that it meets contemporary and future needs. However, a return to more centralised and less flexible workplace relations, with more extensive powers for third parties such as industrial relations commissions and more regulated employment

16 OECD (2003), *OECD Economic Surveys – Australia*, pp. 100-101.

17 OECD data cited in Low Pay Commission (2003), *The National Minimum Wage – Fourth Report of the Low Pay Commission*, London, p. 254.

conditions, would be a regression in policy as it would adversely affect many people in the labour market, including those who are unemployed. A flexible workplace relations system, supported by a safety net of minimum conditions and complementary economic and social policies, can best promote lower unemployment and improved wellbeing.

Skills and capacities

The importance of skills and capacities for labour market performance and wellbeing has become increasingly apparent over time.

The people most likely to be unemployed for sustained periods of time are those who have relatively low education and skills, are of indigenous origin, come from a non-English speaking background or lack labour market experience.¹⁸ Hence, appropriate skills and labour market assistance are necessary to achieve lower unemployment.

Both the level and composition of skills can help in addressing longer-term structural unemployment, which sometimes reflects the declining relevance of some existing skills in the face of economic, technological and social change. New skills can help these people move from unemployment to work, and allow the unemployment rate to fall without creating other pressures in the labour market.

A well-skilled labour force assists the dynamic efficiency of the economy and its ability to expand. In the medium-term, a more appropriately skilled labour force means that as the economy expands there is more likely to be an effective labour supply available and posing less of a wages and inflationary risk to an economic expansion. Over the longer term, a well-skilled labour force can allow the labour market to adjust well to the many forms of structural change and economic dynamics that occur, both boosting economic performance and reducing social dislocation in the face of change.

Over time, governments have developed more active labour market policies which have been found to be more effective than the passive alternatives in getting people into employment.¹⁹ Active labour market policies are in part designed to develop the skills and competencies needed by employers, beyond what have been developed through the mainstream education and training systems. They are targeted at the particular needs of disadvantaged labour market groups and are often remedial or transitional in nature.

18 B. Chapman and C. Kapuscinsky (2001), 'The Transformation of Australia's Population, 1970 to 2030: Labour Force, Employment and Unemployment', Centre for Economic Policy Research, Discussion Paper No. 436, Australian National University, Canberra.

19 J. Martin (1998), 'What works among active labour market policies: evidence from OECD countries' experiences', in G. Debelle and J. Borland (eds), *Unemployment and the Australian Labour Market*, proceedings of a conference held by the Reserve Bank of Australia and the Australian National University, Sydney.

By the mid-1980s, labour market programmes had proliferated, with a complex web of options provided for employers and employees and without clear, overarching objectives.²⁰ As a result, the late 1980s saw some reforms to labour market programmes, with steps taken to achieve a better integration of employment, education and training programmes. In response to the recession of the early 1990s, there was a particular focus on expanding programmes which provided work experience combined with training, in return for income support.²¹ For example, the Newstart programme, introduced in 1991 and focused at the outset on the long-term unemployed, introduced obligations on recipients to actively seek work and assisted the acquisition of skills necessary to gain work. However, these programmes were introduced at too late a stage in the economic cycle and in a relatively under-developed form to be effective in quickly redressing the unemployment which emerged as a result of the recession of the early 1990s.

The *Working Nation* package in 1994 saw a significant expansion in labour market programmes, with the development of a case management system for the unemployed, training wages, direct job creation schemes and a Job Compact. The Job Compact guaranteed an education or training place to a long-term unemployed person to enhance their employment prospects. Many of these initiatives were designed to address long-term unemployment, by developing skills and labour market experience.

In the 1996-97 Budget, the Government announced a new framework for the delivery of labour market assistance. The framework was to provide better-quality assistance to unemployed people, target that assistance according to need, address the weaknesses present in the earlier forms of labour market assistance and achieve better value for money. Greater competition in the provision of employment services was introduced, with a greater focus on achieving outcomes for jobseekers.

The framework was centred on a Job Network. Beginning in 1998, Job Network was a national network of private, community and government organisations contracted by the Government to assist unemployed people to find jobs. A government agency, Centrelink, became the gateway to Job Network and undertook the registration, assessment and referral of jobseekers to Job Network members. Over time, the elements of the programme have been developed to better address the varying needs of the unemployed, with mainstream access to the programme supplemented by additional assistance for different categories of disadvantaged jobseekers.

Significant changes were made to the Job Network in 2003, centred on the introduction of an Active Participation Model. The key features of the model have been to provide more intensive assistance the longer a person has been unemployed and a dedicated Job Seeker Account, providing financial support to meet the particular training needs

20 Kirby Inquiry (1985), summarised in Committee on Employment Opportunities (1993), *Restoring Full Employment : a discussion paper*, AGPS, Canberra, p. 94.

21 J. Dawkins (1992), *Working for the Future: jobs, skills, innovation*, AGPS, Canberra.

or other expenses involved in getting a person into employment. The model involves stronger linkages between Job Network services and a range of other complementary employment and training programmes, such as the Transition to Work programme and Job Placement Employment and Training.

As a result, a jobseeker now has access to a range of workforce information, education, training and employment services that can be customised to their particular needs in order to get them into sustainable employment. The gains made by the new policy framework have been positive. For instance, the OECD has found that the Job Network has delivered comparable results to those obtained under previous systems but at considerably less cost overall.²²

While the labour policy framework has evolved over time to provide more effective support, it will be important to ensure that people access the support services that are available to them and that those services work most effectively to meet a person's labour market needs over the short and longer terms. As a result of these policy evolutions, the current system of labour programmes should be better placed to provide support for ongoing employment growth and participation.

As the first section of this Statement illustrated, the flexibility of the Australian labour market is reflected in the ready availability of part-time employment. This flexibility has assisted in reducing the duration of unemployment, as it has provided an avenue for those who have been unemployed for a considerable period of time to develop skills and experience which can then lead to more extensive and continued employment.²³ Without access to part-time employment, many unemployed people may have found it more difficult to gain sustained employment and to become less welfare dependent. This is a key aspect to the effectiveness of labour market programmes, as their objective is to assist unemployed people to find work in a way which places the jobseeker on a path to sustainable employment over the longer term.

Labour market programmes are usually remedial or reactive in nature, drawn upon when they are needed. However, Australian and State governments have focused also on investing in skills as a way of improving a person's labour market prospects. People with a higher level of educational attainment are more likely to participate in the labour force and to be employed than those with lower levels of educational attainment.

Skills and capacities are a key driver of labour force participation, productivity, employment and reductions in unemployment. Solid foundation skills which are adaptable to different circumstances are important for reducing the likelihood of unemployment.

²² OECD (2001), *Innovations in Labour Market Policies – the Australian Way*, Paris.

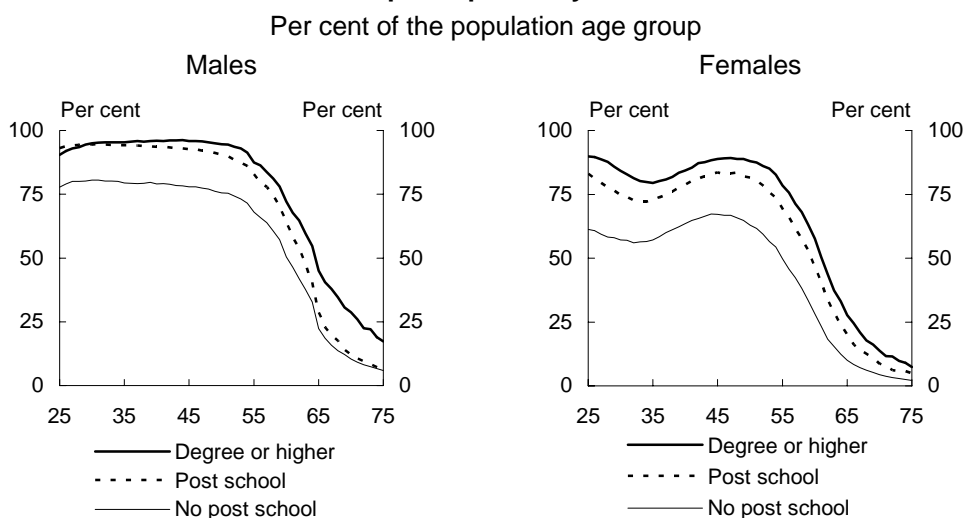
²³ Committee on Employment Opportunities (1993), *Restoring Full Employment: a discussion paper*, AGPS, Canberra, p. 2.

Structural unemployment can be further reduced using the education and training system to better match the skills demanded and supplied in the labour market. In addition, education and training can play a dynamic role in diffusing technologies and promoting innovation, thereby leading to the creation of new industries. Improvements in skills also lead to increased labour mobility which can help to reduce pockets of unemployment in particular regions or occupations.

Those Australians who have not completed secondary school education have a lower labour force participation rate as a group than those with post-secondary qualifications (see Chart 12). This suggests that improving their foundation skills and capacity building could assist in improving employment prospects.

The National Agenda for Early Childhood, initiated in 2003, is one part of the effort to improve foundation skills and capacities to engage in the community, by ensuring that children have a better start in life. A further part of the effort is being made through the National Education Framework for Schools, promoted by the Australian Government to improve the quality of schooling across all key learning areas and to improve the transition to further education and work.

Chart 12: Labour force participation by educational attainment



Source: S. Kennedy and D. Hedley (2003), 'A Note on Educational Attainment and Labour Force Participation in Australia', Australian Treasury, Working Paper 2003-03.

Education and training policies are also important in ensuring that Australians are able to upgrade their skills over time in order to meet areas of emerging demand for labour. Lifelong learning is important for all workers, whether they have trade qualifications or tertiary qualifications, as it allows people to maintain or improve their productivity, respond to change in the world of work and continue to participate in the labour force.

People with already high educational attainment are more likely to participate in formal training, whether on-the-job or in an educational institution, than those with

lower levels of attainment. This may be due to cultural factors and to the various costs of training. For example, significant fees often have to be met by participants up-front without access to financing mechanisms such as those which are available in higher education.²⁴ As a result, improving equity in access and participation in skill development is a priority for the Government and the Australian National Training Authority.²⁵

The skills of the labour force are a function of training as well as the health of the workers involved. Poor occupational health and safety practices, for example, have a significant cost for the Australian economy, through the injuries themselves and the lower levels of participation in the labour force that follow. Hence, improving the health of the labour force will be important for improving productivity and participation, and reducing unemployment.

Reactive health care is expensive relative to preventative health care and, as the population ages, health care costs are expected to rise substantially. Health practices that are focused on preventative health care could mitigate rising health costs but also have substantial benefits in terms of labour force participation and the ability for an individual to continue to engage in employment.

Welfare policies

While skills are an important factor behind labour force participation and the likelihood of employment, welfare and taxation policies also have an effect.

Welfare policies have a substantial effect on the wellbeing of individuals, their households and communities. Greater labour force participation and low unemployment mean that there are higher incomes to draw on. High labour force participation and the minimisation of welfare dependency is better able to create an economically sustainable and inclusive society that is well-connected and better able to manage risks to the economic and social environments.

Policies around publicly-funded income support and income tax arrangements can affect a person's decision to participate in the labour force (and therefore to be employed), along with the extent of their participation. Australia's policies in these areas have changed significantly over the twentieth century, from a comprehensive

24 B. Chapman, L. Watson and L. Wheelahan (2001), 'From silos to seamlessness: towards a cross-sectoral funding model for post-compulsory education and training', Centre for Economic Policy Research, Discussion Paper No. 439, Australian National University, Canberra.

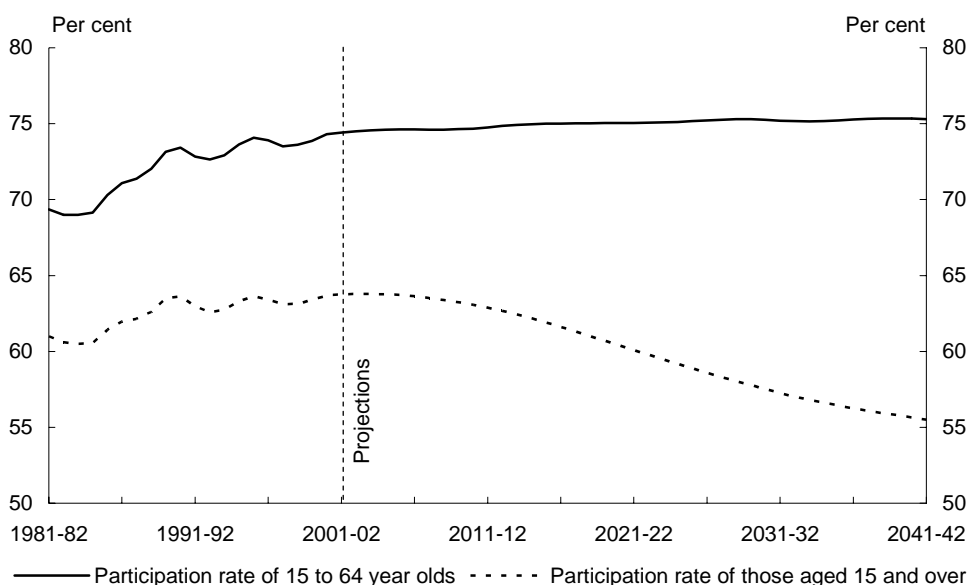
25 Australian National Training Authority (2003), *Shaping Our Future – Australia's national strategy for vocational education and training 2004-2010*, Brisbane.

income support system and wage-earner’s welfare state up until the 1980s to a more targeted welfare system in the late 1990s.²⁶

The proportion of the Australian working age population in the 55+ age group is rising very significantly and people in that category are less likely to participate in the labour force than those who are below 55 years of age. For example, around 72 per cent of men aged between 55 and 59 years participate in the labour force, compared with 91 per cent of 35 to 44 year olds. Similarly, only 50 per cent of women aged between 55 and 59 years participate in the labour force compared with 71 per cent of 35 to 44 year olds.²⁷

The trend towards early retirement, coupled with increasing life expectancy, will have implications for the living standards of all Australians. The community needs to consider how to best provide for its retirement incomes and one readily available solution is to improve labour force participation amongst mature age Australians.

Chart 13: Labour force participation rates by population age category



Source: Australian Government (2002), Budget Paper No. 5, *Intergenerational Report 2002-03*.

Overall labour force participation rates in Australia are also modest in comparison with many other OECD nations, with Australia ranked twelfth highest in the OECD in 2002. In keeping with most other developed countries, Australia’s overall participation

26 K. Green (2002), ‘Welfare reform in Australia and the United States: Tracing the emergence and critiques of the New Paternalism and Mutual Obligation’, *The Drawing Board* 3 (1) July, pp. 15-32.

27 OECD (2003), *Labour force statistics, 1982-2002*, Paris.

rate is expected to decline over the long term as the population ages (see Chart 13), even though the participation rate of those of working age is expected to remain broadly stable. That is, the fall in aggregate participation of those aged 15 and over reflects the declining proportion of working age people as Australian society ages.

The effect of population ageing can be illustrated by comparing Australia's and Japan's current situations. The average age of the Japanese population is older than Australia's and participation rates for most age categories are generally similar to or significantly higher than the equivalent age groups in Australia. If Japan had the same age structure as Australia, its labour force participation rate would be some 2 percentage points higher than at present.²⁸ Hence, the further ageing of the Australian population is projected to have a significant effect on participation and, hence, on growth in national living standards.

Income support is designed to provide a safety net to an individual or family while the primary income earner is out of employment for one reason or another. However, an imbalance between incentives and assistance is a key factor behind structural unemployment. As a result, governments here and abroad have sought to improve the incentives and obligations contained in the income support system.

The Australian income support system for the unemployed was largely designed in the immediate post-World War Two period, when the labour market had very different characteristics to what it has now.

Over time, access to income support has become better targeted according to need, with a reduction in the range of benefits and a tightening of eligibility criteria.

Incentives for some income support recipients to participate were improved through *The New Tax System* and the *Australians Working Together* (AWT) packages. The AWT package in the 2001-02 Budget addressed the principles contained in the 1999 McClure Report on welfare reform, which set out ways in which welfare dependency could be reduced with an overarching aim of assisting out-of-work people back into the workforce. Specific reforms included the introduction of working and training credits; training accounts; as well as other initiatives targeted at parents, the mature-aged, indigenous Australians and people with disabilities – demographic groups which tend to exhibit lower labour force participation rates than other groups, or who are marginally or precariously attached to the labour force.

Reforms announced in the 2001-02 Budget sought to encourage Disability Support Pension recipients to maximise their attachment to the labour market, while similar measures have been introduced for certain Parenting Payment recipients.

28 M. Parkinson (2004), 'Growth drivers: the medium to longer-term challenges to maintain Australia's growth performance', address to the Country CFO Forum, Melbourne, 6 February.

The AWT package built on changes that had already been made to the incentive system in the 1997-98 Budget. The Work for the Dole programme attempted to infuse a principle of 'mutual obligation' into the welfare system. Many unemployed people, particularly young people, are now required to undertake community work in return for income support. The programme is predicated on the view that it is fair and reasonable to ask unemployed people to participate in an activity which both helps to improve their employability and makes a contribution to the community in return for payments of unemployment benefits.

Effective marginal tax rates have also been targeted as part of the welfare-work reform agenda. The concept acknowledges that the decision to participate in the labour force, or to actively seek employment if currently unemployed, is affected not only by the additional income taxation paid on earned income but also by the loss of income support payments through income testing arrangements.

The reduction in income tax rates has improved the incentive to work for those on low incomes or on income support, as after-tax income would be higher for an additional hour of work than it otherwise would have been. This substitution effect is particularly strong for those people on relatively low incomes.

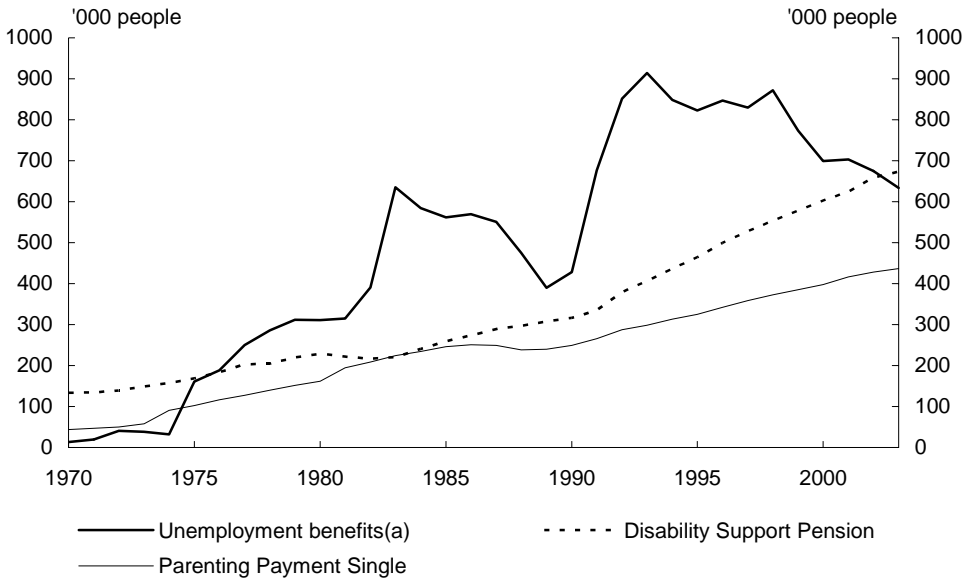
Reductions in effective marginal income tax rates (largely through reduced income tax rates and reduced family assistance taper rates) and an increase in the tax-free income threshold have been delivered at various times since the early 1980s, most significantly through *The New Tax System* reforms in 2002. In its 2003-04 Budget, the Government further reduced income taxation by raising the income thresholds, with the amount of the low income tax offset, and the income threshold from which it starts to phase out, increased. These reforms have allowed income support recipients to retain more of their income support than they would have otherwise been able to do as their employment income rises.

In the 2004-05 Budget, the Government has announced its *More Help for Families* package of assistance to families, tax cuts and incentives for saving for retirement. The package builds on the reforms delivered through *The New Tax System* and in the 2003-04 Budget. The package increases the adequacy of assistance for families by increasing the rate of Family Tax Benefits and reducing the withdrawal rates, with improvements in the rewards from work for low and middle income families, and particularly assisting women wishing to re-enter the workforce after having children.

The package also delivers tax cuts by increasing the thresholds for the top two marginal tax rates. This will ensure that high marginal tax rates are not a disincentive for those taking on additional work, wishing to work overtime, seeking promotion, or acquiring skills. The tax cuts will help ensure that Australia is able to retain and attract people with highly regarded skills.

Of Australia's total working age population of around 14 million, only about 10 million are currently part of the labour force.²⁹ Around 2.7 million working age Australians presently receive income support, representing around 20 per cent of the working age population.³⁰ Among others, this group includes sole parents and recipients of the Disability Support Pension. There are now more people in receipt of the Disability Support Pension than there are people in receipt of standard unemployment benefits (see Chart 14).

Chart 14: Number of selected income support recipients



Source: Department of Family and Community Services.

(a) Unemployment benefits reflects Newstart Allowance and Youth Allowance (non-students).

Many of these people entered the income support system after becoming unemployed or after having left work voluntarily. Others in this group have sought work but with limited success because of a lack of relevant training or skills, or one or more of the various impediments discussed above. Of the group in receipt of income support, only around a third are subject to an activity test and only half of that group is required to actively look for work. Although many of these people are involved in other important activities, such as education and family-related commitments, there is scope for increasing their attachment to the labour market to improve their longer-term economic and social wellbeing and to realise their potential.

In order to increase Australia's participation rate and further reduce unemployment, it is important that the income support system encourages, promotes and supports people to seek out and participate in paid work to the extent they are able. A balance of

²⁹ *Persons Not in Labour Force* (ABS Cat. No. 6220.0).

³⁰ Australian Government (2004), *Australia's Demographic Challenges*, February.

incentives, assistance and requirements will be needed to maximise the participation of people with diverse capacities and availabilities for work. More consistent arrangements between different forms of income support and better integration of access to programmes that provide active assistance to an individual could assist in improving participation amongst income support recipients.

CONCLUDING COMMENTS

Australia's current unemployment rate is at the lowest sustained level for 23 years, with the rate declining to around 6 per cent in late 2002, and below 6 per cent since late 2003. But unlike other times since the early 1980s when the unemployment rate has declined briefly to 6 per cent or less, the unemployment rate is forecast to remain below 6 per cent on average over the forecast horizon. There also seems to be scope for the unemployment rate to fall even further over the medium term, given ongoing economic growth and further policy reform.

The potential of the labour market to sustain low unemployment is a result of improved macroeconomic policy frameworks and extensive microeconomic reform over a long period of time.

A key theme since the early 1980s has been to increase the 'speed limits' on growth through structural reforms and institutions that are better designed to foster productivity and a sustainable expansion in employment. That process of reform involved decentralising employment arrangements, raising the capacity of the labour force through education and training, developing customised job support and outcomes-focused employment services and creating better incentives in the welfare and taxation systems to promote participation and employment.

Structural reforms have been reinforced in recent years by the adoption of a medium-term framework for the setting of both fiscal and monetary policy in Australia. Coupled with the increased flexibility across the economy flowing from the programme of microeconomic reform, this is helping to make the economy more stable, and less prone to the booms and busts of earlier decades which proved to be a major obstacle to steady and sustainable declines in unemployment.

While unemployment in Australia is now at 23 year lows at less than 6 per cent, some other developed economies have succeeded in pushing unemployment to even lower levels. Labour force participation in Australia is also relatively low compared with some other developed countries, particularly with respect to key age and gender cohorts, such as older males. Hence there is a need to further reform policies to reduce or remove impediments to participate in the labour force and to lower unemployment.

Australia is now moving into a period where it has moderate levels of unemployment but with the onset of new long-term pressures from the ageing of the population. As a

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result, labour and welfare policies will need to be attuned both to the shorter-term and to these 'new' longer-term demands.

The 2004-05 Budget includes a package of major initiatives that address directly these demands through increasing participation and productivity. The package includes measures to further reduce welfare traps for low and middle income families and delivers tax cuts. These will increase rewards from work and increase incentives to take on additional work, seek advancement and acquire skills. This is supplemented by a substantive investment in education, health, innovation and infrastructure.

These initiatives, together with the current solid macroeconomic environment, will enable Australia to achieve lower unemployment and higher labour force participation, provide a higher level of social wellbeing and help deal effectively and sustainably with the ageing of the population.

