

**A Submission to the  
House of Representatives Employment and Workplace Relations Committee  
on  
PAVING THE WAY TO PAID WORK**

**The H.R. Nicholls Society Inc**

Foreword

**Ray Evans, President**

This submission to the House of Representatives Employment and Workplace Relations Committee seeks to demonstrate that unemployment, especially in those regions of Australia characterised by particularly high unemployment and the social evils which accompany this tragedy is unnecessary, unnatural, and remediable. It is the consequence of the prohibition by arbitral tribunals and other labour market regulators, of contractual arrangements between Australian citizens which would be to the advantage of both parties, but which do not meet the approval of the arbitral authorities.

Common-law contracts of employment became a great engine of economic progress in the English speaking world during the 19<sup>th</sup> century. They were based, like the law of contract generally, on the principle that free people knew their own interests better than anyone else could, and should be free to pursue those interests with minimal interference by the state.

It is ironic that at the end of the 19<sup>th</sup> century, when Australians were then enjoying the highest incomes and living standards in the world (and thus higher than ever before in the history of mankind), dissatisfaction with freedom in the labour market became widespread. The spectacular bank crash in Victoria in 1893, which was the culmination of frenzied land speculation (fuelled by reckless government borrowing), led to the closure of many factories and businesses, to a population decline, and to attempts by Victorian legislators to ameliorate the poverty that was the consequence of the crash through labour market regulation of a highly intrusive kind.

This same belief, that poverty and industrial unlawfulness could be eradicated by statute, led to the inclusion of the industrial relations power (Section 51:xxxv) in the Australian constitution, and to the passage of the Commonwealth 1904 *Conciliation and Arbitration Act*.

All of these developments were strongly contested, precisely because they were seen by those who opposed them as threatening the freedom of the citizen to live and to work as he or she wished, and to take advantage of whatever economic opportunities were available.

A century after the passage of the 1904 Act, the consequences of regulatory interference are still manifest—most seriously in much higher unemployment than would be the case in a labour market characterised by freedom of contract.

This submission is based on the extensive economic literature on the impacts of regulation and trade union privilege on labour costs; on employment and job creation; on the returns to labour generally; and how regulation creates two classes of employees—those who work in the protected sphere of the regulators, and those who are outside that sphere and are disadvantaged accordingly. In the worst case they are locked out of the labour market because of the cost barriers which have been erected against them by the regulators.

This submission discusses the impact of employment protection laws (such as unfair dismissal laws) and finds that such laws increase the costs of labour for employers, thus increasing unemployment and depressing the price of labour generally.

The primary cause of the malaise in Australia's labour market is the Industrial Relations Commission and its State counterparts. By setting hundreds of minimum award wages and prescribing in great detail other entitlements which may be of little or negative value to the employee, but which certainly impose substantial costs on the employer, these arbitral tribunals impose a great burden on Australian workers and on the economy generally.

This submission recommends legislative reform that allows AWAs to be accessed much more readily and automatically by ordinary Australian workers and employers. This would make a real contribution to reducing unemployment generally. Alternatively, it is recommended that in those regions such as the Victorian La Trobe Valley, where unemployment and social morbidity is particularly high, special free-labour-market zones should be designated to free those people without jobs to determine where their interests lie unconstrained by regulations put in place by people remote from them both geographically and in terms of real appreciation of their plight.

It is understood that a century of regulation and the creation of special interest groups which depend for their well-being on their involvement in the regulatory process, make for political difficulties in the path of reform. But it is the politicians' particular vocation to find ways of overcoming those difficulties and vested interests, so that much personal tragedy is avoided and the national interest is advanced.

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**The H.R. Nicholls Society Inc<sup>1</sup>**

**Geoff Hogbin**

**SUBMISSION SUMMARY**

**1.0 Introduction**

The HR Nicholls Society (the Society) strongly supports the objective of increasing participation in paid work and submits that the most effective way of achieving it is through further deregulation of labour market and employment relationships.

If a business expects that employing a person will add more to its revenue than to its costs, then it is profitable to create a job for that person. Many labour market and employment regulations, however, “price people out of jobs” (that is, cause unnecessarily high rates of unemployment) by artificially raising real labour costs. These regulations are more likely to cause unemployment (that is, to be “binding”) at the lower end of the labour market, and especially in economically depressed regions of the country.

The fact that unemployment rates in Australia have remained near 6 per cent after almost a decade of strong economic growth *and* tightening rules of eligibility for unemployment benefits points to real labour costs as a major factor limiting job creation and employment.

Freeing employers from constraints on job creation will, by making jobs available for those seeking them, enhance both the effectiveness and perceived fairness of welfare benefit reforms aimed at strengthening incentives to participate in paid work.

Rough estimates set out in Appendix 1 suggest that there is scope to increase total employment in Australia by between 400,000 and 500,000 people or by about 5 per cent.

**2.0 If job creation is profitable, will jobs be created?**

Reforming our labour market and employment regulations to make rates of pay and other terms of employment negotiable will allow businesses to profitably employ the kinds of people who cannot at present find jobs, especially in economically depressed areas with labour surpluses.

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<sup>1</sup> This submission has been prepared by Geoff Hogbin with contributions, advice and assistance from Ray Evans, Adam Bisits, Jason Briant and other members of the Board of the HR Nicholls Society Inc.

Would lower rates of pay be unfair? Research shows that the unemployed are very financially disadvantaged relative to low-paid workers. Unemployment also causes personal distress and depression. Getting unemployed people into jobs would place many of them on paths to better jobs and rising incomes. In short, regulations which artificially support real wages for those people with jobs impose a very heavy burden on the unemployed and on discouraged workers.

Cutting real labour costs by deregulation will, by reducing the numbers on unemployment benefits, allow tax cuts to offset wage reductions.

In summary, allowing employees and employers to negotiate terms and conditions of employment free of regulatory constraints will be conducive to net job creation throughout the entire economy. This is especially important for maintaining the viability of regional centres of population.

### **3.0 How do regulations increase real labour costs?**

Job creation and hiring decisions are based on the *expected* real costs of employing people, including regulation-imposed costs.

#### *Mandatory minimum wages*

Award wages set above the corresponding market-clearing wage directly increase labour costs. Also, to the extent that the award wage system undermines incentives to contribute physical and mental effort to jobs, it raises real labour costs by reducing the productivity of employment relationships.

Importantly, binding minimum wages constitute a rigid base on which costs associated with other regulations are superimposed *pari passu*.

#### *Entitlements*

Mandatory entitlements add directly to real costs of employing workers with “binding” award wages. They may also indirectly raise real labour costs by eroding incentives and the productivity of employment relationships.

Also, mandatory employment entitlements effectively make recipient employees unsecured creditors of their employers, thereby exposing employees to the often unwanted risk of their employer’s insolvency.

#### *Employment protection regulations*

A legitimate and important function of governments is to provide some form of insurance against unemployment. However, governments in most OECD countries have gone beyond provision of unemployment insurance by introducing unfair dismissal laws intended to increase job security.

Employment protection regulations cannot protect the holders of the roughly 10 per cent of jobs which become unviable (are “destroyed”) each year in modern economies as part of the process of “creative destruction”. In effect, what these regulations do is

protect people with jobs from competition from workers without jobs and from workers with worse jobs.

Employment protection laws raise the expected real costs of labour, especially of marginal workers, through administrative costs and compensation payments, and on the productivity of employment relationships.

Overseas research consistently shows a strong positive correlation between the stringency of unemployment protection laws and rates of long-term unemployment.

#### *Regulatory institutions, labour unions and real labour costs*

Labour unions reduce participation in paid work in Australia through their influence on wage levels and other terms and conditions in the award-setting process. The interests of marginal workers and the unemployed are largely without representation in award determination processes.

#### *Conclusion*

Minimum wage regulations, mandatory entitlements and employment protection laws all tend to raise real labour costs, especially at the lower end of the labour market where minimum wages are binding. The problem is exacerbated by our centralized wage determination system which favours labour market insiders, represented in wage-setting processes by labour unions, to the detriment of marginal workers and the unemployed.

#### **4.0 Do real wages affect the numbers employed ?**

That raising real labour costs will reduce employment has commonsense appeal and is supported by the preponderance of vast amounts of statistical evidence. Because prolonged unemployment is often seriously damaging to people's lives, policy-makers should be fully alert to the common predisposition to deny (or at least underestimate the strength of) the negative relationship between real wages and quantities of labour demanded.

Studies throughout the world suggest that increasing a minimum wage by 10 per cent reduces employment by between about 1 per cent and 5 per cent. Because low-wage earners are only a fraction of all workers, however, the proportions of low-wage earners priced out of jobs is almost certainly very much higher than indicated by these numbers. Even those who claim that statistical evidence shows that minimum wages have no effects on employment concede that this applies only for minimum wages set close to market-clearing wages.

Because the ratio of minimum wages to average wages is high in Australia relative to most other countries, the Society submits that removing regulatory constraints which increase real labour costs will create jobs and increase participation in paid work, both by cutting expected monetary on-costs and by improving the productivity of employment relationships. In particular, unemployment in depressed regions will be reduced.

## **5.0 Do regulations produce offsetting benefits?**

The Society submits that there is a strong presumption that allowing employers and employees to negotiate terms and conditions of employment free of regulatory constraints will maximize economic and social welfare. Parties to an employment relationship have by far the best information about the requirements of the relationship, about their particular preferences and circumstances in relation to those requirements, and about other feasible alternative job matches. They have infinitely stronger incentives than third parties to discover mutually beneficial arrangements that will maximize the value of their employment relationships. So are there justifiable reasons for governments to regulate labour markets and employment relationships?

There is a consensus that our governments should act to reduce income inequality. However, where labour market regulations price people out of jobs, thereby reducing their earnings to zero, their effects on the distribution of income are manifestly perverse. There is a compelling case to rely on taxes and transfers, rather than labour market regulations, to achieve desired distributional outcomes.

Very few labour market regulations can be justified on any of the grounds that they correct labour market “imperfections”. The contention that regulations are needed to correct “an inherent imbalance of power” in employment relationships has no substance.

Doubtless, there are bosses who treat employees badly, but because business success depends on productive cooperation between the employer and employees, they are exceptions rather than the rule. Keeping unemployment rates low by allowing labour markets to function unfettered by regulations is the most effective way of ensuring that employees are treated fairly.

## **6.0 Recommendations: how should regulations be reformed?**

The long-term objective of labour market reform should be to eliminate all regulations which artificially increase real labour costs, especially at the lower end of the labour market. This would ultimately require:

- dismantling entirely the system of centrally-fixed industrial wage and entitlement awards;
- relying on unemployment benefits to create a “welfare floor” for workers;
- repealing most unfair dismissal laws, in particular those requiring “just cause” and “procedural fairness”, not only for small businesses (already in the legislative pipeline) but for all employers;
- replacing the current system of compulsory conciliation and arbitration of industrial disputes with a voluntary mediation service similar to the UK’s ACAS; and

- abolishing exemptions within the Trade Practices Act which allow trade unions to collude to extract economic rents from employers and to engage in other anti-competitive market practices.

The Society recommends that the following steps be taken immediately in pursuit of these longer-term objectives.

#### *Reforming the award system*

The *WROLA Act 1996*, which has established a precedent for parties to employment contracts to lawfully opt out of the award system by forming Australian Workplace Agreements (AWAs), should be amended to make opting out far simpler and less costly. The “no disadvantage” test should be abolished and the registration requirement abandoned or greatly simplified.

An alternative would be to give the Commonwealth, State or local governments the power to declare any local government area which has persistent labour surpluses a “free labour market zone”.

#### *Unemployment benefits and the “welfare floor”*

Unemployment benefits should be relied on to provide an adequate “safety net”. If, after abolition of minimum wages, the resultant wage rates for some people are considered to be too low, then this should be remedied by wage subsidies or earned income-tax credits.

If minimum wages are not abolished, then responsibility for setting them should be shifted from the AIRC to the Commonwealth Government or to State governments.

#### *Unfair dismissal laws*

Third parties cannot satisfactorily enforce implied and unobservable terms in employment contracts. The costs incurred by both parties in the event that a viable employment relationship is terminated deter capricious terminations by both parties to employment relationships. The Commonwealth Government should therefore repeal all unfair dismissal laws for which it is responsible. Simplifying procedures for opting-out of the award system would allow employers and employees to avoid the most damaging consequences of State laws pertaining to unfair dismissals.

#### *Reform of trade union laws*

Because labour union exemptions from anti-competitive market practices are socially and economically damaging and provide no offsetting benefits, such exemptions in the *Trade Practices Act* should be repealed forthwith. However, workers should continue have the same rights as others, such as employer groups, to pursue their interests through voluntary association with others.

## **7.0 Conclusion**

The Society submits that the reforms set out above are politically feasible and, if implemented, would contribute substantially to “paving the way to paid work”.

# PAVING THE WAY TO PAID WORK

## 1.0 Introduction

The HR Nicholls Society (the Society) strongly supports the Government's goal of increasing participation in paid work. The Society's submits, however, that this goal should be considered, not as an end in itself, but rather as the beneficial outcome of policy reforms to create an institutional environment which is more conducive to job creation; which improves the productivity of employment relationships; and within which people are better able to achieve preferred balances over their lifetimes between household production, paid employment and leisure activities.

The essence of the Society's submission to the House of Representatives Employment and Workplace Relations Committee (EWRC) is that the centrepiece of any set of measures for creating such an environment must be further deregulation of the labour market and employment relationships to allow employers and job-seekers to make choices less distorted by externally imposed constraints and publicly provided welfare benefits.

A distinguishing feature of a private-enterprise economy is that business managers are continually looking for opportunities to profit by creating jobs. If a business expects that employing a person will add more to its revenue than to its costs, then it is profitable to create a job for that person. As technology improves, competition amongst employers for labour drives up workers' real wages over time as labour productivity improves. Competition amongst employers also tends to maintain labour's share of national income at around 65-75 per cent<sup>1</sup> in all industrialised countries, with the balance going to owners of capital.

Many labour market and employment regulations, however, have the effect of "pricing people out of jobs" (that is, causing unnecessarily high rates of unemployment) by artificially raising real labour costs above levels at which they can be profitably employed. Regulations do this either by increasing the expected monetary costs of employing people or by impairing the productivity of employment relationships (or both). These higher real labour costs are more likely to cause unemployment (in other words, to be "binding") at the lower end of the labour market, and especially in economically depressed regions of the country.

Unemployment rates in Australia have been persistently high for most of the last three decades. The fact that they remain near 6 per cent after almost a decade of strong economic growth *and* substantial tightening of eligibility rules for unemployment benefits, points strongly to binding real labour costs as a major factor, probably the major factor, limiting job creation and increased participation in paid work.

Removal of regulatory constraints will allow real wages, particularly for certain categories of labour and in economically depressed regions, to be adjusted more readily to bring demand for labour closer to balance with labour supply, thereby reducing unemployment. This should be complemented by further changes to eligibility rules for publicly provided benefits to remove artificial disincentives to

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<sup>1</sup> This includes returns to the labour of owners of owner-managed enterprises.

engage in paid work. The Society emphasizes that freeing employers from constraints on job creation is doubly important—not only will more jobs be available but, equally important, improved availability of jobs will enhance the effectiveness and perceived fairness of benefit reforms aimed at strengthening incentives to participate in paid work.

Rough estimates set out in the Appendix suggest that there is scope to increase total employment in Australia by between 400,000 and 500,000 people, or by about 5 per cent.

## **2.0 If job creation is profitable, will jobs be created?**

Governments cannot create jobs in the private sector. But what governments in Australia can do is reform our labour market and employment regulations to make job creation by businesses more profitable. The repeal of regulations which artificially raise real labour costs will increase the likelihood that businesses can profitably employ the kinds of people who, under existing institutional arrangements, cannot readily find jobs.

For example, for many years there have been persistent surpluses of labour (indicated by high rates of unemployment) in the La Trobe Valley, much of Tasmania, various places along the eastern seaboard, much of north Australia, and particular suburbs of the major cities which are, to a surprising degree, sharply delineated geographically. Under Australia's award wage system, businesses have no special incentive to think of ways of profiting from these labour surpluses because regulated wage awards make the cost of creating jobs in these areas much the same as elsewhere. But were rates of pay and other terms of employment negotiable, these labour surpluses would be perceived by businessmen as opportunities to create less costly jobs that would not be profitable under existing award wages.

Would these lower rates of pay be unfair or exploitative? To place this issue in perspective it is necessary to be fully aware of the plight of the unemployed. Harding and Richardson (1998, pp151-2) showed that 28 per cent of unemployed people live in families that are below the entire-population poverty line. The proportion in poverty rises to 45 per cent for the "labour-force poverty line", which was a mere \$34 per week (1994-95 dollars) higher than the entire-population poverty line. Comparing low-wage workers and the unemployed, Harding and Richardson (pp. 157-8) conclude that:

... the unemployed are ... *very financially disadvantaged*. They comprise a high proportion of people in the lowest deciles of the income distribution.... Every way that we have looked at it, unemployed workers are much lower in the income distribution than are most low-wage workers.<sup>2</sup> (Italics added.)

Many of those with low-wage jobs have another major advantage over unemployed adults—low-wage jobs for about half of those who have them, are stepping stones to better jobs and rising incomes (Lewis, 2002, p 268). Unemployment is widely

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<sup>2</sup> True, Harding and Richardson make the point that some low-wage workers are in the lowest deciles of the income distribution and "...these should not be forgotten" (p 158).

recognized to also cause personal distress and depression. Clearly, large numbers of unemployed people are severely disadvantaged relative to those with jobs.

In the current regulatory environment, people who are unemployed in depressed areas, such as the La Trobe Valley, are forced to choose between remaining in the region with poor prospects of finding a job, or bearing the costs of moving to jobs elsewhere. The latter has the unfortunate flow-on consequence of causing real estate values to collapse, which is damaging to others in the region, especially the elderly.

Giving unemployed people and profit-seeking businessmen the freedom to negotiate wages that allow jobs to be created profitably, could only make unemployed people in these regions better off. The options of remaining on unemployment benefits or of moving elsewhere in search of jobs would still remain open. Thus, those that chose to take newly created jobs at the lower money wage rates would do so only if they expected to be better off. In this regard, the option of remaining on unemployment benefits would effectively become the “safety net” by creating a wage “floor”. And, by strengthening demand for real estate in the region, those who accepted lower paying jobs would be helping to maintain the wealth of others. Furthermore, since housing costs tend to be lower in regional than in metropolitan areas, and there may be perceived lifestyle benefits from regional living, their real incomes (properly measured) might well be higher than their metropolitan counterparts, lower money wages notwithstanding. If only for this reason, the “comparable worth” argument for equality of money wages throughout the country is clearly fallacious. Moreover, to the extent that it underpins policies which price people out of jobs the fallacy of “comparable worth” has the perverse effect of literally making people worthless in the labour market. Indeed, an important reason for relying on unemployment benefits to create a “wage floor” is that it restores to the individual the fundamental right to decide what his or her labour is worth—a third party simply cannot know enough about others to determine how much the wage attached to a job is worth to a person willing to accept it.

It is true that removing regulatory impediments to job creation would make some people *relatively* worse off by obliging them to compete openly with unemployed people for jobs. However, since overall living standards would rise as currently unutilized labour resources became productive, such people might well be made better off in absolute terms. And, with reduced numbers on unemployment benefits, there may be scope to give offsetting tax cuts for people at the lower end of the wage scale. Under the existing regulatory regime, the cost of artificially raising the wages and other conditions of employment for those with jobs is borne largely by the unemployed and discouraged workers, and is measured by their economic and social disadvantages.

In summary, the Society submits that allowing employees and employers to negotiate wages and other terms and conditions of employment free of regulatory constraints would be strongly conducive to net job creation throughout the entire economy. Increasing the profitability of job creation in regional areas is especially important for maintaining the viability of regional centres of population, which in turn will ease population pressures in the major urban areas.

Many Australian businesses (and businesses from other industrialized countries) have created very large numbers of jobs for people in countries where wages are lower (for example, call centres in India). Over the last 50 years, vast numbers of jobs have been created by businesses moving to the southern states in the US to take advantage of lower labour costs (which tended to equalize wages across the nation). The conclusion is that if jobs can be created profitably in Australia, jobs will be created for all those seeking them.

### **3.0 How do regulations increase real labour costs?**

Job creation and hiring decisions are based on the *expected* real costs of employing people, including *real subjective costs* such as the cost of tolerating an abrasive personality. This section sketches ways in which labour market and employment regulations directly or indirectly increase expected real labour costs in Australia.

#### **3.1 Mandatory minimum wages**

The declared aim of minimum wage laws in most countries is to increase the earnings of low-wage employees. To be effective a minimum wage must therefore be set above the corresponding market-clearing wage, which directly increases labour costs. True, in the case of some workers, legal minimum wages set above market-clearing wages can be offset in various ways (for instance, by reducing perquisites, requiring greater effort from an employee). To the extent that legal minimum wages are binding, however, they directly raise the real cost of hiring people by raising their real money wages.

Australia's regulated minimum wage system, based on centrally-fixed award wages, is extraordinarily complex. In contrast to other countries, the objective is not merely to raise the earnings of low-wage employees but to set minimum wages for a substantial proportion of the workforce, including many whose wages are well above the bottom of the earnings distribution.<sup>3</sup> The system produces an extraordinarily large set of legal minimum wages, varying according to worker experience and qualifications and across industries (some are even specific to enterprises). Many are revised annually. Some workers can choose between working under awards set by the Commonwealth regulator (the Australian Industrial Relations Commission) and those set by the regulatory authority in the State in which they are employed (the various State industrial relations commissions). Removing from a high proportion of the workforce the capacity to negotiate wages reflecting their individual aptitudes, energies and skills has the regrettable effect of "commodifying" labour.

Because of the complexity of the system it is virtually impossible to ascertain the extent to which each of the many hundreds of awards is "binding" in the sense of exceeding a market-clearing wage. However, since in Australia the ratio of minimum wages to average wages appears to be high relative to most other countries, it is likely that many award wages are binding, especially at the lower end of the labour market

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<sup>3</sup> In contrast, the US has a single national minimum wage set by the US government which covers a substantial proportion of the workforce. Most US states also have statutory minimum wages for workers not covered by the national minimum. Arrangements for setting minimum wages in Europe vary widely across countries. In some cases they are set by negotiation between employer organizations and labour unions; in others by governments.

(Table 1). By definition, a binding real wage impedes participation in paid employment.

**Table 1**

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**Ratios of Minimum to Average Wages**  
(selected countries)

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| Country          | Ratio of minimum wage to average wage (%) |           |
|------------------|---|-----------|
|                  | 1976                                      | 2000      |
| Italy            | 78  | 71        |
| Norway           | n/a                                       | 64        |
| France           | 58  | 62        |
| <b>Australia</b> | <b>65</b>                                 | <b>58</b> |
| Germany          | 60  | 58        |
| Ireland          | n/a                                       | 56        |
| Denmark          | 59  | 54        |
| Finland          | n/a                                       | 52        |
| Greece           | 69  | 51        |
| Sweden           | 52  | 51        |
| Belgium          | 58  | 49        |
| Luxembourg       | 41  | 49        |
| Netherlands      | 64  | 47        |
| New Zealand      | 57  | 46        |
| Canada           | 52  | 43        |
| UK               | 43  | 42        |
| Portugal         | 48  | 38        |
| US               | 47  | 36        |
| Japan            | 29  | 33        |
| Spain            | 48  | 32        |

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Source: Neumark and Wascher (2003)

There is another, indirect way in which Australia's award wage system may increase real labour costs. In the absence of regulated wages, employers structure wage increases over time to strengthen incentives for employees to contribute physical and mental efforts to achieving enterprise objectives. Contrariwise, by making pay increases mandatory, the award system undermines the capacity of employers to create such incentives. To the extent that this reduces the productivity of employment relationships it raises real labour costs.

Finally, binding minimum wages constitute a rigid base of real labour costs on which costs associated with other regulations are superimposed, adding *pari passu* to the real costs of labour.

### 3.2 Entitlements<sup>4</sup>

An employee entitlement is created where, under an employment contract, payment of part of the value of an employee's current contribution to production (current earnings) is deferred to the future. For example, part of an employee's current earnings may be in the form of an undertaking by the employer to provide, say, four weeks' paid annual leave. The alternative is for employees to be paid their entire earnings "up-front" with provision for unpaid holidays to be financed out of their savings. Thus, in a freely functioning labour market, an entitlement merely changes the timing of payments without substantially changing total earnings.

Australia's system of award wages includes for many workers mandatory entitlements such as paid holidays with a wage loading, sick leave, redundancy payments, compulsory superannuation and long service leave. Where a worker is paid an award wage, these mandatory entitlements add directly to real costs of employing that worker, thereby increasing the number of people "priced out" of jobs by the award wage system.<sup>5</sup> They may also indirectly raise real labour costs by eroding incentive structures and, consequently, the productivity of employment relationships. For example, mandatory long service leave vitiates inclusion of long service leave in a negotiated "incentive package". Whereas provision of sick leave negotiated between an employer and employee (as in the US—and the UK, until recently) can contribute to strengthening incentives, mandatory sick leave cannot. In addition, we conjecture that because mandatory sick leave cannot be withdrawn and therefore cannot be contribute to "incentive packages", it is more likely to be abused than negotiated sick leave. To the extent that this is so, mandatory sick leave further reduces the productivity of employment relationships and consequently raises real labour costs.

In summary, entitlements tend to increase real labour costs. It might be argued that the regulators who implement the award wage system implicitly set award wage rates lower than otherwise to compensate for the cost of providing entitlements. However, their apparent failure to appreciate the economic consequences of their decisions in other dimensions suggests otherwise.

Finally, it is worth noting that mandatory employment entitlements—paid annual vacations, paid sick leave, long service leave, redundancy payments and the ability to defer compulsory employer contributions to superannuation—effectively make recipient employees unsecured creditors of their employers. Consequently, employees are exposed by such entitlements to the risk of their employer's insolvency. In many cases, this forces them to bear financial risk that they would not voluntarily accept—given the choice, an employee of an enterprise at risk of insolvency would prefer the equivalent value of an entitlement as an "up-front" payment. Mandatory entitlements have the undesirable effect of precluding this.

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<sup>4</sup> This section uses material from Hogbin (2001).

<sup>5</sup> If the worker's wage is above the award wage, then there is scope for a negotiated wage reduction to offset at least some of the cost of an entitlement.

### 3.3 Employment protection regulations

Some unemployment is an inevitable consequence of the processes of “creative destruction” which are part and parcel of the high living standards delivered by market economies. The problem of unemployment is compounded by the susceptibility of market economies to cyclical downturns in economic activity which are accompanied by higher rates of unemployment. Since employees are inevitably exposed to the financial risk associated with unemployment, provision of insurance against unemployment can improve social welfare.

Governments in all OECD countries provide various forms of “insurance” against unemployment. Because the scope for employers and employees to defraud unemployment insurance schemes makes efficient market provision difficult, a legitimate and important function of government is to ensure that workers are adequately “insured” against the financial risk of unemployment.

However, under political pressure from various sources, governments in most OECD countries have gone beyond provision of unemployment insurance by enacting regulations aimed at artificially increasing job security (unfair dismissal laws). A key point about these “employment protection” regulations is that they cannot protect the holders of the roughly 10 per cent of jobs which become unviable (are “destroyed”) each year in modern economies as part of the process of “creative destruction” (Table 2). In effect, what these regulations do is protect people with jobs from competition from workers without jobs and from workers with worse jobs. For this reason employment protection regulations have been characterised as giving employees *de facto* property rights to their jobs.

**Table 2**

| Average annual rates of job turnover*,<br>selected countries and time periods |             |                   |
|---|-------------|-------------------|
| Country   | Time Period | Turnover rate (%) |
| Canada  | 1984-90     | 22.6              |
| Denmark   | 1984-89     | 29.8              |
| Finland   | 1988-91     | 24.2              |
| France  | 1985-87     | 26.3              |
| Germany   | 1977-89     | 15.9              |
| Italy   | 1985-91     | 23.4              |
| Norway  | 1976-86     | 15.6              |
| Sweden  | 1985-91     | 22.7              |
| United Kingdom  | 1982-91     | 15.2              |
| United States   | 1976-91     | 21.5              |

Source: Caves (1998) p 1951.

\*Job turnover is the sum of annual jobs created plus annual jobs destroyed expressed as a percentage of total employment. Numbers of jobs created and destroyed are roughly equal in any given period.

The main kinds of employment protection laws are those governing procedures for dismissing employees, those providing remedies for wrongful termination, and those providing for redundancies. These laws raise the expected real costs of labour,

especially of marginal workers, through their effects on pecuniary outlays and on the productivity of employment relationships. Broadly, the effects on expected pecuniary outlays by employers depend on:

- the probability that a person recruited to a job will be subsequently dismissed for reasons of redundancy or for unsatisfactory performance; and
- the outlays required in the event of dismissal for either reason, including regulated redundancy payments, regulated compensation for dismissal for other reasons, and litigation costs.

The other way in which employment protection legislation tends to increase real labour costs is by reducing the productivity of employment relationships—because employees perceive that the pecuniary costs of unfair dismissal procedures will discourage employers from dismissing them, unfair dismissal laws tend to weaken incentives to contribute physical and mental effort to jobs. Provided minimum wages are not binding, employers can offset costs generated by employment protection laws by negotiating correspondingly lower wages. For workers for whom minimum wages are binding, however, the expected costs of employment protection laws increase real labour costs *pari passu*.

Importantly, employment protection laws make the expected costs of employing what are perceived to be “risky” workers (for example, workers perceived to be of uncertain ability, workers who might disrupt the workplace) very much higher. For this reason, as overseas research consistently shows, there is a strong correlation between the

**Table 3**  
**Cross-country Incidence of Long-term Unemployment, 2001**

| Country          | Number of male workers<br>unemployed for more than 12 months<br>per 1000 males aged 16-64. | Employment/population<br>ratio males, 16-64<br>(average 1997-2001) |
|------------------|--|--|
| Norway           | 2.0  | 81.9   |
| USA              | 2.6  | 80.2   |
| Switzerland      | 3.3  | 87.0   |
| Canada           | 6.6  | 75.2   |
| Netherlands      | 7.2  | 80.5   |
| Austria          | 7.5  | 76.1   |
| Denmark          | 8.1  | 80.7   |
| Portugal         | 9.6  | 75.2   |
| New Zealand      | 9.7  | 77.9   |
| Sweden           | 10.6   | 74.8   |
| <b>Australia</b> | <b>13.6</b>  | <b>75.7</b>  |
| UK               | 14.4   | 78.2   |
| Japan            | 14.7   | 81.3   |
| Ireland          | 18.3   | 72.8   |
| France           | 19.8   | 67.4   |
| Finland          | 20.0   | 68.0   |
| Belgium          | 21.8   | 68.0   |
| Spain            | 22.7   | 70.3   |
| Greece           | 24.7   | 71.3   |
| Germany          | 31.4   | 73.3   |
| Italy            | 35.0   | 67.7   |

*Source:* Derived from OECD, 2002.

stringency of unemployment protection laws and rates of long-term unemployment. For example, France, Germany and Italy, all of which have strong employment protection laws, also have high rates of long-term unemployment (Table 3). The average duration of unemployment in Australia has been in the vicinity of one year since the mid-1980s and the numbers out of work for more than two years have been above 80,000 for 13 of the last 16 years (above 155,000 in 1993 and 1994).<sup>6</sup>

In summary, employment protection laws raise real labour costs, especially the real costs of employing marginal workers and are consistently correlated with high rates of long-term unemployment.

### 3.4 Regulatory institutions, labour unions and real labour costs

It is generally recognized that labour unions use monopoly power derived from statutory privileges to extract economic rents from enterprises in the form of higher wages and other pecuniary and non-pecuniary benefits for their members. To the extent that this reduces the numbers employed in unionized enterprises, the supply of labour for non-unionized enterprises increases. While this places downward pressure on wages in non-unionized enterprises, rent extraction by labour unions does not necessarily reduce aggregate numbers participating in paid work.<sup>7</sup> Indeed, since in addition to negotiating higher wages, rent extraction frequently takes the form of “feather-bedding” conditions of employment, the numbers employed in the targeted enterprises are often higher than in the absence of union power. Thus, while union monopoly power may not *directly* reduce participation in paid work, it almost certainly reduces productivity.

There are, however, compelling reasons for believing that labour unions reduce participation in paid work in Australia through their influence on the award-setting process. Australia’s centralized wage determination system has conferred on labour unions substantial power over award wages and other award entitlements. They also influence the form and outcomes of applications of employment protection laws and, consequently, the contribution of the expected costs of employer-initiated employment relationship separations to real labour costs. Since unions depend for their existence on the financial support of union members and the tacit support of the majority of workers, they tend to lobby in award determination procedures for terms and conditions that will gain the approval of these constituencies.

In contrast, the interests of marginal workers and the unemployed are largely without representation in award determination processes even though, as discussed above, they are the group most directly, substantially and deleteriously affected by the outcomes of those processes. The problem is compounded by the fact that the authority of the regulatory bodies (the industrial relations commissions) also depends on the tacit (at least) approval of the majority of employees, and especially labour unions. In short, an inherent institutional bias in award determination procedures has given labour unions in Australia the effective power to raise the real costs of employing marginal workers and the unemployed. The exercise of this power through our centralized wage-determination system has reduced participation in paid work,

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<sup>6</sup> ABS, 2003.

<sup>7</sup> Although, to the extent that it increases the number of workers for whom minimum wages are binding, it will.

both by pricing people out of jobs and by creating a pool of discouraged workers who are effectively prevented by regulated minimum wages from competing for jobs.

The regulators who implement these award minima have contrived to reduce the employment effects of their decisions by effectively dividing the Australian labour market into an “insider” segment, characterized by workers with secure jobs (high dismissal costs), artificially high rates of pay (above-market wages), and generous entitlements, and an “outsider” segment comprising marginal workers and the unemployed. Insiders are generally more articulate and politically aware than outsiders. Outsiders include workers who, for various reasons, including being insufficiently productive, cannot find, or aspire to, jobs in the insider segment. Consequently, they are forced to compete for jobs which are less secure, have lower rates of pay and fewer entitlements (typically fixed term, part-time and casual jobs and some self-employed workers). This strategy has enabled the regulators to secure the political support from insiders needed to sustain the regulatory apparatus while simultaneously “keeping a lid on” the real costs of employing outsiders, thereby averting unacceptable unemployment rates.<sup>8</sup> In conclusion, it is worth noting that artificial labour market segmentation is a common problem in countries with centralized wage determination procedures, and typically has consequences similar to those observed in Australia

### 3.5 Conclusion

Minimum wage regulations, mandatory entitlements and employment protection laws all tend to raise real labour costs, especially at the lower end of the labour market where minimum wages are binding. The problem is exacerbated by our centralized wage determination system which favours labour market insiders, represented by labour unions, over labour market outsiders.

### 4.0 Do real wages affect the numbers employed ?

Although the proposition that higher real labour costs reduce employment has commonsense appeal, and is supported by the preponderance of vast amounts of statistical evidence, it appears to be an argument that is, nevertheless, not widely understood or believed. As the late George Stigler famously observed: there is pervasive belief that “...all demand curves are inelastic and all supply curves are inelastic too” or, in other words, prices and wages have no influence on quantities demanded and supplied. This seems especially true of beliefs about the relationship between wages and levels of employment. An apparently common view is that, since a profitable business can “afford” to pay its workers more without cutting its workforce, small increases in wages will not reduce employment. However, this view crucially overlooks the consequences of even small wage increases for marginal employment decisions—expanding a business or establishing a new business; decisions to “downsize” to reduce costs, or to cease operations. Because prolonged

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<sup>8</sup> An almost certainly related consequence of this strategy is the high incidence of part-time employment in Australia, which rose from 12 per cent in 1973 to 27 per cent of total employment in 2000 (15 per cent for males, 41 per cent for females in 2000). This is close to the highest for OECD countries, and much higher than in other similar countries such as the US (13 per cent of total employment; 8 per cent of male jobs in 2000) and Canada (18 per cent of total employment; 10 per cent of male jobs in 2000). Source: OECD, 2002.

unemployment is often seriously damaging to people's lives, policy-makers should be fully alert to the common predisposition to deny (or at least underestimate the strength of) the negative relationship between prices and quantities, including real wages and quantities of labour demanded.<sup>9</sup>

For many reasons, however, evidence to support the proposition of an inverse relationship between employment and real wages can never be incontrovertible. Separating the effects of real wage changes from the effects of numerous other factors which affect levels of employment (such as monetary and fiscal policies, weather, fluctuating exchange rates, changes in commodity prices and changes in the structure of an economy) is a complex statistical problem for which there can never be an entirely satisfactory solution. The problem is compounded by lack of data accurately linking levels of employment to corresponding real costs of labour, including difficult-to-measure regulatory costs. Moreover, because most employment contracts are based on long-term relational contracts, time-lags between changes in the real cost of labour and employers' adjustments to their labour forces can be "long and variable". Also, implicit in many contracts are understandings that employers will, at least in the short term, absorb certain kinds of risk, including regulatory risks. Thus, because reductions in money wages tend to undermine the potency of the self-enforcing feature of employment contracts (discussed in 5.4, p 16 below), it may take months, even years, for employers and employees to negotiate new contractual terms to offset a legislated entitlement, such as a holiday leave-loading. For these and other reasons,<sup>10</sup> the issue of the effect of changes in real wages on employment can never be conclusively resolved by statistical evidence.

The effect of increases in regulated minimum wages on participation in paid work has been especially controversial in economics in recent years. Some researchers claim to have produced evidence that, contrary to received theory, raising minimum wages in the US does not reduce employment. While the issue cannot be thoroughly canvassed here, the preponderance of statistical studies throughout the world suggests that increasing a minimum wage (set above the market-clearing wage) by 10 per cent reduces employment by between about 1 per cent and 5 per cent (that is, an unknown number of low-wage workers gain a 10 percent wage increase while between 1 and 5 of every 100 workers will be priced out of their jobs). Note, however, that because low-wage earners are only a fraction of all workers, the proportions of low-wage

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<sup>9</sup> Two striking cases show that even people "close to the action" and with strong incentives to "get it right" may seriously underestimate the strength of price effects, *especially long-term price effects*. First, the Floor Price Plan for wool, which collapsed in the early 1990s with serious financial and social consequences, was supported by a sizeable majority of woolgrowers who must have implicitly believed that prices have little or no effect on quantities of wool demanded (especially) and supplied. Second, because they failed to appreciate the power of increases in oil prices to induce people to find ways of economising on the use of oil products, in the late 1970s "experts" in Exxon, the US Department of Energy, the US Congressional Research Service and the CIA *grossly* underestimated the long-term effect of higher oil prices on world oil consumption. The average of these experts' 1977-78 forecasts of 1985 oil consumption exceeded actual 1985 consumption by more than 60 per cent (van Vector and Tussing (1987). Likewise, the scope for the hundreds of thousands of employers in Australia to find ways of "economising" on labour when real labour costs are artificially forced up is easily underestimated.

<sup>10</sup> A common argument against the proposition that employment is negatively related to real labour costs is that, by lowering workers' incomes, reducing wages lowers aggregate demand and, consequently, *reduces* employment. However, for a variety of reasons the validity of this proposition is dubious at best.

earners priced out of jobs would be very much higher than indicated by these numbers.

As an overall assessment, it is fair to say that the recent controversy notwithstanding, the consensus in the economics profession remains unchanged—minimum wages reduce employment. For example, a widely-publicised plan proposed by five leading economists in 1998 for reducing unemployment in Australia was based on keeping annual adjustments to award wages below inflation rates to lower the real value of awards over time.<sup>11</sup> Moreover, even those who claim statistical evidence that the effect is zero or negative concede that this applies only for minimum wages set close to market-clearing wages and that, pushed above a certain point, employment will be reduced. This point is especially pertinent to debate in Australia, because the ratio of minimum wages to average wages in this country is high relative to most other countries (Table 1 above), a consequence of the inherent bias against low-wage workers in our centralised wage determination processes as discussed in 3.4 above.

Looking behind the effects of real labour costs on aggregate numbers employed gives cause for even greater concern about the negative consequences of minimum wages.

- Even if there is no change in the numbers employed following an increase in a minimum wage, it cannot be presumed that no individual has suffered the loss of a job. The reason is that a higher wage may have induced a relatively highly productive person formerly not in the workforce (such as a university student, or a married female) to enter the workforce and take a job while simultaneously making it unprofitable to employ a marginally productive worker, either in that same job or another job. Although there is no change in the numbers employed, an individual has been forced out of a job—perhaps an individual relatively disadvantaged in the labour market. In short, estimated wage elasticities of aggregate employment measure *net* rather than *gross* changes in numbers. The latter may be substantially greater than the former.
- In this respect, research based on panel data (data that tracks the employment histories of random samples or particular populations of workers over time) shows that the effects of changes in minimum wages on particular groups may be large. For example, Burkhauser *et al.* (2000) find that:

Minimum wage increases [in the US] significantly reduce the employment of the most vulnerable groups in the working-age population—young adults without a high school degree (aged 20-24), young black adults and teenagers (aged 16-24) and teenagers (aged 16-19). While we also find that minimum wage increases significantly reduce the overall employment of young adults and teenagers, these more vulnerable subpopulations are even more adversely affected.

- Long-run responses to minimum wage changes are likely to be larger (in absolute terms) than short-run responses. However, largely to minimize the problem of conflating the effects of wage changes with the effects of other factors that change the numbers employed, many statistical estimates of

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<sup>11</sup> See Dawkins (1999).

responses are based on short time intervals (one or two years) and it is important to be aware that they therefore probably understate the full effects of minimum wage changes on employment.

- Some research suggests that the effects of changes in minimum wages on hours of work are stronger than on numbers employed.

In summary, employers simply will not hire anyone who costs more per hour to employ than the value they produce per hour to the employer. Hence, minimum wages permanently eliminate the participation of many people in paid work. It is difficult to produce irrefutable evidence of this, and even more difficult to estimate reliably the likely sizes of its effects. However, given that minimum wages in Australia are set high relative to average wages and that unemployment rates have remained persistently high despite a decade of strong economic growth and substantial tightening of eligibility rules for unemployment benefits, there is a strong presumption that lowering minimum wages and other regulations which artificially raise real labour costs would increase participation in paid work, especially at the lower end of the wage scale. Sceptics are invited to reflect on the common propensity of people to underestimate the strength of price effects (page 10 and footnote 9, above) and to consider carefully the implications of this propensity for people at the lower end of the labour market.

### Conclusion

The Society submits that removing regulatory constraints which increase real labour costs will create jobs and increase participation in paid work, both by cutting expected monetary on-costs and by improving the productivity of employment relationships. In particular, reducing expected real costs of employing low-wage labour can be expected to reduce unemployment in depressed regions.

### **5.0 Are the negative effects of regulations outweighed by benefits?**

If, as argued above, Australia's system of labour market and employment regulations reduces participation in paid work, might it deliver offsetting benefits of other kinds?

The Society submits that there is a strong presumption that economic and social welfare will be maximized by allowing employers and employee to negotiate terms and conditions of employment, free of regulatory constraints. The main basis for this presumption is that the parties to an employment relationship have by far the best information about the requirements of the relationship, about their particular preferences and circumstances in relation to those requirements, and about other feasible alternative job matches—far more information than any regulatory authority could conceivably obtain. Also, they have infinitely stronger incentives than third parties to discover mutually beneficial arrangements that will maximize the value of the relationships. So are there justifiable reasons for governments to regulate labour markets and employment relationships?

One conceivable reason derives from the consensus that our governments should act to reduce income inequality, especially to alleviate financial hardship resulting from circumstances or events beyond the control of the individual. Indeed, the ostensible

objective of Australia's incredibly labyrinthine award wage system is to improve the distribution of income. However, to the extent that it prices people out of jobs, thereby reducing their earnings to zero, its effects are manifestly perverse. More generally, the effects of the award system on the overall distribution of income seem likely to be, at best, haphazard. For these reasons, there is a compelling case to rely on taxes and transfers, rather than labour market regulations, to achieve desired distributional outcomes. Not only are the resultant distributional outcomes more transparent, which is conducive to greater consistency with social objectives, but also instruments such as wage subsidies and earned income tax credits can be used to reduce real labour costs thereby increasing participation in paid work.

Another conceivable justification for labour market and employment regulations is that they are required to correct labour market "imperfections" which cause "market failures" of various kinds. The three kinds of market imperfections which economic theory identifies as possible grounds for regulatory intervention in labour markets are information asymmetries, monopsony, and externalities. Another possible cause of market failure is an alleged imbalance of power in employment relationships.

### 5.1 Information asymmetries

Information asymmetries, the differences in information known to parties to contracts (and in particular, employment contracts), are pervasive and can result in a party agreeing to terms and conditions which, with more complete information, would not be accepted. Thus, information asymmetries can produce labour market outcomes which, *ex post*, one or other of the parties considers unacceptable.

In forming views on the significance of information asymmetries, two points should be clearly recognized. First, the essential reason for the success of markets as the basis for economic organization is their extraordinary capacity to discover and mobilize information. Second, the Achilles' heel of labour market regulatory processes is that regulators can have virtually no knowledge of the specific circumstances and preferences of the millions of workers and businesses. Thus, it is difficult to argue that regulators could obtain the information required to correct satisfactorily problems caused by information asymmetry. For this reason, the most effective remedy for problems associated with information asymmetries in labour markets is to maintain low unemployment rates, thereby reducing for both parties the cost of separating from unsatisfactory employment relationships. This is discussed in more detail in 5.4 below. In this respect, since regulations tend to increase unemployment by raising real labour costs (as discussed above) they are, paradoxically, more likely to exacerbate problems associated with information asymmetries rather than to solve them.

A possible exception to this is that mandatory annual vacations may correct the tendency for workers to "signal" their commitment to their jobs by voluntarily shortening their vacations. However, the difficulty is that there is no way of obtaining the information about people's preferences for duration of vacation time which is essential to ensuring that a given mandatory vacation entitlement will in fact improve social welfare.

### 5.2 Monopsony power

Where, in a given labour market, there is only one employer for whom a worker or group of workers could feasibly work, the employer is said to be monopsonist. Because a monopsonist faces no competition from other employers in hiring employees, profits are maximised by setting wages below their competitive market counterparts—and lower than the value of the employee's contribution to production. This can be legitimately considered to constitute exploitation of the employee by the employer. The classic text-book example of a monopsony is the country hospital which, because of its remoteness from other hospitals, may have the power to force nurses married to district residents to accept wages below those for nurses in competitive markets.

Although, in principle, monopsony reduces social welfare, most economists consider labour market monopsony a textbook oddity of little practical significance because few, if any, employers have significant monopsony power.<sup>12</sup> The “company town” of the late 19<sup>th</sup> century and early 20<sup>th</sup> century is now history. Size does not matter. Just as few, if any, consumers feel compelled to buy from large department stores, so few, if any, workers feel compelled to work in large companies. Wherever other employers have jobs on offer, a single company, no matter how large, cannot normally hire labour on terms less generous than those offered by others. To the contrary, there is abundant evidence that larger businesses generally provide better terms and conditions of employment than smaller ones—an unresolved puzzle for labour economists. True, to the extent that transport costs may restrict job opportunities for some people, some businesses may be able to “shade” rates of pay, but few economists consider the associated welfare costs to be significant, in the sense that the costs of implementing any conceivable corrective measures are likely to far exceed any benefits they might produce.

In summary, Australia's award wage system cannot be justified on grounds that it is required to prevent employers with monopsony power from exploiting workers.

### 5.3 Externalities or “Spillover effects” on third parties

Choices made by parties to employment relationships may have “spillover effects”, either positive or negative, on others in addition to effects transmitted through labour markets. Such effects are known as externalities. For example, efforts made by one employee to inform managers about safety concerns may benefit all other co-workers (a positive externality). Consequently, since each employee acting separately captures only a fraction of the total benefit from his effort, incentives for individuals to pass information to their superiors are in some sense “too weak”. This provides a *prima facie* case that requiring employers to give their employee organizations a collective “voice” (for example, labour unions or works councils) will improve social welfare. However, as in the case of information asymmetries regulations, since there may be better ways of “internalizing” such externalities, mere demonstration of the existence of an externality is not necessarily sufficient justification for regulation. In particular, externalities provide no justification for minimum wages.

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<sup>12</sup> Alan Manning and co-workers at The London School of Economics have recently revived some interest in the topic, claiming that labour immobilities give many employers limited monopsony power (Bhaskar *et al.*, 2002).

## 5.4 Unequal bargaining power

Perhaps the most important source of pressure on governments to regulate labour markets and employment relationships is a pervasive perception of an unjustifiable imbalance of power between the employer and employees in the employment relationship. Because this perceived power imbalance allegedly allows employers to force unfair terms and conditions on their employees, including dismissing employees unfairly, it is the primary motivation for employment protection (unfair dismissal) laws and the *de jure* and, perhaps more important, the *de facto* privileges granted to trade unions in Australia and many other countries.

The substance of this alleged power imbalance is, however, not well understood. Briefly, since at any given time there are numerous jobs on offer and numerous people looking for jobs, there is no power imbalance *at the time an employment relationship is formed*. Either party can reject terms demanded by the other if they believe they fall short of competitive terms available elsewhere. *Once the relationship is formed*, however, an *employer does have the power* to exert pressure on an employee—the employee may tolerate some unreasonable pressure from the employer to avoid the expected cost of quitting and finding a new job. But by the same token, of course, because hiring and training a replacement is costly, *employees have the power* to exert pressure on the employer. Both parties are constrained from capriciously exercising these “bargaining” powers by the costs they will incur if the other party decides to terminate the relationship. Crucially, these powers serve to make employment contracts “self-enforcing” and, consequently, are essential to maintaining the productivity and value of employment relationships.

The relative strengths of the bargaining powers of the employer and the employee depend on many factors, but it is far from clear that the employer always has the upper hand. There are typically twice as many quits as dismissals in any given time period, even in a country such as the US, which has weak unfair dismissal laws. One factor which tends to reduce the cost to an employer of dismissing an employee is low productivity and, consequently, low profitability of an employment relationship (perhaps because of shirking). Against this, an employer will tolerate a great deal of misbehaviour by an employee to avoid breaking a very productive employment relationship (for example, temperamental movie stars).

Importantly, higher rates of unemployment tend to increase the bargaining power of employers relative to employees. On the employer’s side, the cost of finding a replacement for a dismissed worker is likely to be lower because the pool of unemployed workers is larger. On the employee’s side, the greater scarcity of jobs increases the expected cost of finding a job. Both factors tend to reduce employee bargaining power. This has obvious implications for assessing the merits of labour market and employment regulations—to the extent that such regulations raise labour costs, thereby increasing unemployment, they tend to simultaneously erode the bargaining power of employees and increase the bargaining power of employers. This unintended side-effect of labour market and employment regulations is a serious problem at the lower end of the labour market.

In summary, the alleged imbalance of power in employment relationships provides no basis for regulating either labour markets or employment relationships. Indeed, far from solving problems associated with imbalances of bargaining power, regulations which price workers out of jobs have the perverse effect of reducing their bargaining power to zero—and for workers with jobs, of shifting the balance of bargaining power in favour of their employers.

Like all contracts, employment contracts can never be perfect. Doubtless, there are bosses who treat their employees badly, but because business success depends on productive co-operation between the employer and employees, the Society believes they are exceptions rather than the rule. Business failure tends to “weed out” bad bosses and bad supervisors in the longer term, especially in openly competitive industries, and even more especially where unemployment rates are kept low by allowing labour markets to function unfettered by regulations.

### 5.5 Conclusions

The Society accepts that labour market outcomes can sometimes be less than generous for employees. However, to the extent that this is perceived to be undesirable, taxes and incomes transfers, rather than regulations, are the appropriate remedy. As shown above, by raising real labour costs, and thereby reducing the profitability of job creation, regulations exacerbate the problems of unemployment and regional economic stagnation, which subject people to severe hardships. Because the effects of regulations on the distribution of income tend to be haphazard, taxes and transfer payments are superior to regulations as instruments for redistributing income. Moreover, because of defects in political and regulatory processes, many labour market regulations have perverse effects on labour market outcomes, notably higher rates of unemployment and especially higher rates of long-term unemployment. In particular, in devising measures intended to achieve a more equal distribution of income in society, it is important to examine carefully their potential to damage the lives of people at the lower end of the distribution, especially those without jobs and therefore with earned incomes of zero.

Finally, in assessing the merits of the system of award wages in Australia, there is a fundamental moral issue. Is a government justified in using its coercive power to set a minimum wage which makes some people better off but which forces even one other person into unemployment, especially where the person “thrown to the wolves” is likely to be already disadvantaged in at least some respects? To paraphrase the outstanding US scholar of law and economics, Richard Epstein: those who strive to achieve perfect justice through the laws and regulations often end up creating more injustice.<sup>13</sup>

### 6.0 Recommendations: how should regulations be reformed?

The long-term objective of labour market reform should be to eliminate all regulations which artificially increase real labour costs, especially at the lower end of the labour market. This would ultimately require:

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<sup>13</sup> See, for example, Epstein (1991) p. 10.

- dismantling entirely the system of centrally-fixed industrial wage and entitlement awards;
- relying on unemployment benefits to create a “welfare floor” for workers;
- repealing most unfair dismissal laws, in particular those requiring “just cause” and “procedural fairness”, not only for small businesses (already in the legislative pipeline) but for all employers;
- replacing the current system of compulsory conciliation and arbitration of industrial disputes with a voluntary mediation service similar to the UK’s ACAS; and
- abolishing exemptions within the *Trade Practices Act* which allow trade unions to collude to extract economic rents from employers and to engage in other anti-competitive market practices.

In what follows, the Society sketches recommendations for steps the government should take immediately in pursuit of these longer-term objectives.

### 6.1 Reforming the award system

For a variety of political reasons, dismantling the system of Commonwealth and State awards seems impractical in the short term. As discussed above, however, the many workers priced out of jobs by the award system would gain by escaping from it. A related, and equally fundamental problem with the award system is that, in many cases, the values to employees of the “benefits” it confers on them fall short of the costs to employers of delivering those benefits. This is why they tend to raise real labour costs. Again, in such cases, both the employer and the employee can gain by contracting out of the award system. For example, because mandatory sick leave provisions are so widely abused, in many cases an employer and an employee (especially a conscientious employee) could each gain by agreeing that, in return for a higher wage, the employee would take sick leave only if genuinely sick. Similarly, many workers in risky enterprises would prefer to be paid higher wages instead of accumulating long service leave.

In short, just as workers priced out of jobs can gain from abolition of binding award wages, so employees subject to binding entitlements and benefits—entitlements and benefits for which values as perceived by employees fall short of the costs to employers of providing them—can gain from escaping the award system. Accordingly, the Society’s recommended short-term approach to achieving the long-term objective of dismantling the award system is to allow employees and employers to by-pass it whenever this is mutually beneficial. The expectation is that that this will cause the award system to wither away in the longer term as more and more employees and employers discover the mutual gains from deserting it or find that it serves no useful purpose.

In this respect, the *Workplace Relations and Other Legislation Amendment Act 1996* (*WROLA Act 1996*) has established a landmark precedent in making provision for parties to employment contracts to lawfully opt out of the award system by forming

Australian Workplace Agreements (AWAs). The relevant legislation should now be amended to make opting-out far simpler and therefore less costly in terms of time and money. In particular, the "no disadvantage" test should be abolished and the registration requirement greatly simplified, perhaps abandoned. Since, the employee is the only person with sufficient knowledge of her/his preferences and circumstances to determine whether the terms and conditions of an employment contract are advantageous or disadvantageous, the "no disadvantage" test, at best, serves no purpose and is otherwise detrimental to an employee's welfare. Having abolished the "no disadvantage test", registration procedures become superfluous. There may be a case for requiring the employer and employee choosing to opt out of the award system to hold signed copies of a simple, "standard form" agreement (contract) specifying little, if anything, more than the wage, annual holiday entitlement, period of notice for terminating the contract and payment in lieu of notice. It might also include a standard statement to the effect that the employee is aware that the terms and conditions of this contract may differ from those in the relevant award.

This strategy has some especially desirable features. The award system, a long-established institution of substance with ramifications throughout the economy, remains as a "security blanket" for those who feel a need for it. Since various aspects of it are probably "built in" to many employment relationships and support them in various ways, there may be advantages in allowing it to wither away over time rather than dismantling it precipitately, even were the latter feasible. At the same time, simplifying and reducing the cost of establishing AWAs will allow more people to avoid the more damaging welfare consequences of the system. Finally, the strategy seems likely to be legally parsimonious.

An alternative approach would be to give the Commonwealth, State or local governments the power to declare any local government area which has persistent labour surpluses a "free labour market zone". People and businesses located within these areas would have the option of freely negotiating the terms of employment, so that they can prevail, if the parties so wish, over conflicting State and Federal industrial laws and awards. It is proposed that where an Australian government minister has certified a local government area with a persistent labour surplus or where a test of labour surplus is otherwise met, that either the minister or the local council, or both, have the power to exercise the option.

An advantage of this approach is that it could be introduced on a trial basis where there is local support for it based on the acknowledgement of persistently high unemployment rates in the area concerned. This may make it politically easier to implement than the broader approach. Since businesses may be uncertain about the continued existence of these special freedoms, however, it may be necessary to provide guarantees of some kind to minimize commercial risk.

## 6.2 Unemployment benefits and the "welfare floor"

The Society submits that the availability of unemployment benefits provides an adequate "safety net" without the undesirable side-effect of the unemployment caused by a minimum wage. If, after abolition of minimum wages, the resultant wage rates for some people are considered to be too low, then this should be remedied by wage subsidies or earned income-tax credits. Whereas the cost of maintaining incomes by

way of minimum wages falls disproportionately (and very unfairly) on unemployed people, especially those experiencing long-term unemployment, the costs of wage subsidies and tax credits are spread more evenly (and fairly) across society.

If, despite the evidence of the harmful consequences of minimum wages, it is deemed infeasible to eliminate them, the Society recommends that responsibility for setting a minimum wage for employment contracts should be shifted from the AIRC to the Commonwealth Government or to State governments. The expectation is that a minimum wage set by either the Commonwealth Government, which is ultimately responsible to the electorate for maintaining full employment, or State governments, which are closer to the problem of localized high rates of unemployment, would be substantially lower than the lowest award wages for adult work set by the AIRC, beholden to interest groups as it is.

### 6.3 Unfair dismissal laws

As argued in 3.3 above, employment protection regulations tend to increase real labour costs by encouraging shirking and impeding efficient matching of employees and jobs. The right of an employee to terminate one employment relationship in order to form another offering better terms should be balanced by the right of an employer to replace a worker by another expected to be more productive. In this respect, unfair dismissal laws tend to be unfair to those obliged to seek new jobs following termination from jobs which are no longer viable. For these and other, similar reasons, the Society submits that the government should repeal all unfair dismissal laws. As argued in 5.4 above, the costs incurred by both parties in the event that a viable employment relationship is terminated would create a form of mutual deterrence to capricious dismissals in the absence of regulations.

The Society recognizes that unfair dismissal provisions embodied in State laws may be beyond the control of the Commonwealth government. Simplifying procedures for opting-out of the award system, however, would allow employers and employees to avoid the most damaging consequences of State laws pertaining to unfair dismissals on levels of participation in paid work.

### 6.4 Reform of trade union laws

Because labour union exemptions from anti-competitive market practices are socially and economically damaging and provide no offsetting benefits, trade union exemptions from laws pertaining to anti-competitive market practices should be repealed forthwith. However, workers should have the same rights as others, notably employer groups, to pursue their interests through voluntary association with others.

The abolition of compulsory conciliation and arbitration, which directly facilitates rent extraction by unions from enterprises, would complement the abolition of trade union exemptions from competition laws.

### 6.5 Conclusion

The Society submits that the reforms set out above are politically feasible and, if implemented, would contribute substantially to “paving the way to paid work”.

## APPENDIX

### Assessing the Potential for Increasing Participation in Paid Work

International research has shown that many labour market regulations, employment regulations and rules of eligibility for publicly-provided welfare benefits distort people's choices in ways that artificially inhibit participation in paid work and impede productivity growth. In this appendix, comparisons of unemployment rates and employment/population ratios (EPRs) across countries and over time are used as a rough basis for assessing the scope for increasing participation in paid work in Australia by removing artificial impediments to the functioning of labour markets. For reasons sketched in the next few paragraphs, the approach should be regarded as crude but, nevertheless, providing a useful perspective.

#### A1.1 Conceptual and practical difficulties

Since few, if any, of us would choose to spend all our waking lives at work, it is clear that maximizing participation in paid work is not a sensible policy objective. Rather the objective should be to create an institutional environment which achieves *optimal* levels of employment—an environment which minimally distorts people's choices between paid work and other satisfying ways of using their time, while giving them appropriate incentives to live independently of publicly provided income transfers. If, say, a restaurateur works extremely long hours for 25 years with the objective of retiring to a life of consumption and leisure at the age of 50, then it is not appropriate to adopt policies to compel her (or even induce her) to continue working after age 50 simply to raise the employment/population ratio. In a somewhat different vein, employment/population ratios will also be influenced by the extent to which production of support services for the aged and infirm is conducted within households (prevalent in southern Europe) rather than the market sector or public sector (prevalent in Scandinavia and the English-speaking world). Again, a simplistic focus on the employment/population ratios may be misleading in formulating policies.

Accordingly, the government's aim should be to achieve *optimum* rather than *maximum* levels of employment by removing regulatory impediments to job creation and participation in the labour market, especially at the lower end of the wage distribution. Logically, regulatory reform could increase participation in paid work both by reducing rates of unemployment and by increasing the number of people participating in the labour market (in other words, the number of people with jobs plus people actively looking for jobs). The latter amounts to removing artificial disincentives for people to seek paid employment.

Some of the shortcomings of using international comparisons of employment/population rates and unemployment rates to estimate the scope for increasing participation in paid work for Australia are fairly obvious. Differences in EPRs may reflect differences over time and across countries in undistorted choices not to seek paid jobs. In particular, cross-country differences in EPRs for females may reflect cultural differences in attitudes to working women.<sup>14</sup> Similarly, lower EPRs for

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<sup>14</sup> These and other limitations of simple indicators of labour market performance are elaborated in Appendix 1.

older age groups are likely to be at least partly a consequence of undistorted choices of retirement ages. With respect to unemployment rates, there is no reliable way of ascertaining how much unemployment is an inevitable consequence of job matching processes and structural change and therefore no way of knowing how much regulation-created unemployment could be eliminated by reforms.

In summary, since there is no way of determining optimal levels of employment *a priori*, any assessments of the scope for increasing participation in paid work by reforming labour market and employment regulations should be considered, at best, indicative rather than precise.

## A1.2 Broad comparisons of labour market performance

Because of the possibility that cross-country differences in female participation in paid work are substantially attributable to cultural differences, EPRs and unemployment rates for males are probably better indicators of a country's labour market performance. Table A1 shows that Australia's average EPR for males for the 5-years 1997-2001 was roughly 5 percentage points below corresponding EPRs for Norway, Japan, Denmark, the Netherlands and USA; comparable to the UK, New Zealand, Canada and Sweden; but well above those for several European countries including Italy, France, Finland, Belgium, Spain, Greece and Ireland.<sup>15</sup> Switzerland's male EPR of 87.0 is by far the highest for OECD countries, 11 percentage points above Australia's.

**Table A1**

### Labour Market Performance Indicators

| Country          | <u>Male employment/ Male</u>                      |                                       | <u>Male labour force</u>                            |
|------------------|---|---------------------------------------|---|
|                  | Population ratio<br>(5-year average<br>1997-2001) | rate<br>(5-year average<br>1997-2001) | Participation rate<br>(5-year average<br>1997-2001) |
| 1.               | 2.  | 3.                                    | 4.  |
| Switzerland      | 87.0  | 2.9                                   | 89.6  |
| Norway           | 81.9  | 3.5                                   | 84.9  |
| Japan            | 81.3  | 4.7                                   | 85.2  |
| Denmark          | 80.7  | 4.1                                   | 84.2  |
| Netherlands      | 80.5  | 2.9                                   | 82.9  |
| USA              | 80.2  | 4.5                                   | 83.9  |
| UK               | 78.2  | 6.7                                   | 83.8  |
| New Zealand      | 77.9  | 6.6                                   | 83.5  |
| Austria          | 76.1  | 4.8                                   | 80.0  |
| <b>Australia</b> | <b>75.7</b>                                       | <b>7.6</b>                            | <b>81.9</b>   |
| Canada           | 75.2  | 8.1                                   | 81.8  |

<sup>15</sup> Data are from *OECD Employment Outlook*, OECD, 2002, 2001, 1998, 1996. We rank (and arbitrarily group) by 5-year averages partly because there are some inconsistencies in the data for earlier years and partly because 1997-2001 can be regarded as relatively free of effects of recessions on EPRs. Using the 9-year 1993-2001 average male employment/population (16-64) ratios instead of the 5-year average makes little difference to rankings, except that Spain's average falls by almost 4 percentage points to be the lowest for the selected countries. Values for 1993-2001 averages tend to be 1.0-1.5 percentage points lower, but give no substantial grounds for changing our arbitrary groupings.

|          |      |      |      |
|----------|------|------|------|
| Portugal | 75.2 | 4.2  | 78.6 |
| Sweden   | 74.8 | 7.7  | 81.0 |
| Germany  | 73.3 | 8.4  | 80.0 |
| Ireland  | 72.8 | 6.7  | 77.9 |
| Greece   | 71.3 | 7.1  | 76.8 |
| Spain    | 70.3 | 11.5 | 79.5 |
| Finland  | 68.0 | 10.3 | 75.7 |
| Belgium  | 68.0 | 6.6  | 72.8 |
| France   | 67.4 | 9.4  | 74.3 |
| Italy    | 67.7 | 8.5  | 74.0 |

Source: OECD Employment Outlook, 2002.

These data suggest that there is substantial scope for increasing participation in paid work in Australia, both by reducing unemployment and increasing participation in the workforce (Columns 3 and 4).

### A1.3 More detailed perspectives on participation in paid work

Examination of changes in EPRs over time and differences in EPRs for various age groups across countries helps to ascertain the scope for increasing participation in paid work. Australia's male EPR in 1970 (measured as *total* male employment including men over 65) as a percentage of the male population aged 16-64, was 94.1, 10 percentage points higher than in 2000. Switzerland, Denmark, Germany, Ireland, Netherlands, New Zealand, Portugal, Spain and the UK also had EPRs in 1970 above 90.<sup>16</sup> However, at least part of the reason EPRs for most OECD countries have fallen by 5 to 10 percentage points since 1970 is that participation in full-time education has increased. Also, as real incomes rise, people tend to "buy more leisure" by retiring earlier. On the other hand, whatever their merits, there is no doubt that increasingly generous publicly-provided age and disability pensions have contributed to the decreases in EPRs in many OECD countries, including Australia.

Columns 2 to 5 of Table A2 shows that, of the 21 selected OECD countries, Australia:

- had the *third lowest* EPR for males aged 25-54 in 2001 (although the range for this age group was relatively small);
- ranked around the middle of the of the range of EPRs for males aged 55-64; and
- had the fourth highest EPR for males aged 15-24 (surprisingly perhaps).

**Table A2**  
**Male Employment/population ratios and part-time employment**

| Country     | Average EPR              | EPRs 2001     |               |               | Male Employment,          |
|-------------|--------------------------|---------------|---------------|---------------|---------------------------|
|             | ages 16-64,<br>1997-2001 | Ages<br>15-24 | Ages<br>25-54 | Ages<br>55-64 | 2001<br>Percent part-time |
| 1.          | 2.                       | 3.            | 4.            | 5.            | 6.                        |
| Switzerland | 87.0                     | 64.6          | 95.3          | 81.0          | 8.9                       |
| Norway      | 81.9                     | 57.9          | 88.9          | 72.3          | 9.0                       |

<sup>16</sup> OECD, 2001.

|                  |             |             |             |             |             |
|------------------|-------------|-------------|-------------|-------------|-------------|
| Japan            | 81.3        | 41.6        | 92.8        | 77.5        | 13.7        |
| Denmark          | 80.7        | 64.3        | 88.7        | 63.1        | 9.1         |
| Netherlands      | 80.5        | 71.5        | 92.7        | 50.5        | 13.8        |
| USA              | 80.2        | 59.4        | 87.9        | 65.8        | 8.1         |
| UK               | 78.2        | 57.2        | 87.6        | 61.6        | 8.4*        |
| New Zealand      | 77.9        | 58.5        | 87.6        | 71.3        | 11.2        |
| Austria          | 76.1        | 55.6        | 90.3        | 37.9        | 2.7         |
| <b>Australia</b> | <b>75.7</b> | <b>61.6</b> | <b>85.0</b> | <b>56.7</b> | <b>15.8</b> |
| Canada           | 75.2        | 56.5        | 85.4        | 57.6        | 10.4        |
| Portugal         | 75.2        | 49.2        | 90.4        | 61.6        | 5.1         |
| Sweden           | 74.8        | 47.3        | 86.6        | 69.6        | 7.1         |
| Germany          | 73.3        | 51.6        | 87.5        | 45.4        | 4.8*        |
| Ireland          | 72.8        | 51.5        | 88.7        | 64.6        | 7.1         |
| Greece           | 71.3        | 30.4        | 88.8        | 54.6        | 2.6         |
| Spain            | 70.3        | 44.2        | 85.9        | 57.9        | 2.7         |
| Finland          | 68.0        | 40.2        | 84.7        | 46.7        | 7.3         |
| Belgium          | 68.0        | 31.8        | 86.5        | 35.1        | 5.6         |
| France           | 67.4        | 27.8        | 88.1        | 41.4        | 5.1         |
| Italy            | 67.7        | 32.6        | 81.7        | 29.5        | 5.4         |

Source: OECD Employment Outlook, 2002 and other years.

\* = observations for year 2000.

Conservative “back-of-the-envelope guesstimates” based on data in Table A2 and 2001 demographics suggest scope for increasing male employment in Australia by at least 150,000 prime-age males, 50,000 young males and 50,000 older males or a total of 250,000 males. Since unemployment rates for females have typically been slightly lower than for males, there may somewhat less scope for increasing female participation in paid work than for males, although this is even more difficult to assess.<sup>17</sup> We therefore estimate conservatively that reform of labour market regulations and the welfare system has the potential to increase employment by between 400,000 and 500,000 or by about 5 per cent from 9 million to 9.5 million. The data in Tables A1 and A2 suggest the main source of these gains would be by reducing unemployment, although there is clearly substantial scope for increasing employment by increasing the participation rate (for instance, by strengthening incentives for “discouraged workers” to seek jobs).

Reducing *underemployment* of people with part-time jobs offers further scope for increasing the labour supply. In September 2002, almost 600,000 (22 per cent) of part-time workers wanted to work an average of 15 more hours per week. Creating jobs to satisfy their aspirations would increase hours of labour supplied by perhaps a further 2 per cent.<sup>18</sup> In summary, although difficult to assess, there is little doubt that

<sup>17</sup> Labour markets in OECD countries have accommodated extraordinary increases in female participation in paid work over the last half century as women have been freed from household production by labour-saving changes in technology and shifts of work from the household sector to the market sector (e.g., food preparation, apparel production, child care). For example, over the last 25 years, female employment in Australia has roughly doubled from approximately 2,000,000 to around 4,000,000, lifting the employment/population (16-64) ratio from 47 per cent to 62 per cent. This may have exacerbated male unemployment in many countries, especially at the lower end of their labour markets.

<sup>18</sup> ABS, 2002.

there is substantial, if not spectacular, scope for increasing male participation in paid work through labour market and welfare reform.

#### **A1.4 Geographical distribution of unemployment**

Some regions, including much of Tasmania, much of the seaboard of northern New South Wales and southern Queensland and the immediate hinterland, the LaTrobe Valley, Whyalla, and parts of north and central Australia have persistently high unemployment rates. Data in Table A3 show that these high unemployment rates are associated with low participation rates and, consequently, low EPRs. In some of these regions, part of the reason for the low participation rates is that they are popular locations for retirement. Even so, the high unemployment rates show that there is substantial scope for increasing participation in paid work in these areas and the urgent need for policies which will facilitate job creation in such regions.

**Table A3**  
**Statistical Sub-divisions with**  
**Highest Unemployment Rates for State, 2001**

|                               | Unemployment Rate | EPR  | Median Age |
|-------------------------------|-------------------|------|------------|
| <b>Qld - Hervey Bay</b>       | 14.9              | 37.4 | 43         |
| <b>NT - Bathurst-Melville</b> | 13.1              | 40.9 | 24         |
| <b>NSW - Clarence</b>         | 15.0              | 42.5 | 41         |
| <b>WA - Mandurah</b>          | 12.4              | 46.4 | 39         |
| <b>Tas - Burnie-Devonport</b> | 12.5              | 48.7 | 37         |
| <b>SA - Whyalla</b>           | 13.2              | 50.2 | 35         |
| <b>Vic - LaTrobe</b>          | 12.0              | 51.9 | 35         |

*Source:* Derived from ABS (2003a).

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