Summaries of the Papers

Reflections on US Labour Market Performance

Lawrence F. Katz

This paper considers the impressive employment and unemployment performance of the United States over the past two decades, and the contrasting high unemployment experienced by most other OECD nations over the same period. It concludes that the multiple dimensions of US labour market flexibility have helped to produce strong labour market outcomes. However, the paper also documents the large increase in income inequality that has accompanied strong employment growth in the United States, and considers a number of policies that could address the increased inequality without being detrimental to the other, more favourable labour market outcomes.

The paper contrasts the differing unemployment experiences by examining shifts in the natural rate of unemployment. Evidence from simple Phillips curve regressions suggests the natural rate of unemployment has remained relatively steady in the United States since 1970, but increased substantially during the 1980s and 1990s in OECD Europe.

Three classes of explanations are considered for the divergent evolution of the natural rate in the United States and other OECD nations. The first, based on the concept of hysteresis, argues that in the presence of generous unemployment benefits and high bargaining power of the already employed, declines in employment can have lasting effects on the natural rate of unemployment. In particular, the absence of these rigidities in the US allowed unemployment to recover more quickly after the supply shocks of the 1970s. The second explanation is that technological change has favoured skilled workers, but in many OECD nations this has not been matched by corresponding movements in relative wages between skilled and unskilled workers. This explanation implies that there should be an increase in unskilled unemployment rates in countries with relatively less labour market flexibility; however, this does not appear to have occurred. The third explanation centres on employment protection: more stringent hiring and firing restrictions in Europe reduce the flows of workers into and out of employment. Although firing restrictions alone have little effect on unemployment rates, the interaction of these restrictions with other labour market rigidities may increase unemployment.

The flip-side of strong US employment performance has been a large increase in inequality. Wages have increased more rapidly for those with more education and in high-skill occupations, but the dispersion of wage outcomes within demographic and skill groups has also increased. The paper suggests increased inequality in the US has been fuelled by increasing demand for skilled workers, a relative slowdown in the supply of educated workers, a decline in union membership and falls in the real minimum wage. The paper also suggests several policy options to improve the incomes and labour market prospects of less-skilled workers, including strategies to encourage education of the less skilled and increasing years of schooling for children from low-income families, tailoring job-assistance packages for the unskilled, and tax credits for low-income workers.

European Unemployment: Why is it So High and What Should be Done About it?

Richard Jackman

This paper reviews evidence on the comparative labour market performance of European economies, and evaluates possible reasons for the high rate of unemployment in Europe in recent years. Based on simple comparisons, the paper finds no conclusive evidence that more heavily regulated labour markets such as those in continental Europe have produced inferior employment and unemployment outcomes. A reason for this may be that labour market interventions reduce unemployment initially, but may result in higher unemployment in the long run. This will not be reflected in static comparisons of unemployment rates across countries.

High European unemployment is often explained as the outcome of a range of institutional labour market factors which act to increase aggregate wage pressure. Cross-country studies generally find that factors like union coverage and the duration of unemployment benefits are associated with higher unemployment, although some other features, such as co-ordinated wage bargaining, actually result in lower unemployment.

The paper notes, however, that arguments that interventionist labour market institutions have caused high European unemployment must address the fact that in the 1960s, apparently similar policies and institutions produced very low unemployment, both in an absolute sense and relative to the United States.

The paper offers several competing explanations for this fact. The first is that changes in European labour market institutions since the 1960s have been sufficient to account for the increases in unemployment. A complementary argument is that past unemployment rates in Europe were unsustainably low, reflecting overly expansionary macroeconomic policy.

An alternative explanation, based on hysteresis, is that European labour market institutions do not cause unemployment *per se*, but act to lock in increases in unemployment rates resulting from macroeconomic shocks such as the oil price shocks of the 1970s.

A third explanation stems from the idea that technological change has increased the relative demand for skilled labour. In the United States this has increased the relative wages of skilled workers, while in Europe relative wages have not changed but rather the unemployment rate of unskilled workers has increased.

The paper also notes that differences in unemployment between European countries are large and it is therefore inaccurate to consider Europe as an homogenous region – some of the most regulated European economies have produced the lowest unemployment rates. A popular explanation for this fact is that there is a ‘decentralisation externality’, where individual wage bargainers do not take into account the adverse effect of their actions on third parties. This leads to the idea of a hump-shaped relationship between the degree of centralisation and unemployment, where both highly centralised and largely decentralised systems produce lower unemployment than intermediate systems.

To explain why policy-makers might seek to undertake policy interventions that increase unemployment in the long run, the paper presents a simple model of unemployment sclerosis. In the model, the government is assumed to intervene in labour markets whenever the unemployment rate is above a target rate. In the short run, the intervention reduces unemployment towards the target, but in the long run it increases unemployment even further, which only leads to further policy interventions. The model implies that dismantling interventionist policies will have adverse effects in the short run, but will result in lower unemployment in the long run. These opposing short- and long-run effects mean that static comparisons of labour market outcomes at a point in time may miss key elements of the impact of labour market policies.

Finally, the paper notes the stark contrast between traditional 'continental European' approaches to unemployment, based on principles of social equity, and those of other nations such as the UK which seek to reduce unemployment by making the labour market more responsive to market signals. The paper concludes that these fundamental differences in approach make a co-ordinated European approach to solving unemployment unlikely.

Dimensions, Structure and History of Australian Unemployment

Jeff Borland and Steven Kennedy

This paper provides an overview of the main features of unemployment in Australia. It describes the evolution of unemployment, and shows that the incidence of unemployment varies greatly by skill and demographic groups, and across different phases of the business cycle. The paper also presents evidence on the social consequences of unemployment, showing that life satisfaction and other measures of well-being are significantly lower for the unemployed than for the employed.

The paper begins by summarising aspects of the increase in Australian unemployment since the 1970s. Unemployment rates for teenagers, the less educated, and some groups of immigrants lie well above the national average. Those whose last job was as a labourer or tradesperson, or in the manufacturing, construction or accommodation/restaurants/ cafes industries also have an above-average incidence of unemployment, although unemployment rates have increased across most industry groups. Unemployment rates in each state generally do not differ greatly from the national rate, but a greater degree of variation exists between the unemployment rates of different regions within a state. The paper also summarises estimates of the natural rate of unemployment which suggest that it has risen from 2 per cent to 7 per cent since the early 1970s.

The paper further breaks down developments in aggregate unemployment by examining trends in male and female participation rates and employment to population ratios. Cyclical phases where aggregate unemployment has increased have been associated with falls in the male full-time employment to population ratio, resulting mainly from lower employment in manufacturing, construction and agriculture. Growth in female employment has occurred mainly in trade, finance, community services and personal services. Analysis of flows into and out of unemployment show that rates of inflow and outflow are larger for women than for men, but that flow rates exhibit a stronger cyclical pattern for men than for women. There is also some evidence that both inflow and outflow rates for males have increased in the 1990s compared with the 1980s.

The paper concludes with a discussion of the social consequences of unemployment. Unemployed persons are disproportionately concentrated in the bottom two deciles of the income distribution. Some evidence exists that crime rates by region are positively related to regional unemployment rates, and unemployment also has an adverse effect on health levels, partially as a result of lower incomes. Survey evidence suggests that unemployed persons report significantly lower levels of life satisfaction than employed persons, although it is difficult to establish the direction of causation.

Microeconomics of the Australian Labour Market

John Freebairn

This paper discusses the microeconomic foundations of the Australian labour market. The starting point of the paper is a 'sticky wage' model of the labour market comprised of a labour demand, labour supply and wage-offer curve. Relatively sticky wages mean that quantity (and quality) adjustments are an important part of labour market adjustment. The paper considers the microeconomic features of each of the components of the model in turn, and discusses empirical estimates of their key parameters. In general, the paper highlights that much empirical work remains to be done to improve understanding of the workings of the labour market.

The wage-offer curve describes the behaviour of wages at each level of employment. The existence of this curve reflects non-market-clearing aspects of the labour market, such as inflexible institutional arrangements, nominal rigidities or efficiency wage effects. The paper discusses three alternative models of aggregate wage-setting: a disequilibrium labour market model, an expectations-augmented wage Phillips curve, and a bargaining model. At an individual level, wages vary according to factors which determine the level of human capital, such as education, and years of workforce experience. While there is some evidence that wage relativities partially adjust to changes in labour demand across industries, there is still considerable stickiness in these relativities perhaps reflecting social and political notions of equity and fairness, the existence of implicit contracts between workers and firms, and the existence of centralised wage-bargaining arrangements.

The body of Australian empirical research on labour demand generally finds an output elasticity of labour demand close to unity, a negative wage elasticity, and a negative effect of productivity on labour demand. The paper speculates that substitutability between labour and other factors of production varies significantly across skill, gender, age and occupation, although there is a dearth of convincing empirical evidence on the magnitude of these differences.

There is considerable time-series evidence that the supply of labour responds to the state of the economic cycle – the encouraged/discouraged worker effect. The evidence suggests that labour supply does not respond greatly to changes in wages. The paper also reviews the literature which examines the quality of labour supply in terms of education levels and skills development.

Finally, the paper also notes that the Australian economy is characterised by substantial reallocations of labour across industries, occupations, regions and skill groupings. Quantitative signals, such as differentials in employment growth or vacancy rates across sectors, play a key part in these reallocations.

Unemployment and Income Distribution

Ann Harding and Sue Richardson

This paper examines the link between unemployment, income distribution and poverty. The incomes and demographic characteristics of unemployed individuals and families are compared with those in the labour force, with low-paid workers, and with the population at large. The paper also speculates about the effects on income inequality of a wage cut for low-wage workers.

The paper summarises recent trends in inequality in the distribution of earnings in Australia. It finds that the distributions of both individual and family disposable incomes have become more unequal over the past two decades or so. The growth in earnings inequality is not explained by increasing differentials in education; indeed, the returns to education appear to have fallen. Instead, there has been an increase in 'within group' inequality – inequality has increased between individuals with similar measured educational and skill characteristics. The increase in income inequality in Australia is greater than in continental Europe, but less than in the United States or the United Kingdom.

The paper examines the income positions of the unemployed, using data from the 1994–95 ABS *Survey of Income and Housing Costs*. The average gross income of unemployed individuals is only one-fifth of average wage and salary earners' income, while families including a wage or salary earner enjoy gross incomes about $2^1/_2$ times greater than families with an unemployed member.

Government benefits are the main source of income for families with an unemployed member, rather than the wage and salary income of other family members. However, unemployed women are more likely to have a family member earning a wage income than unemployed men. Government cash benefits provide nearly all the personal income of unemployed people and only a small proportion of the incomes of employed people, reflecting a tightly targeted welfare system. The unemployed are heavily concentrated in geographic areas with low socioeconomic status, and this is especially true of the long-term unemployed.

The unemployed are also overly represented in the lowest three deciles of the income distribution. They are significantly more concentrated at the bottom of the earnings distribution than employed workers on minimum wages. Using a poverty line arbitrarily defined as half the median family disposable income, the paper then examines the relationship between unemployment and poverty. Only 8 per cent of families, but 28 per cent of families with at least one unemployed member, are in poverty by this measure.

The paper concludes by presenting some caveats to the argument that a cut in minimum wages would stimulate employment and provide an equitable way of reducing income inequality. Firstly, the paper argues that the cost of a mechanism to increase the incomes of the unemployed should be borne by all wage and salary earners, not just low-paid workers. Second, available evidence suggests the employment effects of a cut in minimum wages would be modest. Third, a fall in the salaries of the low paid would exacerbate the high effective tax rates faced by individuals moving from unemployment benefits to low-paid employment. Finally, many of the jobs created could go to people outside the labour force, dampening the effect of higher employment on the measured unemployment rate.

Industrial Relations Reform and Labour Market Outcomes: A Comparison of Australia, New Zealand and the United Kingdom

Mark Wooden and Judith Sloan

This paper compares and contrasts the evolution of industrial relations regimes in Australia, New Zealand and the United Kingdom, drawing out conclusions about the effect of these changes on labour market outcomes. The paper also conducts a cross-country comparison of OECD nations which finds some evidence for a 'hump shaped' relationship between the degree of labour market centralisation and labour market performance.

Around 25 years ago, labour market institutions in Australia, New Zealand and the United Kingdom were quite similar. The paper reviews and contrasts the reforms that have been undertaken in the three countries, each of which has moved towards a more deregulated labour market in recent years. In the United Kingdom, the process of deregulation began in the early 1980s, and has continued at a consistent pace since that time. Reform in New Zealand occurred quite rapidly during the period between the mid 1980s and early 1990s, when there was a movement towards individual employment contracts and the award system was dismantled. In Australia, there was an initial move towards a centralised wage-fixing system under the Accord, followed by a gradual move towards enterprise bargaining and decentralisation. Despite differences in the pace and timing of industrial relations reform, labour market outcomes such as trends in unemployment rates and employment to population ratios, declining union membership and falling levels of industrial disputes have been remarkably similar in each of the three countries.

The paper reports further evidence on the validity of the Calmfors and Driffill 'hump' hypothesis that either a highly centralised or highly decentralised system produces superior labour market outcomes to a partially centralised system. The paper argues that all three countries were close to the top of the hump at the beginning of the 1980s, sharing features of both centralised and enterprise-based bargaining systems. Subsequently, both the United Kingdom and New Zealand have moved down the left (decentralised) side of the hump. The Accord can be viewed as an attempt to move Australia down the hump to the right (increased centralisation). Since that time, however, Australia has shifted towards more decentralised bargaining.

The paper does not find strong evidence that these regime shifts resulted in much difference in employment and unemployment outcomes. This may reflect the difficulty of isolating changes in industrial relations regimes from other factors, the complexity of the response of the economy to institutional change, or the unknown length of lags between institutional changes and observed outcomes.

Finally, the paper conducts a wider international comparison to test the Calmfors-Driffill hypothesis, dividing OECD countries into centralised, decentralised and intermediate groups. By this comparison, economies moving away from the intermediate position (at the top of the hump) performed better on all indicators than economies moving towards the intermediate position, providing some support for the hump-shaped relationship between the degree of centralisation and labour market outcomes.

Prospects for Output and Employment Growth with Steady Inflation

Mardi Dungey and John Pitchford

This paper argues that macroeconomic policy can reduce unemployment both by ameliorating recessions, and by achieving the highest possible growth rate consistent with steady inflation. The paper estimates this steady inflation rate of growth, or SIRG, to be 4.37 per cent for Australia over the post-float period. The paper suggests that growth at the SIRG for four to five years could bring unemployment down to a rate near that experienced in the late 1980s, although this is subject to some uncertainty.

Firstly, the paper develops and estimates an equation for consumer goods inflation. The price of domestic consumption goods is modelled as a weighted average of the prices of domestic goods and imports. Domestic goods prices respond to excess demand pressures, for which the rate of economic growth is used as a proxy. An empirical inflation equation is estimated which is then used to derive the steady inflation rate of growth. When the inflation equation is estimated over the period since 1983, this growth rate is 4.37 per cent. Using the estimated equation, it is shown that deviations in import prices have affected the actual inflation rate by up to two percentage points at various times during the sample period.

The paper then presents estimates of an aggregate labour demand equation, which is used to estimate the effect of a change in output growth on employment. From these estimated results, bands of wage growth consistent with particular rates of output and employment growth are calculated.

The paper argues that policy should act to counter domestic goods price inflation caused by excess demand pressures. However, policy should not respond to inflationary pressures resulting from a depreciation in the real exchange rate. Rather, policy-makers should aim to maintain growth at the SIRG, tolerate the movement in the inflation rate, and wait for a subsequent appreciation in the real exchange rate to reverse the upward pressure of traded goods prices on aggregate inflation.

Finally, the paper estimates the effect of a sustained period of growth at the SIRG on the unemployment rate using various assumptions for the growth in real wages. The fall in unemployment is sensitive to the assumptions used, although in most cases, growth at the SIRG allows unemployment to fall to around 5 per cent after four years.

The Macroeconomics of Australian Unemployment

Guy Debelle and James Vickery

This paper analyses the Australian labour market from an aggregate perspective, and develops a framework to analyse how unemployment could be permanently lowered from its current level. In particular, it estimates that a fall in real wage growth below trend of 2 per cent for one year could lead to a permanent reduction in the unemployment rate of about 1 percentage point. Although monetary policy cannot influence the equilibrium or 'natural' rate of unemployment, it can significantly affect the speed of adjustment of unemployment towards the new equilibrium rate.

Firstly, the paper discusses broad trends in the Australian labour market. Increases in the unemployment rate since 1960 have been concentrated in three relatively short episodes. The first of these was associated with a sharp increase in labour costs during the mid 1970s; the second was coincident with both a wages push and the 1982–83 recession; and the third occurred during the recession of the early 1990s. These episodes demonstrate the important impact of aggregate demand and real wages on employment and unemployment. The large increases in unemployment during recessions also highlight the benefits of maintaining a steady rate of growth.

Estimates of the natural rate of unemployment suggest that the natural rate rose substantially during the 1970s, but since that time has been relatively constant. Current estimates place the natural rate at between 7 and 7½ per cent. The actual unemployment rate has remained above the natural rate for most of the 1990s, reflecting disinflation during the early part of the decade and the slow adjustment of inflation expectations to the new lower rate of inflation.

The paper estimates an imperfect-competition model of the labour market. It then uses empirical estimates of labour demand and supply elasticities to simulate the effects of a fall in the aggregate real wage on employment and unemployment. If it is assumed that a fall in the real wage has no effect on the level of output, a 2 per cent fall in the real wage causes employment to increase by 0.8 per cent, and unemployment to fall by 0.4 percentage points. The increase in employment is more pronounced than the fall in unemployment, because the higher employment stimulates labour supply through the encouraged worker effect. If however, as seems more likely, output is assumed to rise as employment rises, the higher output amplifies the employment effects of the cut in wages. In this case, the 2 per cent fall in wages causes employment to rise by 2 per cent, and unemployment to fall by just over 1 per cent. The effect of higher employment on output could be even greater if the capital stock expands as a consequence of the increase in employment.

In this framework, monetary policy cannot affect the equilibrium or natural rate of unemployment. However, it can affect the speed with which the economy adjusts towards the new natural rate. The model shows that the faster the central bank 'learns' that the wage change is permanent, the less the gap between the actual rate of unemployment and the natural rate during the adjustment phase. However, in practice, it may be difficult to identify whether developments in the labour market are temporary or permanent. An inflation-targeting framework for monetary policy is beneficial in this regard to ensure that monetary policy is forward-looking and because developments in the labour market are a crucial component of the outlook for inflation.

What Works Among Active Labour Market Policies: Evidence from OECD Countries' Experience

John P. Martin

Active labour market policies aim to improve the access of the unemployed to the labour market, develop the skills of the unemployed and enhance labour market efficiency. This paper summarises OECD research examining which active labour market policies are successful, and in what circumstances. It concludes that such policies, if properly designed, can be a useful component of an overall labour market strategy, however they are not a 'magic bullet' solution to unemployment in their own right.

Across the OECD, spending on active labour market programs averages 0.9 per cent of GDP, and has increased somewhat over the past decade, although there are large differences in spending between countries. Despite a broad consensus that spending on the labour market should focus on active rather than passive programs such as increased unemployment benefits, the proportions devoted to the two types of spending have not changed greatly over the past decade.

Macroeconomic evaluations of active programs, focusing on aggregate relationships between the level of active labour market spending and macroeconomic variables such as unemployment, find mixed results regarding the effectiveness of active labour market programs. However, since such evaluations are necessarily crude, the paper focuses instead on the literature on the evaluation of individual labour market programs. From this literature, the paper draws five main rules to guide policy-makers in their selection of active labour market policies: (i) rely as much as possible on in-depth counselling, job-finding incentives and job-search assistance; (ii) public training programs should be kept small, and highly targeted to the needs of job-seekers and employers; (iii) early interventions – as early as pre-school – can reduce early school-leaving and improve the job-readiness of disadvantaged young people; (iv) employment subsidies of short duration can be used as unemployment duration lengthens to maintain contact with the labour market; and (v) provide subsidies to start-up businesses for unemployed people with entrepreneurial skills.

The paper argues that there are important linkages between active and passive labour market programs. It presents evidence that work incentives may be adversely affected in countries where unemployment-benefit replacement ratios are relatively high, and that a generous and poorly managed unemployment benefit scheme substantially reduces the beneficial effects of active labour market programs.

Finally, the paper suggests that an integrated public employment agency controlling job placement, benefits payment and participation in active programs can help improve the degree of co-ordination between different aspects of labour market assistance. The receipt of benefits should be linked to participation in labour market programs and availability for work criteria, passive income support should be made as active as possible, and profiling should be used to target potential long-term unemployed for counselling and job-search assistance when they first become unemployed.