

Chapter 4: The task of reducing unemployment

Introduction

- 4.1 The Commission is required by the WR Act to have regard to the capacity of the unemployed to obtain employment. This aspect of the WorkChoices reforms is a major change from the previous legislation which only addressed the issue of the desirability of attaining high levels of employment.
- 4.2 While the historic reduction in unemployment is welcome, further reductions are both achievable and desirable. This requires a strong expansion of employment opportunities to ensure that the unemployed are able to benefit, given that most new jobs are filled by new entrants to the workforce. Moreover, the expansion of employment opportunities will need to include the lower skilled, lower productivity sectors of the workforce given the skill levels and work experience of many of the unemployed.
- 4.3 Decisions regarding the appropriate level of minimum wages have an important part to play in expanding employment opportunities. This chapter addresses the issues involved with ensuring that employment opportunities expand sufficiently to further reduce unemployment.

Labour market experience over the past 15 years

- 4.4 Since the end of the last recession¹ in the December quarter of 1991, the Australian labour market has produced extraordinarily strong outcomes. Employment has grown sufficiently to absorb both the growing working age population and increases in participation while also enabling the unemployment rate to fall from 10.1 to 4.9 per cent. Labour productivity² growth has also been strong, increasing by 2.5 per cent per annum³ between December 1991 and March 2006. Meanwhile real wages⁴ have grown by 1.5 per cent per annum⁵ with minimal impact on inflation over the same period.

¹ Technically, a recession is defined as two consecutive quarters of negative GDP growth (measured in seasonally adjusted terms). Note that exact timeframes may differ from quarter to quarter due to revisions of National Accounts estimates by the ABS.

² As measured by real GDP per hour worked in the market sector.

³ ABS, *Australian National Accounts: National Income, Expenditure and Product* (Cat. No. 5206.0), Mar 2006, Table 2 Key National Accounts Aggregates, Seasonally Adjusted.

⁴ Nominal average non-farm compensation per employee deflated by the implicit price deflator for final consumption expenditure – households.

- 4.5 Consequently, some may consider that the problem of unemployment is close to solved. Notwithstanding the past success in reducing unemployment, the post-recession experience demonstrates how difficult it is to reduce unemployment sustainably.
- 4.6 This can be seen in Table 4.1 which presents data on the changes in the labour market between December 1991 and May 2006. It shows that employment growth of 2.0 per cent per annum was required to bring the unemployment rate down by 5.2 percentage points (from 10.1 to 4.9 per cent). During this period the labour force grew by 1.6 per cent per annum as a consequence of a growing population of working age (1.4 per cent per annum) and a slight increase in the participation rate (0.1 percentage point per annum).

Table 4.1: Labour market changes December 1991 – May 2006

Change	Absolute		Percentage	
	Total	Per annum	Total	Per annum
Employed ('000)	2,480.0	172.0	32.4	2.0
Unemployed ('000)	-342.1	-23.7	-39.6	-3.4
Labour Force ('000)	2,137.9	148.3	25.1	1.6
Not in the Labour Force ('000)	862.9	59.9	17.3	1.1
Civilian population aged 15 & over ('000)	3,000.9	208.2	22.2	1.4
Unemployment (percentage point)	-5.2	-0.4		
Participation (percentage point)	1.5	0.1		

Source: ABS Labour Force Australia Spreadsheets (Cat No 6202.0.55.001), May 2006, Table 02.

- 4.7 Over this period, a reduction in the number of unemployed by 342,100 persons was associated with the creation of 2,480,000 additional jobs – each year employment grew by 172,000 persons while unemployment fell by only 23,700 persons. That is, it took the creation of seven additional jobs to be associated with the reduction of the number of unemployed by one person.
- 4.8 Moreover, job growth has to continue at a sustained rate to ensure that the reduction in unemployment is maintained. When the rate of job growth slackens, the level and rate of unemployment rises. For example, employment growth fell to 38,000 in the year to July 2001, or a rate of just 0.4 per cent.⁶

⁵ ABS Australian National Accounts: National Income, Expenditure and Product (Cat. No. 5206.0) March quarter 2006. Tables 12 and 41.

⁶ ABS Labour Force Australia Spreadsheets (Cat No 6202.0.55.001), May 2006, Table 02, Labour Force Status by Sex, Seasonally Adjusted.

Over this same period the number of unemployed grew by 16 per cent or 92,000, with the rate of unemployment increasing by 0.8 percentage points.⁷

- 4.9 The main lesson from the labour market experience of the last 15 years is that to reduce the level and rate of unemployment, employment growth must be strong and sustained over long periods, with sound economic growth that generates substantial employment opportunities.
- 4.10 There has been much research undertaken to explain this persistence in unemployment following an economic downturn. That is, the tendency for unemployment to rise relatively quickly during recessions but to fall slowly during subsequent upturns in economic activity.
- 4.11 The concept of persistence in unemployment has its origins in the work of Blanchard and Summers.⁸ The authors proposed that the equilibrium or so-called natural rate of unemployment depends on the history of the actual rate of unemployment.
- 4.12 The authors identified several mechanisms to explain this occurrence. In particular, they noted that due to the fixed costs of hiring new workers, “insiders” (the employed) have relatively more bargaining power than “outsiders” (the unemployed). As a result the unemployed have no effect in exerting the downward pressure on wages that would otherwise lead to an increase in employment during economic recoveries.
- 4.13 In Australia, this problem of “insiders” and “outsiders” was formalised in the previous WR Act in the setting of minimum wages under the Safety Net Review. The annual setting of minimum wages was the outcome of a wage claim by the ACTU. The AIRC arbitrated on the claim and took evidence from unions, employer groups, state and Australian governments and other groups regarding the appropriate size of the wage increase for award-reliant workers.
- 4.14 The Australian Government, through its submissions, did intervene in the public interest to argue that employment opportunities should not be closed-off by large increases in minimum wages. But importantly, the AIRC was not directed in the legislation to directly take the employment needs of the unemployed into account.

⁷ Ibid.

⁸ O J Blanchard and L H Summers ‘Hysteresis in Unemployment’, *European Economic Review*, 1987, Vol 31, pages 288-295.

- 4.15 Blanchard and Summers also noted that the atrophy of skills, reduced job-search intensity and the adverse signals to employers are all associated with long periods of unemployment.⁹ These factors also help to account for persistently high rates of unemployment following downturns in economic activity.
- 4.16 Empirical evidence although somewhat mixed, generally provides strong support for persistence in unemployment. This is particularly the case for Australia. Mitchell, using data for 1969 to 1984, found that a 1 per cent increase in the actual rate of unemployment was associated with a 0.5 per cent increase in the equilibrium rate of unemployment.¹⁰ More recent studies, using data for the 1980s and 1990s and based on more advanced econometric techniques also provide support for the existence of persistence in unemployment.¹¹
- 4.17 The challenge of persistence in unemployment entails several policy responses.¹² First, it requires that macroeconomic policies be set in such a way that the economy grows in a strong sustained manner as it exits recession, and thereby minimises the risk of the recently unemployed becoming long-term unemployed.
- 4.18 This is precisely what occurred in the early 1990s as Australia emerged from recession.¹³ Employment grew rapidly from mid-1993 but returned to more moderate rates of growth in the later half of 1995. Since then, the economy has been characterised by a decade of marked macroeconomic stability and a heightened resilience to shocks.
- 4.19 This stability is a feature that can be attributed in part to the introduction of medium-term frameworks for monetary and fiscal policy. The Australian Government's focus on budget balance over the economic cycle and the Reserve Bank's inflation targeting regime have contributed to relatively high

⁹ Ibid, pages 288-295.

¹⁰ Cited in J Borland and I McDonald, 'Labour Market Models of Unemployment in Australia', Melbourne Institute Working Paper No. 15/00, September 2000, page 18.

¹¹ See, for example, R Smyth 'Unemployment Hysteresis in Australian States and Territories: Evidence from Panel Data Unit Root Tests', *Australian Economic Review*, 2003, Vol.36, No. 2, pages 181-192; A Stegman and T Stegman 'Labour Market Reform and the Macroeconomic Efficiency of the Labour Market in Australia' in *Cambridge Journal of Economics*, 2004, Vol. 28, pages 743-766; M Gustavsson and P Osterholm 'Hysteresis and Non-Linearities in Unemployment Rates', 2005, Department of Economics Uppsala University, Sweden.

¹² See, for example, C Richardson 'Unemployment or Tax Reform' in proceedings of the conference *Unemployment and the Australian Labour Market* edited by G Debelle and J Borland, 1998, page 347.

¹³ See for example, K Henry 'The Task of Economic Policy' address to the Sydney Institute, 2005, 20 June.

average rates of growth, low volatility and a low and stable rate of inflation. These steadier macroeconomic settings have helped ensure the economy is less prone to the boom-bust cycles of the past.

- 4.20 Second, active labour market policies need to address skill atrophy, reduced job-search intensity and effectiveness and adverse signalling associated with long spells of unemployment.
- 4.21 Over the past decade the Australian Government has implemented a range of labour market and welfare reforms that have contributed to the strong performance of the Australian labour market. These reforms have included the establishment of Job Network which has facilitated greater competition in the provision of employment services and an improved focus on achieving outcomes for jobseekers. They have also included the introduction of Mutual Obligation, Australians Working Together and Welfare to Work (from July 2006) involving a range of initiatives to help demographic groups such as parents, the mature-aged, indigenous Australians and people with a disability improve and maximise their attachment to the labour force.
- 4.22 These reforms have been particularly important in addressing the various disadvantages that people face in the labour market and the employment prospects of those who are less responsive to general increases in labour demand.
- 4.23 Finally, and most importantly from a minimum wage perspective, the problem of unemployment persistence requires an assurance that the minimum wages of the least skilled in the labour market are not set at levels which appropriate most of the income gains following upturns in economic activity. That is, while business expenditure on wage costs will grow during economic upturns, growth in wage rates should not absorb all of this increased expenditure.
- 4.24 The recent reforms to the WR Act seek to ensure that the employment opportunities of the unemployed are taken into account when minimum wage setting decisions are taken. That is, the increased expenditure on wage costs by employers should generate increased job opportunities as well as higher worker incomes.

Conclusion

- 4.25 The task of further reducing unemployment is difficult, notwithstanding the current strong labour market conditions.

- 4.26 The experience of the past decade and a half is that unemployment can be brought down but it requires sustained economic growth and wage increases in line with productivity growth.
- 4.27 The unemployed are generally lower skilled and have lower productivity than the existing workforce. Accordingly, the expansion of these employment opportunities for the unemployed can be facilitated by an appropriately set minimum wage.