ATTACHMENT B

Termination Change and Redundancy Case –

Commonwealth's Final Submission

Appendix 9: Economic Impact of the ACTU's Claim

Note: Some documents referred to in the Commonwealth's submission are not contained in this extract. A guide to these documents can be found at **Attachment D**.

APPENDIX 9 ECONOMIC IMPACT OF THE ACTU'S CLAIM

Introduction

1. The ACTU asserts that its claim will have a negligible impact on the economy.[1] This assertion does not stand up to scrutiny.

2. The ACTU's costings do not address two substantial kinds of understatement entangled in its basic retrenchment data. Also, the costings are cast too broadly, at the level of the national economy. Consequently, they do not reflect the heavy burden which the claim will impose on the subset of firms which actually make retrenchments. The cost to small business will be particularly severe.

3. A large body of international research demonstrates that onerous firing costs (which may take a number of forms including severance payments) have a harmful effect on the labour market. Firing costs discourage recruitment, limit job opportunities and hamper essential change in the labour market. The ACTU ignores this research, despite the clear implication that the claim will make it harder for retrenched workers to regain employment.

4. Most retrenchments occur as firms try to adjust to competitive pressure or adverse circumstances. The savings which arise from retrenchment are necessary for the continued survival of the firm but do not necessarily provide additional benefits or profits to the business. Providing retrenched workers with a portion of these 'benefits', as the ACTU calls these savings, will weaken firms' survival prospects and place more jobs at risk.

5. The challenges which confront retrenching firms, and the business adjustments and failures which arise from them, are part of the inevitable and fundamental processes of technological, social and economic change. By making firm-based adjustment more expensive, the ACTU's claim will make it more difficult for Australia to respond positively to these changes.

[1] Exhibit ACTU 1 at paragraph 53.

The direct costs of the claim

6. The ACTU in its opening address attempted to portray its severance pay claim as a modest increase to the TCR standard. The ACTU suggested that just under half of employees would get one week or less as an enhancement to their redundancy pay if the ACTU's claim were successful. Furthermore, only one in seven employees would receive the maximum severance pay.

7. The ACTU's claim is not modest. Using the material in the ACTU's costings, without applying any of the corrections that we discuss later in this Appendix, we calculate that ACTU's claim would lift the retrenchment costs applicable to all wage and salary earners from an average of $3593 to $5539, an increase of over 150 per cent (see **Attachment B**, particularly Figure 9B.3). For larger businesses, the ACTU's claim also represents an increase of over 150 per cent above the average cost of retrenching a permanent employee under the current standard, which is approximately $4000. It is not credible to portray an average increase of over 150 per cent in an entitlement as modest.

<u>The ACTU's costings - the prevalence of retrenchment</u>

8. The ACTU's costing of the claim is based on the number of retrenched workers reported in the ABS's *Retrenchment and Redundancy* survey which examined the period between July 1998 and July 2001.[2] The ABS's estimate for total retrenchments in the private sector over this period is divided by three and then compared to the annual wages bill.

9. There are a number of major problems with this approach. First, a respondent recall problem seems to lead to an underestimate of retrenchments in the first two years of each three year period covered by the survey. A large shortfall is evident between the results of *Retrenchment and Redundancy* survey and the ABS's *Labour Mobility* survey which covers retrenchments over a 12 month period. (This is explained in more detail in **Attachment A**.) The ACTU uses a retrenchment rate of 2.2 per cent, a figure that conflicts significantly with the rate of between 4 and 5 per cent that is widely accepted by labour market economists, including the ACTU's witness Professor Webber. Consequently, the ACTU has underestimated the level of retrenchments,

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[2] Exhibit ACTU 2 at Tag 10.

a figure which forms the basis of its costings. This leads to a significant underestimate of the cost of the claim.

10. In his opening comments before the Commission, Mr Watson argued that the Commonwealth was wrong in asserting that the ACTU had underestimated the volume of retrenchments by using the *Retrenchment and Redundancy* survey data.[3] However, as **Attachment A** explains, the ACTU's own material and the comments of its expert witness, Professor Webber, show that the *Labour Mobility* survey provides a better guide to the prevalence of retrenchment in the Australian economy.

11. The ACTU's costing is based on an annual level of private sector retrenchments of 176,000.[4] However, analysis of the *Labour Mobility* survey reveals that about 383,200 workers were retrenched in 2001, corresponding to a retrenchment rate of 4.2 per cent, as compared with the ACTU's rate of 2.2 per cent. Approximately 340,000 of these retrenchments would have occurred in the private sector, using the same ratio of private sector to total retrenchments reflected in the ACTU's costings.

- The use of the larger and more accurate figure would raise the cost impact of the claim from 0.09 per cent to about 0.17 per cent of the annual wages bill.

12. This is a larger correction than the correction identified in the Commonwealth's outline of contentions lodged on 11 April [Exhibit C/W 3]. In our earlier costings we used a slightly lower retrenchment rate that was derived from the *Retrenchment and Redundancy* survey. We have used the rate from *Labour Mobility* survey in these costings to demonstrate that irrespective of which of these two rates is used, the correction that has to be made to the ACTU's costings is extremely large. In fact, it is clear that any correction that uses a retrenchment rate consistent with the level indicated by Professor Webber and the other material submitted by the ACTU will be extremely large.

13. Furthermore, the level of retrenchments in 2001 reflects relatively favourable economic conditions. Naturally, the prevalence of retrenchment varies with the economic cycle, as the ACTU's own

[3] Transcript, 26 May 2003 at PN443.
[4] The 527,900 figure presented in Table 1 of Exhibit ACTU 2, Tag 10, divided by three.

evidence acknowledges.[5] To gain a better idea of the negative impact of the claim, it is important to examine recessionary conditions, as **Attachment A** discusses.

14. During the economic downturns of the early 1980s and the early 1990s the retrenchment rate rose to 7.1 per cent and 8.1 per cent respectively, well above the 2001 rate which is either 3.7 per cent or 4.2 per cent depending on whether the *Retrenchment and Redundancy* survey or the *Labour Mobility* survey is used.

15. If the recessionary retrenchment rate of 7.1 per cent applied to a workforce of a size matching the average 2002 level, and all other things remained equal, then the ACTU's count of private sector retrenchments would have to be revised upwards again, to about 575,000. Accordingly, the costs of the claim would rise to over 0.29 per cent of the annual wages bill. This does not amount to a negligible impact on the economy.

<u>Retrenchments occur in a sub-group of employers</u>

16. Expressing retrenchment costs as a proportion of the total wages bill across the whole workforce acts to understate the claim's actual impact. The recent decision made by the Queensland Commission in the Queensland TCR case also acknowledges the flaw in deriving the cost of the claim over the total workforce.

> *In considering the cost implications, it should be noted that the Full Bench is aware that the real cost is not shared by the community at large but is a discrete cost to individual business concerned in an actual redundancy situation. We do not consider it is that helpful to estimate a cost spread across a whole community when many businesses would never have an occasion to make an employee redundant."* [6]

17. Retrenchment costs will be felt largely in the private sector which is the site of the great majority of redundancies – 88.5 per cent according to the 2001 *Retrenchment and Redundancy* survey. Just as the ACTU counts only private sector redundancies in its calculations, the cost of

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[5] Webber M. and Weller S. 'Retrenchment and Labour Market Change' Exhibit ACTU 2, Tag 1, Paragraphs 5, 32 and 53.

[6] Queensland TCR test case decision, 171 QGIG 1417 at paragrpah72.

those redundancies under the claim should be expressed as a proportion of the private sector wages bill.

18. During the period covered by the 2001 *Retrenchment and Redundancy* survey, the private sector accounted for close to 73 per cent of the private and public sector wages bill.[7] On this basis, the expected impact figure should be adjusted upward, from 0.29 per cent to 0.38 per cent. It is also necessary to adjust wages costs to cover just the federal sector. This has been done using the 40 per cent figure with which the ACTU reduced retrenchment numbers for sectoral coverage. The cost impact figure therefore should rise again, to 0.94 per cent of wage costs of private sector firms in the federal system.

19. Retrenchments do not occur in all private sector firms each year. Many will not be affected by the ACTU's claim. However, this means that firms which do make retrenchments will wear a much heavier burden than indicated by the ACTU's estimates. While there is a lack of comprehensive data on the number of firms which retrench, the 1995 *Australian Workplace Industrial Relations Survey* (AWIRS) suggests that the number may be relatively small.[8] Approximately 18 per cent of private sector workplaces with five or more employees intentionally reduced the size of their workforce in the 12 months prior to the survey.

20. If this figure is used to focus only on those private sector firms in the federal arena which retrench employees in a given year, the cost of the ACTU's claim represents about 5.23 per cent of their combined annual wage bill (or 3.09 per cent if retrenchment rates always remained at current levels).

21. The ACTU suggests in Exhibit ACTU 8 that the Commonwealth's use of 18 per cent as the proportion of firms that retrench in a given year, over inflates the actual cost of their claim.[9] They note that *The contours of restructuring and downsizing in Australia* reports that 60 per cent of private sector organisations reduced employment in the previous two years.[10] Therefore the argument is presented that, if this figure was used in place of that used by the Commonwealth, the firm-specific cost would reduce.

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[7] According to data in the December 2001 ABS Wage and Salary Earners publication (ABS Cat No 6248), the private sector accounted for 76.9 per cent of gross earnings in the December quarter 2001.
[8] Attachment A provides an overview of AWIRS data on workforce reductions.
[9] Exhibit ACTU 8, Tag 1 at paragraph R165.
[10] Dawkins, P., Littler, C. R., Valenzuela, Ma. R. and Jensen, B. *The Contours of Restructuring and Downsizing*, 1999.

22. However, the use of a figure of 60 per cent is flawed. Firstly, 60 per cent corresponds to the proportion of businesses that reduced employment in the previous two years. It would therefore be reasonable to assume that halving the figure would give an indication of a yearly rate.

23. Further, the report on which the alternate figure is drawn only concentrates on larger businesses (those with greater than 50 employees) and hence does not take into account the experience of small to medium businesses. Using AWIRS, which was used to obtain the Commonwealth's 18 per cent figure, it is evident that approximately 31 per cent of firms with greater than 50 employees retrench in a given year, which is roughly equivalent to the 30 per cent obtained from *The contours of restructuring and downsizing in Australia*. The data from *The contours of restructuring and downsizing in Australia* therefore confirms rather than contradicts the AWIRS data.

24. The Commonwealth therefore submits that the AWIRS data gives the best possible estimate of the proportion of firms that retrench in a given year and that the costs outlined above are accurate and not over inflated as the ACTU suggest.

25. The ACTU makes a further significant error in the amended costings presented in its final written submission. The ACTU attempts to revise its costings downwards. In large part the ACTU bases its revision on a new estimate of the proportion of private sector employees (and firms) that are covered by the federal award system (paragraph 423). It also reduces its cost estimate on the basis that some firms will not be affected by the claim because they are covered by agreements that contain severance pay above the standard (paragraph 418). The ACTU's newest error arises in paragraph 429 of its final submission. Here the ACTU uses its revisions to reduce its estimate of the average cost to retrenching firms of the ACTU's claim. This reduction is wrong. What the ACTU has missed is that adjustments to the proportion of firms covered by the claim will not change the average firm-specific cost. The magnitude of the impact of the claim on the average firm is independent of the proportion of firms impacted by the claim. The ACTU has failed to see this because it has not adjusted all the inputs used in its costings that will change if the revised estimates referred to above are adopted. Once this is done, the changes cancel each other out, leaving the final estimate of firm-specific cost unchanged. The ACTU's attempt to reduce the estimate of the firm-specific cost fails.

26. Further, should firms decide or be required to put aside sufficient funds to cover the severance entitlements of all their employees, regardless of whether they actually retrench workers, the costs of the claim would be very large indeed. On the basis of similar assumptions to those underlying the ACTU's cost estimates, private sector firms would have to set aside an additional amount of approximately 6.4 per cent of their wage bill. The calculations are explained in **Attachment B**.

Broad consequences for the business community

27. The ACTU's assertion in this case seems to be clearly based on the premise that only those firms that actually retrench staff will be impacted by the claim and that this impact is only relatively small. However, this premise fails to acknowledge the indirect impact that an increase in the potential liability associated with severance pay will have on all firms in general.

28. Mr Humphris, the ACTU's own witness, confirms that in obtaining finance firms are assessed on the worst-case scenario and hence even though there is no obligation to include it on the balance sheet, liabilities associated with redundancy payments in the event of liquidation are taken into account.

> *[Mr Humphris] …a bank…will make an assessment of the company's security position based on its assets and liabilities, and they will do that on the appraisal of the worst case scenario which tends to be in a liquidation sense. So they will value the assets at very low prices based on probable liquidation realisation values, and they will also then put value on the liabilities that would rank ahead of them which would clearly include employee entitlements and any contingencies in the circumstances of a redundancy payment.*[11]

29. Further, as Mr Watson conceded in the questioning of Mr Gillespie, and Mr Humphris confirmed in cross-examination, banks are likely to account for the extra risk associated with the higher levels of potential liability due to increased retrenchment costs by increasing the interest rates charged on facilities held by the firm.[12]

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[11] Transcript, 29 May 2003 at PN2716.
[12] Transcript, 26 June 2003 at PN4509-10.

30. As mentioned in a previous section of this Appendix, if firms decided or were required to set aside sufficient funds to cover the severance entitlements of all of their employees, regardless of whether they actually retrench workers, the cost of this claim would be extremely large.

31. Businesses that choose not to set aside sufficient funds to cover potential severance requirements, however, do not escape the economic impact of the ACTU's claim. The increased liability that would result if the claim is successful would leave these firms potentially more vulnerable to any reductions in demand or external shocks within the economic environment that may eventuate in the future. This is especially the case with small business, which is discussed in more detail later in this Appendix.

32. These factors clearly demonstrate that this claim will potentially have a significant impact on the broader business community in terms of their access to adequate finance and their economic health and survival in general.

The cumulative impact of concurrent ACTU claims

33. Not only would the ACTU's severance claim impose a heavy financial burden on a significant minority of firms, it is being made alongside the continuing Safety Net Review process which has recently granted an increase of $17 per week to the majority of award paid workers.

34. As the Commonwealth's submission to the Safety Net Review explains, the economic outlook is generally positive but the current downside risks are particularly severe, mainly because of the drought, the weak state of the international economy, the recent SARS epidemic, ongoing volatility in Iraq, as well as other geopolitical uncertainty.[13] In these circumstances the ACTU's claims could have an especially adverse impact on many firms. This point is illustrated in evidence presented by employers:

> *We believe our sales were 16% down for the 2001/2002 financial year and 26% down from November 2001 to April 2002, which is traditionally our peak trading period. In the months after September 11, we found that not only did we lose*

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[13] Commonwealth Government Submission, 2002- 2003 Safety Net Review Submission – Wages, 26 February 2003, Section 2.

> *sales due to the lack of travel, we also lost market share due to imports being discounted. We were also faced with the situation where we had to extend trading terms to assist retailers through the difficult times. Currently the events of October 12 and now the "Alliance of the Willing" have continued the trend against travel. Additionally, there are parts of Australia that have the added burden of drought, which we believe is also impacting upon demand.*[14]

35. If the ACTU's claim succeeds on top of the recent Safety Net decision, firms would be caught between rising labour costs and greater financial penalties for adjustment of the size or the composition of their workforces. Firms will become reluctant to hire, reducing the prospects of job seekers, as the Commonwealth argues in the next section of this Appendix and in its Safety Net Review submission.[15]

<u>Response to the NIEIR report</u>

36. The ACTU presents a report prepared by NIEIR.[16] The alternate costings by NIEIR, although calculated slightly differently, contain the same methodological flaws that the Commonwealth has identified in the ACTU's costings. The NIEIR costings seriously underestimate the true economic impact of the claim to the same extent as the ACTU costings.

37. For example, like the ACTU, the NIEIR has calculated the cost of the claim as a proportion of the whole wages bill. This approach leads to a substantial underestimate of the true cost impact of the claim on those employers that actually retrench in a given year.

38. The NIEIR report also attempts to analyse the performance of NSW in bankruptcy experience and employment growth compared to other States following the changes in redundancy arrangements in 1994.

39. Tables 16, 17 and 18 of the NIEIR report provide Gross State Product (GSP) per full-time equivalent person employed, GSP per capita, employment to population ratios and the ratio of the number of bankruptcies to the number of private sector businesses for each of the States. The measures of productivity growth, GSP per capita and

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[14] Exhibit AIG 12, Tab 3 at paragraph 25.
[15] Commonwealth Government Submission, 2002- 2003 Safety Net Review Submission – Wages, 26 February 2003, Section 9.
[16] Exhibit ACTU 8, Tag 5.

employment/population are provided for the period 1992-93 to 2001-02, while the data on bankruptcies is provided for years 1994-95 to 2000-01.

40. The impact of the changed redundancy arrangements can be analysed in two ways – one is to present evidence of the performance of the NSW economy before and after the 1994 changes taking care to account for <u>all of the other factors</u> likely to affect the economic performance of NSW over this period. The other is to compare the growth rates of NSW with other States again taking account of <u>all of the other factors</u> affecting the economic performances of the respective States. The NIEIR's analysis does neither – it is inadequate in revealing the impact of the 1994 changes in redundancy arrangements.

41. The results as presented cannot be used to reveal the impact of the 1994 changes in NSW. The growth rates of productivity, per capita GDP, employment/population and bankruptcies will be affected by a host of factors which will confound any simple conclusion regarding the impact of the changed termination and redundancy arrangements in NSW. The general point made by Professor Lewis below holds for inter-State comparisons as well as international comparisons:

> *[Mr Watson] Yes, which is just another way of saying is it not, that when you do the multi varied analysis you have got to try and control for those factors?---*
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> *[Professor Lewis] Well, I would say it is almost impossible to control. For instance in France, the French they actually provide quite significant subsidies for firms to keep on workers who would have otherwise been retrenched and they also provide quite generous retirement schemes for older workers who have been retrenched, which I suppose backs up the thesis that if you reduce labour costs by subsidies then you increase employment and hence if you increase costs you will of course have loss of jobs.*
>
> *[Mr Watson] Well - yes. Are you saying then that - that in this field there is simply no point in the international comparisons which the OECD undertook in its June '99 Outlook?---*
>
> *[Professor Lewis] I am simply saying that when interpreting these results be very careful in the same way that people regard my results as somewhat less than convincing and I am sure that there are people who find those results less than convincing.*
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> *(Transcript, 23 June 2003, PN4033-4034)*

42. The NIEIR's report points out that growth in NSW is lower over the period compared to other States, but doesn't attribute this difference to the change in 1994 to the NSW TCR standard. Instead, the NIEIR uses the concept of the 'convergence law' of economic performance to justify this difference. Convergence law refers to a theory of relative regional/national economic performance whereby initially high productivity countries or regions grow more slowly than lower productivity countries or regions – productivity thereby converges over time. That is, the NIEIR expected NSW growth per capita to be lower than the rest of Australia because productivity was initially higher in NSW. However, convergence of economic performance is most certainly not a law as indicated by the NIEIR which applies indisputably in all situations or at all times. The theoretical and empirical discussions concerning economic convergence yield no easily generalisable conclusions and are not without severely conflicting evidence.

43. For example, Sachs (1995) concludes recent research has emphasised not the notion of convergence but rather divergence of economic growth rates as the initial advantages that particular regions enjoy are exploited and further developed.[17] Highlighting the limitations of the convergence theory is a study by Williamson (1995) which reveals that the appearance of convergence in the economic growth data appears to depend largely upon the particular time period analysed.[18] Williamson identifies a certain period within the twentieth century, 1914 to 1950, during which the gap between rich and poor countries widened rather than contracted. Even where economic convergence occurs it is not as easily identified as suggested by the NIEIR. Convergence processes when they occur take place over the very long term – that is, two or three decades and not a single decade as indicated by the NIEIR.

44. In short, it is not possible to have predicted the growth per capita of NSW compared to the other States based on the theory of 'economic convergence'. Accordingly, it is not possible to arrive at a view of what the economic performance of NSW would have been if the 1994 redundancy changes had not occurred.

45. The analysis of the effect of the performance on NSW in generating jobs compared to the other States post-1994 is also unconvincing. Again,

[17] Sachs, J. and Warner, A. 'Economic Convergence and Economic Policies', Brookings Papers on Economic Activity, ed. W. Brainard and G Perry, 1:1995, 1-95, 108-118.

[18] Williamson, J. 'Globalization, Convergence and History', Journal of Economic History, vol 56, no 2 (June 1996): 1-30.

it is not possible to arrive at a counterfactual regarding the employment experience in NSW in the absence of the 1994 changes.

46. Use of the ratio of number of business bankruptcies to number of private sector businesses in any one year employed by the NIEIR to demonstrate the lack of an impact of the changes in NSW redundancy arrangements is also not meaningful (Table 18). Business bankruptcy can result from many different circumstances other than simply from the impact of the redundancy provisions. Some of the intervening factors do not even relate to the business but, rather, to the business owner, as revealed by the following advice in the glossary of the ABS publication used by the NIEIR:

> *Bankruptcies Bankruptcy is a legal state relating to an individual, permitting the orderly repayment and release of their debts. It may be initiated either voluntarily by the debtor or by a creditor against the debtor's will, and even in the debtor's absence. The legislation generally provides for the assets of a bankrupt to be sold and the proceeds to be distributed to creditors*
>
> *Business bankruptcies When bankruptcy proceedings are taking place and it is found that the individual has been involved in any business activity in the five years preceding bankruptcy, then the bankruptcy is referred to as a 'business bankruptcy'.*
>
> *(ABS 1321.0 Small Business in Australia 2001)*

47. Hence, a business bankruptcy can occur due to the circumstances of an individual completely unrelated to the operations of the business. Further, it is clear that even where the bankruptcy was directly related to the business operations, the eventual bankruptcy 'event' will often relate to events that occurred in previous years. This, coupled with the time taken to conclude bankruptcy proceedings, will have a serious lag impact in the data which is not accounted for in the ACTU's analysis. Finally, it is also important to note that when a business is experiencing extreme financial difficulty, bankruptcy is merely one of several options available to a business owner to resolve the situation.

48. Further to the NIEIR's report, the ACTU presented data on the percentage of insolvency cases by State along with the percentage of employing businesses by State, noting that there were no major

differences between the two.[19] The ACTU is attempting to show that the changes to the NSW TCR standard in 1994 and the removal of the small business exemption in South Australia have not had a significant affect on the number of insolvency cases in those states. This analysis, however, suffers from the same flaw as the NIEIR's report as it does not take account of all of the other factors that will impact on the number of insolvency cases in each of the states.

The direct cost of the claim for small business

49. The impact of the claim on small business is likely to be much greater than the figure for retrenching firms in general. It is not possible to develop a precise estimate of this impact because the necessary data concerning the characteristics of those retrenched from small businesses are not available. However, the information contained in the ACTU's costing allows a broad estimate to be calculated, as explained in **Attachment B**.

50. Using the assumptions and cost estimates presented by the ACTU, the cost of the claim for small business would be approximately equal to 0.4 per cent of the total wage bill. Furthermore, all of the adjustments to the general estimates, noted above, should be repeated for small business. When all of the required adjustments are made, they show that the claim would lead to an increase in the costs of small business firms which retrench to approximately 7.8 per cent of their wage bill (4.58 per cent while current retrenchment rates continue). In order for a small business to cover the severance pay entitlements of all its employees, an additional amount equivalent to approximately 15.9 per cent of its wage bill would be required.

51. From the figures on the employment duration of retrenched workers presented at Tables 1 and 6 of the ACTU's costings, it appears that, on average, the retrenchment of a permanent employee (full-time or part-time) entitled to the proposed standard of severance pay would cost over $6100.[20] This claim would see small business subject to this cost in full.

52. The ACTU's claim would increase the wages costs of the hiring by small business of a new employee (or a large business hiring of a casual employee) by at least 5 per cent, for any period of employment between

[19] Exhibit ACTU 28; Transcript, 7 August 2003 at PN5381-5385.
[20] But correcting for the mistake in the ACTU's calculations, noted above.

one and six years. The same businesses would incur an additional liability equivalent to 7.7 per cent of wages already paid to every ongoing employee who commences their second year with the business.

The capacity of small business to make severance payments

53. With respect to the removal of the small business exemption, the ACTU bases its case on the main assertion that small businesses are just as profitable as larger businesses and therefore have the capacity to pay severance. However, in making this assumption the ACTU fails to acknowledge the substantial evidence which acknowledges the relative lack of financial resilience experienced by small business.

54. All the evidence before the Commission, including that put by the ACTU, clearly shows that small businesses face a number of intrinsic difficulties, especially with respect to access to sufficient finance.

55. The findings of the Senate Committee Inquiry into Small Business Employment referred to by both the AiG and the ACCI highlight that many small businesses have particular difficulty obtaining funding for start-up, growth, working capital or large expenses.[21]

56. The Industry Commission report submitted by the ACTU at Exhibit ACTU 3 further points out that large businesses have a number of advantages in accessing finance.[22] Examples given were that large business in contrast to small business can:

- access equity through organised stock markets;
- obtain debt finance from the banks at lower interest rates and less onerous collateral requirements; and
- engage in many diverse activities in order to spread the risk more effectively.

57. As the NSW Commission did in 1994, the Queensland Commission acknowledges this substantial evidence in its recent TCR test case decision.

[21] Senate Employment, Workplace Relations and Education References Committee: (2003) Small Business Employment Report.
[22] Revesz, J. & Lattimore, R. (1997) 'Small Business Employment', Industry Commission Staff Research Paper, August, in Exhibit ACTU 3, Tag 3, p. 295.

> *In our view, the small business exemption should be retained. Many small businesses operate in marginal circumstances. An obligation to make severance payments has the very real potential to result in the insolvency of a number of small businesses. The lack of financial resilience in small business previously referred to has not changed since 1994. We accept the Queensland Government's submission the small business would generally have smaller cash reserves to meet severance pay requirements, and redundancies occurring would represent a greater proportion of the overall labour cost of the business.* [23]

58. A range of material and analysis presented below further lends weight to the argument that, contrary to the ACTU's assertions, small businesses, for a range of reasons, are qualitatively different to larger businesses and lack financial resilience and have a reduced capacity to accommodate any severance entitlements.

59. Like large businesses, small firms rely heavily on access to finance for both firm formation and survival. Without finance, firms aren't able to expand or innovate in a buoyant economic environment or remain profitable and survive in times of difficulty.

60. Small businesses, in contrast however, are often plagued by undercapitalisation and hence suffer a relative lack of financial resilience. This is arises from both the inherent structure and operational aspects of small business as well as the difficulties faced in obtaining funds either internally or externally.

61. In granting loans, financial institutions usually require some element of security to balance the associated risks. In the case of small businesses this often takes the form of collateral assets held by the owner such as the family home or car.

62. As a consequence, further finance is often difficult to obtain unless adequate justification can be made through the demonstration that the profit position of the firm would cover the risk. It is the Commonwealth's contention with respect to this case that retrenchments in small firms are likely to occur during times of financial difficulty and hence any further finance will be dependent on the availability of adequate net assets that are taken into account as security. These net assets are assessed after liabilities including contingent liabilities such as redundancy entitlements are taken into account.

[23] Queensland TCR test case decision, 171 QGIG 1417 at paragraph 100.

63. The ACTU's own expert witness, Mr Humphris, acknowledges this impediment:

> *In my experience it is often the case that a business cannot be restructured due to the lack of fixed assets acceptable to lenders for the purposes of advancing the necessary funds to restructure the enterprise. This is particularly the case with small businesses.*[24]

64. Due to the fact that the owner's collateral assets has already been secured against, small businesses are likely to be hindered in accessing vital finance due to the lack of further fixed assets. This is in contrast to larger businesses that are able to raise capital through means such as share floats, debenture issues or from existing holdings.

65. Therefore, when a small business is seeking to restructure, especially in the case where the firm is struggling, the required finance is often unavailable. Mr Humphris, in cross-examination, states:

> *[Mr Humphris] The circumstance… is that most small businesses don't have sufficient balance sheets assets to actually justify the credit risk the bank is looking for, so accordingly the bank will look to collateral security in the form of a residence or some other investment. When they look to a restructuring position, restructuring normally requires additional capital … And in that sense, the bank will look at the balance sheet in a normal sense and say, well, the balance sheet isn't going to support any additional capital that we would consider worthy security, and we have already got your house for the current facility, so they are locked into a situation of saying we can't help you.*[25]

66. Also, with respect to liquidation, due to the fact that employee entitlements are ranked above the entitlements of floating charge creditors, if small firms experiencing financial difficulties seek further finance, lenders (floating charge holders) might seek to wind up a business rather than keep it as a going concern, in order to gain as much as possible from the liquidation. Mr Humphris confirms this:

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[24] Exhibit ACTU 8, Tag 4, Witness Statement of Mr Humphris at paragraph 13.
[25] Transcript, 29 May 2003 at PN2810.

"[Floating] Charge holders will often prefer to sever all ties with the client and recover sufficient funds from fixed assets to discharge the indebtedness." [26]

67. Mr Humphris further points out in cross-examination that, in assessing a firm's situation with respect to granting finance, a bank will base its calculations on the 'worst case scenario'.

[Mr Humphris] …a bank…will make an assessment of the companies security position based on its assets and liabilities, and they will do that on the appraisal of the worst case scenario which tends to be in a liquidation sense. So they will value the assets at very low prices based on probable liquidation realisation values, and they will also then put value on the liabilities that would rank ahead of them which would clearly include employee entitlements and any contingencies in the circumstances of a redundancy payment.[27]

68. The chronic undercapitalisation experienced by small business arises in a large part due to banks and other lenders treating small businesses differently with respect to interest rates. Cited in Carpenter and Petersen, Butters and Lintner found that:

…. many small companies – even companies with promising growth opportunities – find it extremely difficult or impossible to raise outside capital on reasonably favourable terms. [28]

69. In the Australian context this is confirmed by RBA data on indicator lending rates showing that small businesses traditionally pay a higher interest rate than large businesses as demonstrated in Figure 9.1.[29] The small business interest rate premium seems to have worsened significantly since the end of 1999. The premium rose from 7.8 per cent in December 1999 to 20.3 per cent in March 2003.

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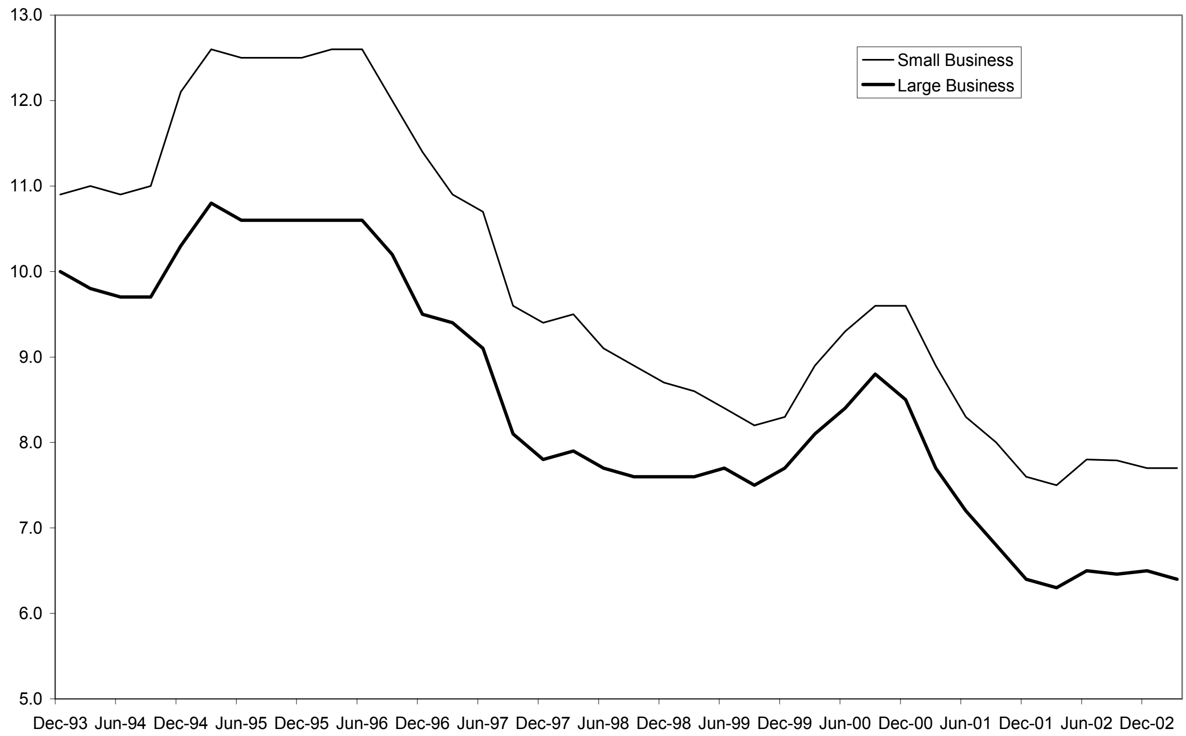
[26] Exhibit ACTU 8, Tag 4, Witness Statement of Mr Humphris at paragraph 13.
[27] Transcript, 29 May 2003 at PN2716.
[28] Carpenter, R. & Petersen, B. (2002) 'Is the growth of small firms constrained by internal finance', *The Review of Economics and Statistics*, Vol. 84 No. 2, pp. 298-309.
[29] Reserve Bank of Australia Website www.rba.gov.au , Indicator Lending Rates, Table F5.

FIGURE 9.1: SMALL BUSINESS AND LARGE BUSINESS INTEREST RATES(A).



Source: Reserve Bank of Australia Website www.rba.gov.au , Indicator Lending Rates, Table F5, 23 January 2003.
(a) The weighted-average interest rate on credit outstanding is used as this incorporates risks margins.

70. If the ACTU's claim is successful and the small business exemption is removed, this premium is likely to inflate even more, leaving many small businesses in a very precarious situation. Mr Humphris himself acknowledges that it is possible that banks as a result of the increased potential liability associated with redundancies may respond to the added risk by either reducing the amount of money they are willing to lend or by increasing the interest rates on loans.[30]

71. The relatively high cost of external finance therefore means that small businesses often rely heavily on internal finance. Carpenter and Peterson state that "*the growth of most small firms is constrained by the availability of internal finance*".[31] The Australian Yellow Pages survey on innovation shows that 82 per cent of small businesses use their own internal funds as a source of finance for innovation (compared with 18 per cent who used a bank as a source of funds).[32]

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[30] Transcript, 29 May 2003 at PN2728-31.
[31] Carpenter, R. and Petersen, B., (2002) 'Is the growth of small firms constrained by internal finance', *The Review of Economics and Statistics*, vol. 84, No. 2, pp.298-309.
[32] Sensis, Yellow Pages® Business Index Special Report into Innovation and SMEs, February 2001.

72. By removing the small business exemption, the provision of severance pay would reduce the level of, or constrain the use of, internal funds available to these firms. Small business innovation, growth and survival would be all adversely affected as a result.

73. Due to their chronic undercapitalisation it is particularly difficult for small businesses to build up reserves that would enable them to cope with severance pay if the need arises. This is supported by the Queensland Commission:

> *…small business would generally have smaller cash reserves to meet severance payments…*[33]

74. Furthermore, as Mr Humphris stresses in both his witness statement and cross-examination, businesses in most cases are not legally required to include potential severance pay liabilities on the firm's balance sheet until the redundancies are actually made.

75. Therefore, if firms decide to set aside funds to cover redundancies that may occur in the future they will be taxed on the amounts set aside. The AiG's witness Mr Lopez eludes to this in his statement:

> *Unlike other employee entitlements, such as wages, holiday and sick pay, redundancy can't really be planned and budgeted for. Like long service leave entitlements, redundancy entitlements are only a contingency that may never be used. Nevertheless, businesses will need to account for it as an accrued expense. A problem with accruals is the accrued expense is not deductible for tax purposes, That means, the business will be paying tax on a proportion of the profit it has not made. This only exacerbates the business's financial burden.*[34]

76. Further, due to the highly competitive nature of the small business sector, those small firms that do act prudently and set aside funds will place themselves at a significant competitive disadvantage.

77. As mentioned above, the evidence clearly show that small business often don't have sufficient reserves to cover severance pay requirements.

[33] Queensland TCR test case decision, 171 QGIG 1417 at paragraph 100.
[34] Exhibit B 4, Attachment J.

In the event that retrenchments were necessary, the requirement to pay severance would therefore significantly increase the likelihood that a small business will become insolvent. Mr Taylor, an official liquidator of the Victorian Supreme Court, illustrated this point in his witness statement:

> *If the small business exemption was removed and the quantum was increased it would effectively make most small businesses technically insolvent.*[35]

78. Smaller firms are also likely to need to make greater use of retrenchments. Unlike large businesses, small firms have less capital to liquidate in times of financial difficulty and don't have alternative options such as divesting, diversifying or the redeployment of staff, capital or any other factors of production. Instead, they are confined more tightly to their core activities and structures.[36]

79. Also, inherent in the nature of small businesses, management is often in a process of experimentation and learning. The Productivity Commission material presented by the ACTU states that:

> *Economies get better through a process of experimentation and natural selection. New entrepreneurs constantly introduce new production processes and offer consumers new products. During this process some businesses survive and prosper, but others fail...* [37]

80. In this context, retrenchments can be seen as an essential tool for small business adjustment throughout start-up and learning periods. Also, small firms aren't able to readily hire expertise and hence have less capacity to forecast or predict changing circumstances such as demand.

81. For this reason, increased severance payments will especially inhibit small businesses in operating flexibly and being able to adjust to negative shocks. Research suggests that small firms that remained

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[35] Exhibit B 4, Attachment M.
[36] Michael, S. & Robbins, D., (1998) 'Retrenchment among small manufacturing firms during recession', *Journal of Small Business Management*, July.
[37] Bickerdyke, I., Lattimore, R. & Madge, A. (2000) 'Business Failure and Change: An Australian Perspective', Productivity Commission Staff Research Paper, December in Exhibit ACTU 3, Tag 2, p.30.

profitable or quickly returned to profitability during a recession did so through effective retrenchment strategies.[38] Retrenchments are therefore essential for small firms to reduce costs in order to survive during these times. The ACTU's claim has the potential to further increase financial stress, raising the danger of closures and insolvency.

82. The small business paper presented by the ACTU also directly contradicts its contention that small businesses do not have less capacity to pay severance.[39] The authors consider the particular needs of small business in dealing with Employment Protection Legislation (EPL). Severance pay is clearly like the examples of such legislation provided in the paper, in the sense that severance also affects *"conditions for the exit of an employee"* and can *"adversely affect hiring"* as is explained below in this Appendix. The authors note that "*arguably, small employing firms may find such legislation more costly than larger business*". Reasons cited for this include that:

> *...they have less capacity to economically develop high quality recruitment practices which reduce the probability of an employee mismatch; and*
>
> *they are more likely to need to develop a protocol for the dismissal of a worker than a large business…(which) would often have such systems in place, even if not legislatively required.*

83. Therefore, the ACTU's claim will mean that small business will bear a disproportionate burden and hence experience a greater propensity to become insolvent and have a reduced pool of finances to draw upon in order to expand, innovate and ultimately survive.

Business Exits

84. With respect to business exits, the ACTU has made a number of assertions in both Exhibit ACTU 1[40] and Exhibit ACTU 8.[41] Using the Productivity Commission's report as the source of data, the ACTU

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[38] DeDee, J. & Vorhies, D. (1998) 'Retrenchment activities of small firms during economic downturn: An empirical investigation', *Journal of Small Business Management*, July.
[39] Revesz, J. & Lattimore, R. (1997) 'Small Business Employment', Industry Commission Staff Research Paper, August at Exhibit ACTU 3, Tag 3, p. 190.
[40] Exhibit ACTU 1 at paragraph 32.
[41] Exhibit ACTU 8, Tag 1, at paragraphs R65-R67.

highlights four main points with respect to the characteristics of business exits.

- The single greatest reason for a business to exit is to realise a profit;
- of the 7.5 per cent of businesses who exit in any year only 0.5 per cent are bankruptcies or insolvencies;
- just over a quarter of small businesses cease in the first five years and around half cease in their first 15 years; and
- many business exits are anticipated years before they actually occur.

85. Clearly in making these assertions the ACTU is attempting to demonstrate that the vast majority of business exits are anticipated and to realise a profit and hence imply that businesses for the most part are able to sufficiently fund severance requirements. The assertions rely on a flawed interpretation of the evidence. Evident in the ACTU's assertion is the misconception that all business exits (sale and closures) will involve retrenchments. This, however, ignores the fact that the sale of businesses, which are often sold to realise a profit, do not necessarily entail retrenchments.

86. Given this misconception, the ACTU asserts that the single greatest reason for business exits is to realise a profit. This is based entirely on evidence obtained from research conducted by Watson and Everett[42] (paper included at the end of Attachment A of Appendix 7 of Exhibit C/W 4). The data, drawn from Watson and Everett, however, are misleading in the context of this case as they encompasses business exits both in the sense of business cessation and changes in ownership. The findings of this research which the ACTU and the Productivity Commission rely on are examined in detail in **Attachment A**.

87. In summary, our analysis demonstrates what would be expected – the majority of business exits that are initiated to realise a profit involve the sale of the business. They do not involve the closure of the business and consequent retrenchments. The ACTU is therefore wrong when it suggests that because many business exits are initiated to realise a profit businesses can afford retrenchments.

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[42] Bickerdyke, I., Lattimore, R. & Madge, A. (2000) 'Business Failure and Change: An Australian Perspective', Productivity Commission Staff Research Paper, December in Exhibit ACTU 3, Tag 2, p. 20.

88. The ACTU in its reply submission made a number of criticisms of the analysis undertaken by the Commonwealth. The ACTU tries to discredit the arguments presented by the Commonwealth by asserting that the Commonwealth has manipulated the data presented by Watson and Everett by only taking into account those businesses that have ceased to exist and that this *"does no more than muddy the waters in considering the reasons for business exits"*.[43]

89. The Commonwealth, as also outlined in more detail in **Attachment A**, challenges the strict compatibility of the Watson and Everett results with the relevant ABS data. The study is limited to small businesses in major shopping centres and the results, as the authors themselves caution, may not be representative of the broader population of small businesses.[44] One likely reason for this is that shopping centre managers carefully screen, monitor and support tenant businesses in a number of ways, thus reducing their failure rate. Also there seems to be a significantly greater propensity to change ownership in the Watson and Everett findings then those drawn from the ABS data.

90. If used, however, as the Productivity Commission has, to get an indication of the proportion of solvent failure as a subcomponent of those businesses that cease to exist, it seems logical and methodologically accurate to only use the data that pertain to those businesses that do indeed cease to exist.

91. The Watson and Everett study shows that if the business exit rate is restricted to mean only business cessation, the proportion of business exits (cessations) to realise a profit falls significantly from 3.4 per cent (or 36 per cent of business exits) to 0.6 per cent (or 15 per cent of business exits). This puts the reason of 'to realise a profit' behind the reasons of 'to prevent further losses', 'unknown', 'didn't make a go of it' and places profit realisation only marginally above 'bankruptcy'. The premise, therefore, that the majority of business cessations are to realise a profit is simply unfounded and wrong.

92. The overall business exit rate, used by the ACTU and Productivity Commission, of 7.5 per cent is taken from ABS data. Also taken from the

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[43] Exhibit ACTU 8 at paragraph R66.
[44] Watson, J. & Everett, J. (1996) 'Do small businesses have high failure rates?: Evidence form Australian Retailers' *Journal of Small Business Management*, October, page 52.

ABS is the more relevant subset of exits due to business cessation, amounting to 6.0 percentage points.[45]

93. Using data for just those businesses which cease to exist suggests that about 3.7 percentage points of the 6.0 percentage point component of exits is due to solvent failure. This is almost double the 2.0 percentage point figure reported by the Productivity Commission.

94. If a further 0.5 percentage points representing exits due to insolvencies is added, the proportion of total exits due to poor financial performance rises to 4.2 percentage points. In other words, almost 56 per cent of all business exits, including change of ownership, may be due to financial losses or failure, rather than for the realisation of profit or gain.

95. With respect to the ACTU's assertion that *"many business exits are anticipated years before they actually occur"*,[46] the data produced by the Productivity Commission in fact shows that the overwhelming majority of business exits (78 per cent) were not anticipated, compared to only 22 per cent that were anticipated.

96. It seems logically plausible to also assume that a proportion, if not a substantial proportion, of these anticipated exits were as a result of a change in ownership and therefore it is hardly accurate and highly misleading to imply that many business <u>cessations</u> are anticipated years before. In fact by doing so the ACTU itself is *"muddying the waters"* with respect to this issue.

97. Lastly, the ACTU makes the statement that *"…just over a quarter of small businesses cease in their first 5 years and around half cease in their first 15 years"*.[47] It is unclear what the ACTU is actually asserting in this point. However, the data used here importantly show that small businesses are twice as likely to cease in the earlier years of operation. This seems to fall slightly as the age of the business increases – however, even after 15 years of operation small businesses are 1.7 times more likely to cease than large businesses.

98. The ACTU also proceeds to argue in Exhibit ACTU 1 that, although small business employment is important, employment growth for small

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[45] ABS (1997), Business Exits Australia 1994-95 and 1995-96, Occasional Paper, Cat. No. 8144.0, ABS Canberra.
[46] Exhibit ACTU 1 at paragraph 32.
[47] Ibid.

business has been significantly weaker than that of larger business.[48] It states that from March 1992 to March 2001 employment grew at an average annualised rate of 2.3 per year for small business compared to 3.5 per cent for large business.

99. However, to produce these figures the ACTU has used total small business employment and therefore includes owner-managers, self-employed persons and unpaid family helpers. These groups which are particularly prevalent in small business employment do not receive severance entitlements. When examining only small business employees, the employment growth for small business over this period appears equivalent to that of large businesses at 3.5 per cent per year.

100. Also, it is important to note that the time period selected by the ACTU for this comparison particularly suits its case. If the full extent of the data provided as evidence is used (that is, March 1990 to December 2001 instead of just March 1992 to March 2001), employment growth becomes substantially higher for small business (2.4 per cent) than for larger business (2.1 per cent) and therefore highlights the importance of the small business sector in terms of employment growth.

The indirect costs of the claim

<u>In the labour market</u>

101. A large body of international research which is examined in **Attachment C** demonstrates that large firing costs make employers reluctant to hire job seekers who appear to be of doubtful productivity. Cross-country comparisons by the OECD show that this reduces the employment rates of youth and women and tends to raise their unemployment rates.[49] Severance pay is an important form of firing costs.

102. Furthermore, the higher cost of firing causes it to become less frequent but more notable. Consequently, dismissed workers will carry a

[48] Ibid, paragraph 34.
[49] OECD Employment Outlook June 1999 ‘Employment Protection and Labour Market Performance’.

"*stigma*" as Canziani and Petrongolo call it, making them unattractive to employers and reducing their re-employment prospects.[50]

103. If severance pay is increased, retrenching firms will no doubt wish to gain greater productivity benefits from workforce restructuring. Realising this, recruiting firms will be concerned that retrenchees have been selected according to their performance even if other retrenchment methods such as 'last in first out' are still in general use.

104. The ACTU's own evidence clearly demonstrates that employers tend to have negative or at least stereotypical perceptions of retrenchees.[51] Professor Webber (Exhibit ACTU 8, page 60, paragraph 1.4) is wrong to dismiss the findings of Canziani and Petrongolo[52] as, whilst firing and redundancy are different processes, they can produce the same perceptions in the minds of prospective employers regarding the productivity and employability of previously employed jobseekers. Consequently, the ACTU's claim could harm the re-employment prospects of retrenched workers, the very group they are trying to help. Even though retrenchees may lose their job through no fault of their own, their re-employment prospects will be reduced, in all likelihood, if their retrenchment cost their previous employers substantial amounts through severance entitlements.

105. Taking a broader view of the labour market, large severance entitlements will act to stifle the flows of individuals between labour market states. The unemployment pool becomes stagnant due to the lower inflows and outflows. A larger portion of the population becomes trapped in long-duration unemployment or a pattern of cycling between unemployment and temporary jobs.

106. Again, the ACTU's evidence shows that many retrenchees, especially those who are older or have few marketable skills, are particularly at risk of long term unemployment.[53]

107. In contrast, the importance of rapid job search, acceptance of available jobs and use of stepping stones in recovering from retrenchment

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[50] Canziani, P. & Petrongolo, B. (2000) 'Firing Costs and Stigma: A Theoretical Analysis and Evidence from Micro Data', page 20.
[51] Webber, M. and Weller, S. (2002) 'Retrenchment and Labour Market Change' Exhibit ACTU 2, Tag 1, pages 6 & 29 and M Wooden (1988) 'The Impact of Redundancy on Subsequent Labour Market Experience' Exhibit ACTU 2, Tag 4.
[52] Exhibit ACTU 8, Tag 2, p.60, paragraph 1.4.
[53] Webber, M. and Weller, S. (2002) 'Retrenchment and Labour Market Change' Exhibit ACTU 2, Tag1, pages 29-32.

is shown by material submitted by the ACTU. Wooden reports that 'job snatchers' who seek out and accept available jobs as a stop gap measure after redundancy and then search for another job that makes better use of their skills tend to do better than those retrenchees who prolong job search in order to find a higher quality job initially.[54]

108. It is important to note here that the material presented by the ACTU also shows that prolonged unemployment leads to skill loss, premature retirement, discouraged job search and financial losses for retrenched workers.[55] Retrenchees' families, the broader community and the whole Australian economy are also affected for the worse by long term joblessness, as **Attachment C** of this submission explains.

109. This highlights a critical weakness of the ACTU's sole claim regarding the economic benefits of a new severance standard.[56] In making this claim, the ACTU refers to Webber and Weller's assertion that severance pay leads to prolonged job search which enables a better match between unemployed workers and vacancies, and thereby reduces labour adjustment costs.[57] This assertion is made despite their preceding and detailed examination of the problems of long term joblessness among retrenched workers.

110. To the extent that this better matching is actually achieved by prolonged job search, its benefits could be easily overshadowed by the costs of long term joblessness, a danger which is clearly increased if retrenched workers decide not to focus on immediate job opportunities.

111. Excessive severance pay renders the labour market as a whole less flexible and responsive to shifts in the state of the economy. While job loss may not be as severe in downturns, job growth is weaker during upswings. Job creation and destruction rates slow, with the result that the labour market is unable to quickly adjust to new technology and other forms of structural change. The effects of labour market adjustment will be more focused on those who become unemployed for longer periods.

112. Severance pay may place upward pressure on wages by sharpening the difference between protected workers ('insiders') and the

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[54] Wooden, M. (1988) 'The Impact of Redundancy on Subsequent Labour Market Experience' Exhibit ACTU 2, Tag 4, p. 104.
[55] Webber, M. and Weller, S. (2002) 'Retrenchment and Labour Market Change' Exhibit ACTU 2, Tag 1, pages 29-35.
[56] Exhibit ACTU 1 at paragraph 52.
[57] Webber, M. and Weller, S. (2002) 'Retrenchment and Labour Market Change' Exhibit ACTU 2, Tag 1, page 38.

unemployed and temporary workers ('outsiders'). The protection offered by severance pay allows insiders to extract higher wages with less concern about adverse consequences for their continued employment. This has a negative effect on employment and economic activity.

113. There is some evidence of reductions in the overall employment level due to large firing costs which render the labour market and economy less dynamic and productive. Hopenhayn and Rogerson find that a tax on dismissals equal to one year's wages reduces long-run employment by roughly 2.5 per cent.[58]

114. Much of the research which informs the Commonwealth's concern about the ACTU's claim, especially regarding its effect on job losers and unemployed people, has examined European countries, sometimes comparing them with the United States. The OECD's research covers a broader range of member countries including Australia. It generally confirms the results of the more country-specific studies. Taken together, the entire body of research makes it clear that firing costs resulting from severance payments or strict regulation of dismissal or other requirements such as lengthy notice periods have a harmful impact on the labour market.

115. The OECD's survey gives Australia a relatively low ranking for severity of EPL among member countries. This is a broad term encompassing severance pay, unfair dismissal and reinstatement procedures, the use of temporary contracts and so on. In terms of dismissal costs alone, however, Australia is a middling performer in the OECD's scale.

116. Furthermore, the ACTU's claim would cause a very large increase in severance entitlement, particularly with regard to small business and casual employees. At the same time, European countries are removing or easing restrictive and costly labour market controls, particularly by allowing greater use of temporary employment which does not carry large firing costs. In this context the OECD and other research sounds a clear and consistent note of caution and is not irrelevant to Australia or this case.

117. In conclusion, the ACTU's claim will adversely affect the labour market by stifling its operation, despite Professor Webber's assertions to

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[58] Hopenhayn, H. and Rogerson, R. (1993) 'Job Turnover and Policy Evaluation: A General Equilibrium Analysis' *Journal of Political Economy*, vol 101, no 5.

the contrary.[59] Professor Webber raises the issue of the complexity of the labour force with, for example, gender based segmentation being affected by factors other than severance pay. To assert other factors matter is not the same as saying increased severance pay does not matter. The Commonwealth is not arguing other factors won't affect employment levels in general or employment of particular groups. What the evidence presented by the Commonwealth does indicate, however, is that increased severance pay will negatively affect employment.

<u>Raising the costs on adjustment and innovation</u>

118. The ACTU's outline of contentions asserts that the losses experienced by retrenched workers *"are complemented by reciprocal benefits to employers and the national economy* and that *the losses to employees should be compensated for by a transfer of resources from those who benefit"*.[60] These assertions seem to rest on a simple principle of fairness. However, the appeal to this principle masks the complex reality of benefits and costs associated with retrenchments, a reality that is not reflected in the ACTU's contentions. Professor Webber under cross-examination conceded that there will be cases in which employers that retrench do not capture any benefits that can be distributed as severance pay.

> *[Professor Webber] But a firm that is struggling to survive, that is hit with a significant drop in demand which might be because of the drought or the drop in tourism, by the Asian economic crisis, if it is hit with a sudden, significant drop in demand, and it will have to retrench workers, not to get additional benefits but just to continue to survive. Where does it get the - there are no reciprocal benefits there that can be distributed as severance pay, are there? --- Well, I thought that I had conceded or agreed, depending on what you think the appropriate word is - I thought that I had said that there will be cases where firms do not get benefits out of, in that sense, of what is going on, but that is indeed the case. I - - -*[61]

Therefore, in many cases imposing the cost of severance pay on firms is economically inefficient when the benefits go to the community, not employers.

119. From the perspective of the firm, retrenchment may not confer benefits that can be provided to its workforce. This is clear in the case of

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[59] Exhibit ACTU 8, Tag 2, paragraph 1.6.
[60] Exhibit ACTU 1 at paragraph 15.
[61] Transcript, 28 May 2003 at PN1416.

business closure due to insolvency. In the paper prepared for the ACTU, Webber and Weller acknowledge that the benefits will accrue to the insolvent business's competitors.[62] This would include the competing firms' workforces which may expand or gain wage increases if reduced competition allows surviving firms to expand their output.

120. The AWIRS of 1990 and 1995 provide information about the link between financial pressure in ongoing businesses and retrenchments. The two surveys show that lack of demand, the need to achieve savings and other forms of financial pressure are key reasons for workforce reductions, cited by at least 51 per cent of workplaces with 20 or more employees making such reductions in 1990 and at least 38 per cent in 1995 (see **Attachment A**).

121. Only a very small proportion of retrenched workers and workplaces making workforce reductions point to causes like 'new technology', 'cutting edge innovation' or 'rapid growth' which might, under favourable developments, lead to higher revenue. Both the *Retrenchment and Redundancy* survey[63] and AWIRS 95[64] refer to roughly 5 per cent of retrenched workers and shrinking workplaces respectively in this situation.

122. Consequently, it is probable that a large proportion of retrenchments are a response to adverse circumstances or poor performance. In these cases retrenchments may be necessary to make the savings which allow survival of the firm. Increasing severance payments would jeopardise that survival and endanger even more jobs.

123. Just as some workers benefit from the change afforded by retrenchment, it is part of a process of change and growth that underlies a productive economy. The ACTU's reference to the 'national economy' in paragraph 15 of its contentions attests to these broad benefits of retrenchments, as does its evidence concerning the national productivity benefits of business failure and closure.[65] **Attachment D** of this appendix explains in more detail how retrenchment forms part of the process of structural adjustment which, if responded to positively, will facilitate growth and improvements in living standards.

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[62] Webber, M. and Weller, S. (2002) "Retrenchment and Labour Market Change", Exhibit ACTU 2, Tag 1, paragraph 48.
[63] ABS, Retrenchment and Redundancy Survey, Cat. No. 6266.0, July 2001 and July 1997.
[64] Moorhead, Alison; Steele, Mairi; Alexander, Michael; Alexander; Stephen, Kerry; Duffin, Linton (Department of Workplace Relations and Small Business) 1997 *Changes at Work the 1995 Australian Workplace Industrial Relations Survey*. Longman, South Melbourne.
[65] Bickerdyke, I., Lattimore, R. & Madge, A. (2000) 'Business Failure and Change: An Australian Perspective', Productivity Commission Staff Research Paper, December, Exhibit ACTU 3, Tag 2, p. 29.

124. With the broad scope of benefits in mind, it is important to note that the ACTU in its material has only focussed on the costs of retrenchment to the employee and has failed to take account of the resulting broader and potentially greater costs to the economy if the claim is successful.

125. By raising firing costs and hence inhibiting labour adjustments, the ACTU's claim will hamper structural change. This will impose costs to society in the form of reduced potential for economic and employment growth and for higher living standards.

126. Many forces constitute structural change (see **Attachment D**). These include globalisation and more open trade policy, technological innovation, evolving consumer preferences and demographic and social shifts. The Australian economy is subject to all of these forces and undergoing widespread change.

127. To remain competitive within this environment, industries and firms innovate and adapt. If successful, this claim will impact greatly upon the type, level and success of firms' responses. Often innovation and adaptation requires change not only in the structure of the organisation but also of the type and level of work required. In order to innovate and adapt successfully, firms need to adjust their workforce, shedding skills that have become obsolete and gaining new skills that are required, or sometimes simply reducing in size.

128. Although down-sizing helps firms to boost productivity and efficiency, it does not always achieve the desired outcome. Given the increasingly competitive and unpredictable economic environment in which firms now operate, having to respond quickly to unforeseen problems can lead to ineffective retrenchment strategies. Nonetheless, retrenchment remains an integral means for firms to keep their businesses operating.

Innovation and retrenchment

129. The ACTU argues that the benefits generated by restructuring, including innovating and adopting new technologies, should be redistributed to those employees that bear the direct cost of retrenchment. However, studies discussed below show that in many cases firms do not gain an *extra*ordinary benefit (that is, short term excess profit in the economic sense) from the processes of innovation and adaptation. In fact,

such changes are required for firms to simply remain competitive and survive.

130. The Productivity Commission (then Industry Commission) appears to concur with this point, stating that:

> *In many industries, R&D is an essential continuing requirement simply to maintain competitiveness in the face of rapid technological change and increasingly sophisticated consumer needs…Firms not only undertake R&D to steal a competitive advantage. They are also forced to innovate to survive.*[66]

131. Economic theory suggests that competitive pressures drive the internal rate of return to innovation to the market rate – that is, as the intensity of competition increases the returns to innovation decrease. [67]

132. However, this is not to say that firms don't receive any benefits or rents from innovation. Innovation in most cases ultimately enhances the firms competitive position against rivals. However, it is important to note that rents or economic profit are often eroded once other firms begin mimicking the new product or service. Geroski acknowledges this by stating:

> *…innovation is…likely to have an effect on performance which occurs immediately after its arrival, but this effect is likely to be transitory: profits and growth will be elevated above 'normal' levels for only as long as the innovator can defend itself from rivals.* [68]

133. Geroski, in his work, also examines the effect of the process of innovating generally on a firm's performance. On this point he draws the following conclusion:

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[66] Industry Commission (1995) 'Research and Development', Industry Commission Inquiry Report No. 44.

[67] Jackson, J., McIver, R., McConnell, C., Brue, S. (1994) 'Economics' McGraw Hill Book Company Sydney, page 585. Samuelson P, (1976) 'Economics' McGraw Hill Book Compnay, New York, page 747.

[68] Geroski, P. (1994) 'Market Structure, Corporate Performance and Innovative Activity', Clarendon Press, Oxford.

> *…the process of innovation transforms the firm itself, building up its internal capabilities in a variety of ways that create generic differences between innovating and non-innovating firms.*
>
> *..large fixed differences in profitability exist between innovators and non-innovators, but these differences are observable only in recessions. That is, innovating firms appear to differ generically from non-innovators in ways which make them less sensitive to cyclical downturns.*

134. This clearly demonstrates that innovative processes implemented by firms play an essential role in assuring that firms have the capacity to remain profitable during times of economic downturn. This may even reduce the likelihood of further retrenchments during such times.

135. The ACTU's claim would inhibit this innovative process and further reduce the rents that are obtained through innovation. The OECD argues that firing restrictions may increase the implementation costs of innovations by hindering labour adjustments (for example, downsizing and/or restructuring of the workforce), which are often needed after innovations have been introduced.[69] Also, the OECD points to evidence that countries with a decentralised industrial relations system, especially with respect to wage setting, are more sensitive to the adjustment costs imposed by firing restrictions.

136. The OECD's own analysis of member countries shows that EPL, including severance pay, has a significant negative impact on innovation, especially in the high-tech industries of countries with decentralised wage setting arrangements. This is exploratory work. However, the reporting of this research in one of the OECD's flagship publications *The Employment Outlook* shows that the results have been given some weight by the organisation.[70] They should not be dismissed lightly, contrary to what the ACTU suggest.[71]

137. Australia is classed by the OECD as having a decentralised industrial relations system with a low level of coordination and centralisation, particularly with regard to wage setting. Australia also receives a low rating for severity of EPL, considered as a whole. In terms

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[69] Bassanini, A. & Ernst, E. (2002) 'Labour market institutions, product market regulation, and innovation: Cross-country evidence', OECD Economics Department Working Paper No. 316.
[70] OECD (2002) 'And the twain shall meet: cross-market effects of labour and product market policies', The Employment Outlook, July, pp. 245-300.
[71] Exhibit ACTU 8, Tag 1, paragraphs R174-R175.

of the direct cost of dismissals (including severance pay), however, Australia does not score so well being ranked tenth out of 18 OECD countries.[72]

138. Under cross- examination Professor Webber acknowledged that the latest OECD research showed that Australia is in the middle of the range of existing legislative frameworks for severance pay.[73] The ACTU asserts in its final written submission that if its claim were granted, it would have little impact on Australia's relative ranking (paragraph 494). However, the ACTU bases its assertion on the ranking methodology used in the 1999 OECD paper.[74] This ranking methodology is very different to the factor analysis that was used to rank countries in the 2000 OECD paper referred to above.[75] It is the ranking provided by the 2000 OECD paper that Professor Webber acknowledged. Furthermore, the ranking was calculated using the employment duration categories of 'more than 9 months', 'more than 4 years' and 'more than 20 years'. These categories are too broad to accurately capture the impact of the claim which impacts most on medium duration categories. As a consequence, the ACTU's argument that granting the claim would not significantly increase the mean unemployment duration fails.

139. By inhibiting labour market flexibility, the ACTU's claim for dramatically increased severance payments will reduce the incentive for Australian firms to develop and adopt new technologies, especially within our low-tech industries.

140. More broadly, research by Abraham and Houseman (see **Attachment D**) suggests that severance pay in particular has a significant impact on the speed of labour adjustment.[76] Their results demonstrate, by comparing countries with different levels of severance pay, that the adjustment of labour to changing levels of demand occurs much faster in countries with low levels of severance pay.

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[72] Nicoletti, G., Scarpetta, S. & Boylaud, O. (2000) 'Summary indicators of product market regulation with an extention to employment protection legislation', OECD Economics Department Working Papers No. 226. p,48 and 82.
[73] Transcript, 27 May 2003 at PN959.
[74] OECD Employment Outlook June 1999 'Employment Protection and Labour Market Performance' Exhibit ACTU 26, Annex 2.B, page 115.
[75] Nicoletti, G., Scarpetta, S. & Boylaud, O. (2000) 'Summary indicators of product market regulation with an extension to employment protection legislation', OECD Economics Department Working Papers No. 226, pp. 48 and 82.
[76] Abraham, K. & Houseman, S. (1994) 'Does employment protection inhibit labor market flexibility? Lessons from Germany, France and Belgium,' in Social protection versus economic flexibility, ed. by Blank, R., The University of Chicago Press, Chicago.

141. If granted, the ACTU's claim will greatly decrease a firm's ability to operate efficiently and productively through the use of retrenchments. Increased severance pay will increase costs associated with the adoption and development of innovations and the adjustment of inefficient organisational structures. Ultimately, this claim will hinder the competitive and productive development of not only the national economy but also the industries and firms that operate within it.

Conclusion

142. If successful, the ACTU's claim would have a significant impact on the economy. The addition to the total private sector wages bill could be 0.38 per cent under very plausible assumptions during some future labour market downturn. There is no sense in making firms' adjustment processes more expensive, particularly considering the current degree of risk to a generally positive economic outlook.

143. The ACTU has asserted, with no substantive evidence, that small business is just as capable of paying severance as larger firms. This Appendix has pointed to a range of evidence which shows the contrary – small businesses will experience greater difficulty in meeting the new standard. Our submission demonstrates that small businesses have been exempted from severance pay for very good reasons, and the exemption should continue.

144. Furthermore, the ACTU has not acknowledged the large body of research that points to the broader impact of severance pay on the labour market and the economy. Increased severance pay will exacerbate problems of entrenched unemployment. The claim would make retrenched workers more susceptible to this state. The higher levels of job protection afforded by onerous severance standards could allow protected workers to press for larger wage increases with negative consequences for the economy as a whole.

145. Finally, high levels of severance pay will hamper processes of adjustment and innovation which help to build economic resilience and to foster growth in an economic environment which is characterised by rapid and far reaching change.

ATTACHMENT A: RETRENCHMENT, WORKPLACE CHANGE AND BUSINESS EXIT IN AUSTRALIA

The incidence of retrenchment in the workforce

1. The most detailed information on retrenchments in Australia comes from the ABS's *Retrenchment and Redundancy* survey which has so far covered two three year periods, from July 1994 to July 1997 and July 1998 to July 2001.[1] While use of this survey provides valuable information about specific aspects of retrenchment, its estimates for the number of employed people who were retrenched over each three year period appears to be too low. Within the three year period covered by each survey the number of retrenched workers in the year immediately preceding the survey is much larger than for earlier years.

Figure 9A.1: Estimates of redundancy and retrenchment numbers – Retrenchment and Redundancy Survey: '000

Survey Date	Period for the Estimate	Actual Estimate	Full-year Equivalent
	Jul- Dec 1994	70.6	141.2
July 1997	1995	152.8	152.8
	1996	264.3	264.3
	Jan-Jun 1997	194.7	389.4
	Jul-Dec 1998	78.3	156.6
July 2001	1999	138.3	138.3
	2000	208.2	208.2
	Jan- Jun 2001	171.6	343.2

Source: ABS Retrenchment and Redundancy July 2001 and July 1997 (Cat No 6266)

[1] ABS Retrenchment and Redundancy July 2001 and July 1997 (Cat No 6266).

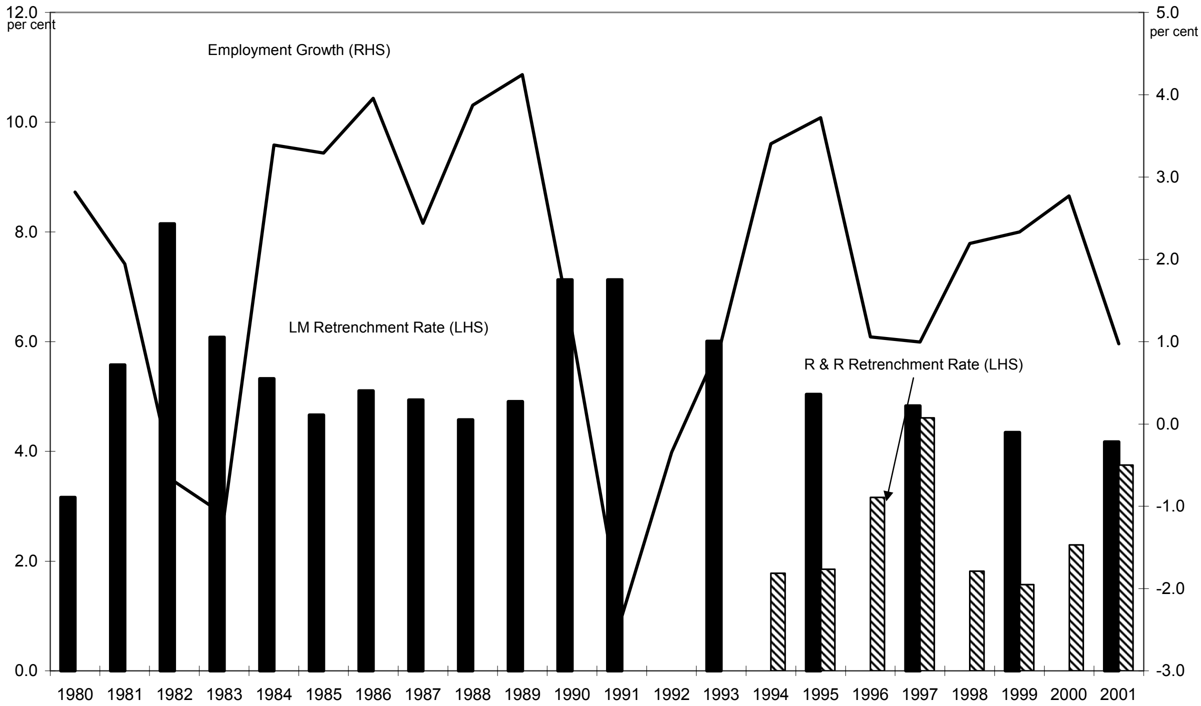
2. Figure 9A.1 shows the estimates of retrenchment numbers for the entire workforce in each year covered by the survey. Full year equivalent values have been calculated by doubling the published estimates for 1994, 1997, 1998 and 2001 as the survey covered only six months of these years. It is clear that in full year terms, the estimated number of retrenchments increases the closer the reference period is to the timing of the survey. Perhaps this is due to recall problems on the part of the survey respondents.

3. The ACTU quotes ABS advice in support of its criticism of our doubling of the six monthly estimates to obtain annual estimates. We agree that in some cases seasonal variations might mean that doubling six monthly estimates might not provide accurate annual figures. However, in this case there is no reason to believe (and certainly no evidence) that seasonal variations in retrenchment rates would have any serious effect. The following analysis reinforces this view.

4. Figure 9A.2 compares the estimates of retrenchments from the *Retrenchment and Redundancy* survey, using full-year equivalents as indicated in Figure 9A.1, with estimates derived from the *Labour Mobility* survey which is conducted biennially. The *Labour Mobility* survey asks respondents only about the previous 12 months and should not be as heavily influenced by recall bias. The figure also shows the rate of growth in average employment levels in each calendar year.[2]

[2] ABS Labour Mobility (Cat No 6209).The reference period for the Labour Mobility survey is the 12 months to February of the survey year. While the retrenchment rates for this survey has been calculated with employment data over this period, the average employment levels hardly differ from those calculated over the calendar year.

Figure 9A.2: Retrenchment rates and employment growth rates



Source: ABS Labour Mobility (ABS Cat No 6209) various issues; ABS Retrenchment and Redundancy July 2001 and July 1997 (Cat No 6266)

5. The figure illustrates three important points:

- The results from the *Retrenchment and Redundancy* survey and the *Labour Mobility* survey correspond only in 1997 and 2001, the years in which respondents were answering the *Retrenchment and Redundancy* questionnaire. In 1995 and 1999 the *Retrenchment and Redundancy* survey shows a very large shortfall. While the ABS states that the results of the two surveys are not directly comparable, it is highly unlikely that the stark, time-based pattern evident in the two sets of retrenchment data is due to simple comparability limitations.
- The retrenchment rate fluctuates inversely with the rate of employment growth. The rate jumped quickly to historical peaks of 8.1 per cent and 7.1 per cent in the recessions of the early 1980s and the early 1990s respectively. Once employment growth resumes, retrenchment rates begin to ease, but this improvement is slower than the rapid pace of the recessionary increases.
- The state of the labour market appears to have very little to do with the growth in the retrenchment rate derived from the *Retrenchment and Redundancy* survey between 1994 and 1997 and again between 1998 and 2001. Judging by the consistent behaviour of the rate derived

from the *Labour Mobility* survey, relatively small fluctuations in the rate of employment growth do not have a strong impact on retrenchments. Moreover, the same pattern of growth in the retrenchment rate derived from the *Retrenchment and Redundancy* survey is evident both between 1995 and 1997 when there was some weakening of the labour market and between 1998 and 2000 when a moderate recovery took place.

6. The ACTU's supporting material includes a graph showing the annual retrenchment rate derived from the *Labour Mobility* survey from 1979 to 1998. The retrenchment rate shown in this graph matches that depicted in dark bars in Figure 9A.2 which is also derived from the *Labour Mobility* survey. So, the data presented by the ACTU can be seen as confirming the Commonwealth's assertion that the rates derived from the *Retrenchment and Redundancy* survey understate the prevalence of retrenchments except in 1997 and 2001 when the survey was actually conducted.

7. Further confirmation was given by Professor Webber, one of the co-authors of the relevant ACTU paper, who stated in evidence before the Commission that the long run retrenchment rate is about 5 per cent in Australia.[3] This figure is consistent with the time series based on *Labour Mobility* survey data which is presented in Figure 9A.2, and is close to the actual annual rates between 1995 and 2001. It is also much higher than the rates derived from the *Retrenchment and Redundancy* survey except in 1997 and 2001.

8. Professor Webber agreed that the *Retrenchment and Redundancy* survey data could be tested against the *Labour Mobility* survey data by comparing the retrenchment rates calculated from each source.[4] If the number of retrenchments for the full three year period (mid 1998 to mid 2001) covered by the 2001 *Retrenchment and Redundancy* survey is converted to an annual average, as the ACTU has done in calculating its costings, the associated annual average retrenchment rate is 2.2 per cent, roughly half the rate derived from the *Labour Mobility* survey.

9. The ACTU seems completely unaware that the retrenchment rate it uses in its costings differs so widely from the retrenchment rate that is referred to repeatedly by its expert witness and by the material it has presented to the Commission. As we have indicated above, the number

[3] Transcript, 27 May 2003 at PN1083.
[4] Transcript, 27 May 2003 at PN1298.

of retrenchments used by the ACTU in its costings equates to a retrenchment rate of about 2.2 per cent (this rate is calculated by dividing the annual number of retrenchments used by the ACTU in its costings by the average level of employment over the relevant period). In stark contrast, the retrenchment rate that is repeatedly cited in material the ACTU has provided in Exhibit ACTU 2 and that is given by Professor Webber is around 4 to 5 per cent. The credibility of this widely accepted estimate is reinforced by international evidence - as Murtough and Waite indicate, the rate of retrenchment in other developed countries is close to 5 per cent.[5]

10. In its final written submission the ACTU compounds this error. Rather than recognise the problem and use a higher retrenchment rate, the ACTU appears to use an even lower retrenchment rate in order to revise the cost estimates downwards (for example, see paragraphs 416 and 423 of the ACTU's final written submission). The ACTU's difficulty with retrenchment rates also manifests in paragraph 417 of its final written submission. Here the ACTU argues that the AiG's survey must be wrong because it shows a redundancy rate of 3 per cent where the *Retrenchment and Redundancy* survey records a rate of 12.1 per cent for the same industry sector. The ACTU is wrong about the rate from the *Retrenchment and Redundancy* survey. The rate of 12.1 per cent has been calculated using the total redundancies over the three year period examined by the survey. It should be divided by three to get an annual rate.

11. Because the ACTU uses these low retrenchment rates, its costings seriously underestimate true costs. We have corrected this flaw by recalculating the ACTU's costings using a retrenchment rate of 4.2 per cent. This is the retrenchment rate from the *Labour Mobility* survey for 2001 (using the survey count of 383,200 retrenchments and taking 88.5 per cent of these as being in the private sector). In contrast, the three year figure of 596,400 from the *Retrenchment and Redundancy* survey appears to be a major underestimate of retrenchment levels.

12. The magnitude of cyclical fluctuations in the retrenchment rate coupled with growth in the workforce means that a very large number of retrenchments would probably occur in the next recession. Average annual employment levels grew by 24 per cent between 1990 (just at the onset of the last recession) and 2002.

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[5] Exhibit ACTU 2 at paragraph 154.

13. The ratio of retrenchment rates for 1991 and 2001, based on labour mobility data, is 1.7.[6] If this ratio is applied to the *Labour Mobility* survey count, then the level of retrenchments would increase from approximately 383,200 to more than 650,000 across the entire workforce. The latter number gives an idea of the number of retrenchments which would occur under plausible economic conditions at some point in the future, given a workforce of similar size and composition to that which exists now.

Workforce reductions and redundancies in Australian workplaces

14. The AWIRS, while last conducted in 1995, probably still provides the most comprehensive source of information about workforce reductions, from the perspective of Australian workplaces. The AWIRS surveys of 1995 and 1990 found that a significant minority of Australian workplaces intentionally reduce the size of their workforce. Eighteen per cent of all workplaces with five or more employees did so in 1995, up from the 1990 figure of 13 per cent.[7]

15. Retrenchments are an important method of reducing workforce size and employers seem to have had a growing need to use this method in the 1990s. Compulsory or voluntary redundancies were used by 49 per cent of workplaces with 20 or more employees which made workforce reductions in 1990 and by 74 per cent of such workplaces in 1995.[8] The major reason for this growth is voluntary redundancies which were used by 13 per cent of shrinking workplaces in 1990 and 37 per cent in 1995.

16. However, retrenchment is not the most frequently cited method of workforce reduction. The voluntary turnover rate of labour is significant. This method was used by 20.2 per cent of all workplaces with five or more employees and 14.4 per cent of small businesses in 1995. Natural wastage or attrition was used by over half of those workplaces making workforce reductions (60 per cent in 1990 and 51 per cent in 1995).

[6] The rates derived from Labour Mobility data are used for both 1991 and 2001 (equal to 4.2 per cent and 7.1 per cent respectively) for the sake of consistency, as there are methodological differences between this survey and the Retrenchment and Redundancy Survey.

[7] In AWIRS, a workplace may be a stand alone entity or it may be part of a larger firm or organisation. The ABS definition of 'workplace' is used, specifically 'a single physical area occupied by the establishment from which it engages in productive activity on a relatively permanent basis'. Moorhead, Alison; Steele, Mairi; Alexander, Michael; Alexander; Stephen, Kerry; Duffin, Linton (Department of Workplace Relations and Small Business) 1997 *Changes at Work the 1995 Australian Workplace Industrial Relations Survey,* Longman, South Melbourne.

[8] Proportional data may sum to more than 100 per cent where AWIRS allowed responses to more than one category within a question.

- Redeployment was also used in over a third of these shrinking workplaces which were also part of a larger organisation.

17. Workforce reductions in many workplaces seem to be a response to adverse circumstances or pressure. In Figure 9A.3 below, lack of demand and financial problems were identified by 38 per cent of workplaces in 1995, considerably more than in 1990, as the recession was becoming entrenched. To some extent "decreased costs or increased efficiency" probably also reflects adverse circumstances. It is very likely that these proportions would be much larger if the table covered private sector workplaces only.

Figure 9A.3: Reasons for workforce reductions in workplaces with 20 or more employees and reporting workforce reductions (per cent of workplaces)

Method	1990	1995
Organisational or government initiated restructuring	24	41
Technological change	4	6
Lack of demand for product for service	43	30
Financial problems or difficulties	8	8
Deceased costs or increased efficiency	10	11
Other	11	3

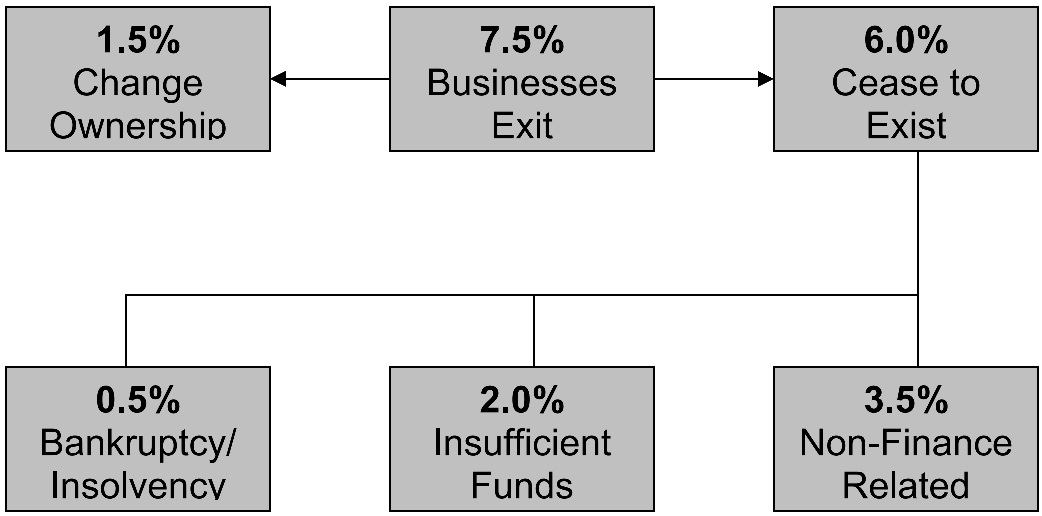
Source: AWIRS 1995, table 4.7, page 76.

Business exit rates

18. Business exits occur for a number of reasons and hence it is important to differentiate between them in order to analyse this subject accurately. The ACTU cites evidence from a Productivity Commission report in paragraph 32 of its outline of contentions as an attempt to do

this.[9] That evidence suggests that of the 7.5 per cent of businesses which exit each year, around one third, or 2.5 percentage points, are either insolvent or have insufficient funds. The evidence is summarised in Figure 9A.4 below.

Figure 9A.4: Breakdown of business exits by reason for exit



Source: Bickerdale et al – see footnote 9.

19. However, there are concerns with the use of these figures. On closer analysis it seems they substantially underestimate the role of financial difficulty in business exits. The key points of concern are set out below.

Applicability

20. The data are derived by the Productivity Commission using both ABS and academic research. There are a number of methodological issues to note.

21. First, the Watson and Everett study used by the Productivity Commission to determine the proportion of exits due to insufficient funds is limited to retail small businesses in major shopping centres and therefore may not be representative of the broader population of small

[9] Bickerdyke, I, Lattimore, R & Madge, A. (2000) 'Business Failure and Change: An Australian Perspective', Productivity Commission Staff Research Paper, December, Exhibit ACTU 3.

businesses.[10] Due to the narrow scope of this study the results should be applied cautiously to general business exit data, a point conceded by the authors themselves.

22. One notable difference between the general ABS data and the results from Watson and Everett is that it seems that retail businesses in managed shopping centres are more likely to change ownership rather than discontinue the business. For example, Watson and Everett show that 60 per cent of business exits are due to a change in ownership, compared to only 20 per cent suggested by the ABS.

23. One possible explanation for this difference is that shopping centre managers carefully screen, monitor and support tenant businesses in a number of ways thus reducing their failure rate.

24. For this reason, there is a question on the applicability of the Watson and Everett study to the ABS data used by the Productivity Commission. This said however, the Commonwealth accepts that there is a limited pool of data available on the number and reason of business exits in Australia and therefore Watson and Everett may be a useful information source.

<u>Reason for Exit</u>

25. Even if we accept the applicability of the Watson and Everett study to the ABS data, however, there are still several issues to be considered regarding the use of the data by the Productivity Commission.

26. The Productivity Commission derives a figure from Watson and Everett that suggests that 28 per cent of businesses exit due to solvent failure (as distinct from bankruptcy). In its calculations, however, the Productivity Commission fails to include the 166 business exits that are classed as unknown and as solvent failures.[11] As can be seen in Figure 9A.5, with the inclusion of these the proportion jumps to 35 per cent.

27. Furthermore, the data used to determine these figures cover both cessations and changes in ownership. The proportion of solvent failures increases substantially to 62 per cent by using data just for those

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[10] Watson, J & Everett, J (1996) 'Do small businesses have high failure rates?: Evidence from Australian Retailers' *Journal of Small Business Management*, October, Exhibit C/W 4, Appendix 8.

[11] 166 of the unknown business exits are classified by Watson and Everett as failed. They justify this by stating: "…it seems reasonable to classify as failed (failed to make a go of it) those businesses where the reason for discontinuance is unknown and the business is liquidated."

businesses which cease to exist. That is more than double the rate used by the Productivity Commission and suggests that in fact about 3.7 percentage points of the six percentage point component of exits is due to solvent failure, much more than the two percentage point figure used by the Productivity Commission.

Figure 9A.5: Business failure rates for various reasons for sale or closure

Reason for sale or closure	Discont. of ownership[(a)]		Discont. of business	
Bankruptcy	179	7%	114	11%
To prevent further losses	415	16%	270	27%
Did not make a “go of it”	267	11%	162	16%
Retirement or ill health	126	5%	37	4%
To realise a profit	916	36%	152	15%
Unknown	329	13%	166	17%
Other – Not failed	277	11%	78	8%
Other – Failed	34	1%	23	2%
Bankruptcy	**179**	**7%**	**114**	**11%**
Solvent Failure[(b)]	**882**	**35%**	**621**	**62%**
Non Finance Related[(c)]	**1482**	**58%**	**267**	**27%**
Total	**2543**	**100%**	**1002**	**100%**

Source: Watson & Everett – see footnote 10.
(a) Discontinuance of Ownership includes those businesses exits that cease to exist and those that change ownership.
(b) Solvent failure includes the reasons “to prevent further losses”, “Did not make a go of it”, “Other – failed” and 166 of the Unknown category (as explained in footnote x).
(c) Non-Finance Related includes the reasons “Retirement or ill health”, “To realise a profit”, “Other – not failed” and the remaining 163 businesses in the Unknown category.

28. If a further 0.5 percentage points representing exits due to insolvencies is added, the proportion of total exits due to poor financial performance rises to 4.2 percentage points. In other words, almost 56 per cent of all business exits including change in ownership, may be due to financial losses or failure, rather than those exits due to non-financial reasons such as to realise a profit or retirement. This therefore indicates that the Productivity Commission’s figure of 33 per cent significantly underestimates the role of financial difficulties in business exits.

<u>ACTU's contention with regard to 'realising a profit'</u>

29. The ACTU claims that the single greatest reason for business exits is to realise a profit. The data used, however, as discussed above, encompass business exits both in the sense of business cessations and changes in ownership.

30. As shown in Figure 9A.6, Watson and Everett clearly show that, if the business exit rate is defined to mean only business cessations, the proportion due to realising a profit falls significantly from 3.4 per cent (or 36 per cent of business exits) to 0.6 per cent (or 15 per cent of business exits).

Figure 9A.6: Business Exit Rates for various reasons for sale or closure.

Reason for sale or closure	Discont. of ownership[(a)]		Discont. of business	
Bankruptcy	179	0.7%	114	0.4%
To prevent further losses	415	1.5%	270	1.0%
Did not make a "go of it"	267	1.0%	162	0.6%
Retirement or ill health	126	0.5%	37	0.1%
To realise a profit	916	3.4%	152	0.6%
Unknown	329	1.2%	166	0.6%
Other – Not failed	277	1.0%	78	0.3%
Other – Failed	34	0.1%	23	0.1%
Total Exits	**2543**	**9.4%**	**1002**	**3.7%**
Total Businesses	**27067**	**100%**	**27067**	**100%**

Source: Watson & Everett – see footnote 10
(a) Discontinuance of Ownership includes those businesses exits that cease to exist and those that change ownership.

31. This puts the reason of "to realise a profit" behind the reasons of "to prevent further losses", "unknown", "didn't make a go of it" and places profit realisation only marginally above "bankruptcy". The premise that the majority of businesses cease to realise a profit is therefore unfounded.

Business cycles

32. The Watson and Everett study was conducted using data over a 30 year period (from 1961 to 1990) which was then added to give the figures in Table 9A.3. This is useful to get an average rate of business exits over the period but fails to show differences due to varying economic conditions. Usefully, Watson and Everett acknowledge this and provide a breakdown of the figures for the various reasons of business exits.

33. These results show that in difficult economic periods, such as the recession in 1982 and the aftermath of the stock market crash in 1987, the level of business exits increase, especially solvent failures. For example, during the 1982 recession, the level of bankruptcies more than doubled, from 0.4 percentage points in 1981 to 1.0 percentage points in 1982. In terms of the stock market crash in 1987, Watson and Everett state:

> *The failure rate under each of the definitions peaked in 1989, a little over a year after the stock market crash of October 1987.*[12]

[12] Watson, J. & Everette, J. (1996) 'Do small businesses have high failure rates?: Evidence from Australian Retailers' *Journal of Small Business Management,* October, p. 54, Exhibit C/W 4, Appendix 8.

ATTACHMENT B: ISSUES RELATING TO THE FINANCIAL COSTS OF THE ACTU'S CLAIM

The small business component of the ACTU's costs

1. The ACTU excludes small business from its calculation of the costs of the existing severance standard because it is largely exempt from that standard. The small business sector is included, but not separately identified, in its costing of the new standard.

2. The ACTU's cost estimate for the existing standard (0.0429 per cent of the wages bill) excludes small business retrenchments. This exclusion is made according to a weighted figure for the small business proportion of private sector employment. While the ACTU does not state the value of this proportion, it appears to be about 31 per cent.[1] With this figure it is possible to calculate the costs which would occur if small businesses were required to meet the existing severance standard. As Figure 9B.1 shows, the hypothetical cost of the existing standard would be 0.0619 per cent of the total wages bill and the small business component would be 0.0190 per cent of the wages bill.

[1] The proportion derived from Wage and Salary Earners ABS Cat No 6248 December 2001 is weighted by 0.8 to account for the lower small business threshold in the definition used for severance standard (15 employees) compared to that in the ABS data (20 employees). From data covering all four quarters of 2001 (which thereby minimises the influence of seasonal patterns) the weighted figure is 30.67 per cent.

Figure 9.1: Identifying the small business component of the ACTU's costs

Item	Proportion of the Annual Wages Bill (per cent)
1. Existing severance pay standard	0.0429
2. Hypothetical addition to existing standard to include small business	0.0190
3. Hypothetical cost of current standard including small business	0.0619
4. Difference between the hypothetical cost of the existing standard and the corrected cost of the proposed standard	0.0699
5. Small business component of the difference between hypothetical cost and the proposed standard	0.0214
6. Total cost of the claim	0.1318
7. Total small business component of the claim (Items 2 and 5)	0.0404

3. The difference between the figure of 0.0619 per cent which hypothetically includes small business under the existing standard and the 0.1318 per cent figure (the corrected estimate for the total cost of the proposed standard) can be attributed to small and larger private sector employers using the same 31 per cent proportion. This small business component is equivalent to 0.0214 per cent of the total annual wages bill.

4. Addition of the two small business components identified in Figure 9.1 yields an estimate of approximately 0.0404 per cent of the total wages bill.

Costs of provision for severance entitlements for all employees

5. These costs are calculated from retrenchment numbers presented in the ACTU's costings and from data on employee numbers and gross earnings from the December quarter *Wage and Salary Earners* survey.[2] The *Wage and Salary Earners* data allow the small business exclusion under the current standard to be factored in, using the same assumption employed by the ACTU.[3]

[2] Wage and Salary Earners, ABS Cat No 6248.
[3] Described at footnote 1 in this Attachment.

6. The data on the number of retrenched workers and their duration of employment provided in the ACTU's Tables 1 and 6 are used to calculate the average costs of retrenchment according to both the old and the new standard. As Figure 9B.2 shows, the distributions of the duration of employment for retrenched workers and the broader workforce differ, but this will not have a major effect on the broad magnitude of the costs of provision for the entire workforce.

Figure 9B.2: Duration distributions of employees and retrenched workers

Duration	Employees (%)	Retrenched Workers (%)
Under 1 year	22.9	29.9
1 year and under 2 years	11.9	14.4
2 years and under 3 years	10.6	8.2
3 years and under 5 years	13.7	11.9
5 years and under 10 years	17.0	13.6
10 years and under 20 years	15.3	14.1
20 years and over	8.7	7.9
Total	**100.0**	**100.0**

Source: Labour Mobility February 2002, ABS Cat No 6209, Retrenchment and Redundancy July 2001, ABS Cat No 6266.

7. For the reasons explained below, the level of average weekly earnings for all employees is used to render the weeks-of-pay entitlement as a cash value. The average costs of retrenchment under the existing and proposed standards are:

- Current standard - $3593;
- Proposed standard - $5539.

8. To determine the expense of making provision for all employees in a firm, the retrenchment costs are multiplied by the average number of wage and salary earners in 2001, drawn from the December quarter 2001 *Employed Wage and Salary Earners* publication.

Figure 9B.3: Calculation of the costs of provision for all employees

	All Wage and Salary Earners		**Wage and Salary Earners in Small Firms**	
	Current Standard	**Proposed Standard**	**Current Standard**	**Proposed Standard**
Average Weekly Earnings ($)	668	668	Na	543
Average Retrenchment Costs ($)	3593	5539	Na	4503
Employees	4,203,260	6,062,500	Na	1,859,240
Provision for Full Retrenchment ($m)	15,101.7	33,581.8	Na	8,371.6
Gross Earnings ($m)	158,670.0	211,308.5	Na	52,638.5
Provision for Full Retrenchment as a Proportion of Earnings (%)	**9.5**	**15.9**	**Na**	**15.9**

9. The resulting costs of provision for full retrenchment are then expressed as a proportion of the gross earnings for wage and salary earners, again drawn from the December quarter 2001 *Employed Wage and Salary Earners* publication. Managers whose conditions are determined under or by reference to awards would be eligible for the new standard. Consequently, it is appropriate to use the broad measure average weekly earnings encompassing both managers and non-managers. Furthermore, the publication does not present gross earnings estimates for managerial and non-managerial employees.

10. The data do show, however, that average weekly earnings are lower in the small business sector compared to the broader workforce. Consequently, small business has a smaller average cost of retrenchment. The costs of provision in the small business sector have been calculated on this basis.

11. It should also be noted that these average retrenchment costs are the average for all employees, including casuals. Earlier in this submission we have referred to average retrenchment costs for permanent (full-time and part-time) employees. The average for permanent employees is higher than those shown above because it is not reduced by the inclusion of casual retrenchees who often would not be entitled to severance pay because of their lower duration of employment.

12. Figure 9.3 presents the key elements of the calculations.

ATTACHMENT C: IMPACT ON THE LABOUR MARKET

Introduction

1. A healthy, properly functioning labour market is characterised by steady, sustainable employment growth, a low unemployment rate, labour turnover that enables structural change and short durations of unemployment.

2. A considerable body of research shows that firing costs and restrictions, including severance pay, have an adverse impact on the labour market. Higher firing costs act to discourage firms from both firing and hiring. Labour market flows are stifled. The incidence of long term unemployment increases and particular groups are rendered more susceptible to it or are more confined to the secondary labour market.

3. By dampening down both hiring and firing, severance pay makes employment less responsive to changes in economic activity. While this may help to soften declines in employment during a downturn, there are significant implicit costs such as keeping non-productive workers in the firm or remaining overstaffed for significant periods of time following reductions in demand.

4. Excessive severance pay sharpens the divide between ‘insiders’ and ‘outsiders’ and between primary and secondary labour markets. There is some evidence that this acts to exacerbate wage pressures and thereby weakens longer term growth rates of employment and the economy.

Labour market flows

5. Severance pay is an obvious disincentive to retrenchment and dismissal of workers. It also inhibits hiring. When deciding whether to create vacancies and in the assessment of new applicants, a firm must consider the likely productivity of applicants against a range of costs including recruitment and training. This must be done in the context of rapid change and a degree of economic uncertainty. Given the difficulty

of making a correct decision about vacancies and applicants, firms will be inhibited by costly firing procedures.

6. By discouraging hiring and firing, stricter severance pay requirements reduce the volume of labour market flows and job creation and destruction. Booth and McCulloch show that firing costs reduce hiring in good times and discourage layoffs in bad times.[1] The result is lower turnover which means that jobs and unemployment spells tend to last longer. The unemployment pool becomes stagnant due to the smaller inflows and outflows. Consequently, a greater proportion of unemployment will be long term in nature.[2]

7. The slowing of job creation and destruction also hampers the process of structural adjustment that forms an important part of a dynamic economy.[3]

8. Professor Webber in Exhibit ACTU 8 states there is a long term need to nurture and reproduce the labour force.[4] Yet as the material in this attachment demonstrates, the ACTU's claim will only hinder the operation of the labour market and its capacity to generate employment. Increasing the TCR standard will give implicit 'protection' to workers already in employment at the expense of new entrants to the labour market. Further, lowering the turnover of existing workers will reduce their capacity to gain labour market experience. Under cross-examination Professor Webber confirmed he accepts the OECD findings that stricter EPL will lower labour market turnover and increase unemployment durations.

> *[Mr Stewart] Yes, and there is a final dot point, a final finding that is unqualified, which says, and I quote:*
>
> *Stricter EPL is associated with lower turnover in the labour market with both jobs and unemployment spells tending to last longer. Fewer workers experience unemployment in any given year in countries with stricter EPL but those becoming unemployed have a greater probability of remaining unemployed for a year or more.*
>
> *I end my quote there. My recollection is that yesterday you accepted that a finding of this research is that, in effect, the stricter EPL, including the severance*

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[1] Booth, A. and McCulloch, A. 'Firing Costs, Unions and Employment' 1996.
[2] OECD Employment Outlook June 1999 'Employment Protection and Labour Market Performance'.
[3] Refer also to Attachment D 'Flexibility, Adjustment and Innovation'.
[4] Exhibit ACTU 8, Tag 2, paragraph 1.1.

pay, can, so to speak, gum up the labour market in that it reduces turnover, protects insiders relative to outsiders and that that - - -?

[Professor Webber] That is what this is saying.

[Mr Stewart] Yes. Thank you?

[Professor Webber] So when I said that yesterday, this is the evidence that I was relying on to say that.

(Transcript, 28 May 2003, PN 1356-59)

Composition of employment and unemployment

9. The problem of reduced labour market flows and turnover is clearly evident in the composition of employment and unemployment. As Canziani and Petrongolo point out, the productivity of applicants with previous labour market experience is easier to assess than that of job seekers who are new entrants or who are returning after a long period of absence.[5] This will obviously affect the relative job prospects of young people and those returning after a period of parenting or other long term caring duties.

10. The OECD[6] has found that high levels of EPL[7] are associated with higher rates of unemployment for youth and women. These two groups also feel the impact of EPL as lower employment rates and a greater likelihood of working in lower paying, temporary jobs. On the other hand, EPL tends to increase the job security enjoyed by prime age men.

11. The ACTU suggests that the Commonwealth's "reliance on *Employment Protection and Labour Market Performance* from the OECD Employment Outlook, June 1999 is misleading".[8] Professor Webber in relation to the OECD article states that correlation is not causation.[9] Correlation is supported by the theory, however, for the fact that raising

[5]Canziani, P. and Petrongolo, B. 'Firing Costs and Stigma: A Theoretical Analysis and Evidence from Micro Data' March 2000.
[6]OECD Employment Outlook June 1999 'Employment Protection and Labour Market Performance' Exhibit ACTU 26.
[7]EPL is the set of rules governing the hiring and terminating of employees. EPL includes items such as severance pay, notice, unfair dismissal and short term contracts.
[8]Exhibit ACTU 8, Tag 1, paragraph 171.
[9]Exhibit ACTU 8, Tag 2, paragraph 1.2.

costs through increased severance pay will have a detrimental affect on employment. Webber also said that the Commonwealth did not refer to the important qualifications contained in the conclusion of the OECD Employment Outlook June 1999 article.[10]

12. The OECD states that cross-country comparisons suggest EPL raises employment for prime age men, with the qualification that *"these correlations become very weak and statistically insignificant when multivariate regressions are used to isolate the causal impact of EPL from that of other determinants of employment"*.[11]

13. However, the OECD considers the bivariate analysis (the findings that EPL reduces employment for youth and women and raises employment for prime age men) to be of value in assessing the impact of EPL:

> *Multivariate analysis may provide a superior assessment of the effects of employment protection on labour market performance since it controls for other determinants of cross- country differences in employment and unemployment.....Although it is desirable to control for other determinants of labour market outcomes, these regression models rely on strong assumptions that may not be justified. As a result, both the bivariate and the multivariate results are of value for assessing the impact of EPL.* [12]

14. Under cross-examination Professor Lewis explained why the multivariate analysis might not show the real impact of EPL provisions. [13] Lewis pointed out that, in the United States, Japan, France and the Scandinavian countries, governments have put in place policies to reduce the incidence of retrenchments. For example, in France the government provides significant subsidies for firms to keep on workers who would have otherwise been retrenched, along with generous retirement schemes for older workers that have been retrenched. Thus Lewis suggests it is very difficult for the multivariate analysis to account for such factors. Lewis also states that reducing labour costs through subsidies (as the French do) to raise employment backs up the thesis that if you increase costs you will have job loss.

15. The concluding paragraph from the OECD research is:

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[10]Exhibit ACTU 8, Tag 2, paragraphs 1.2 and 1.6.
[11]OECD Employment Outlook June 1999 'Employment Protection and Labour Market Performance' Exhibit ACTU 26, p60.
[12]Ibid, p75.
[13]Transcript, 23 June 2003 at PN4032-4034.

> *The implications of these findings for policymaking cannot be reduced to a simple formula. Overall, the analysis confirms that EPL should be monitored closely as part of the continuing process of evaluating and fine-tuning an overall strategy for lowering long-duration unemployment and improving labour market performance generally. As labour market conditions evolve, it should be verified that excessively restrictive or poorly designed provisions for employment protection are not creating barriers to employment for youths or other labour force groups that may face difficulties in gaining access to stable jobs. However, any initiatives to reform employment protection practices have to confront difficult trade-offs, such as whether to lessen job protection for high-tenure workers in order to improve employment opportunities for recent school leavers.* [14]

16. The ACTU is wrong to dismiss the OECD research. The ACTU's TCR claim is inconsistent with the need to exercise caution in altering EPL provisions.

17. In other words, severance pay appears to be one of those factors which reinforce the position of 'insiders', those who work in secure jobs in the primary sector of the labour market, at the expense of a more insecure position for women and youth who tend to be outsiders in the secondary segment of the labour market. From a broader perspective, 'outsiders' include unemployed persons more generally. Their difficulty in finding secure work will be exacerbated if hiring is inhibited.

18. However, EPL can adversely affect those in the primary labour market in certain circumstances. If severance pay reduces overall hiring in the economy, it may lock protected workers into relatively poorly matching jobs by making it more difficult for them to obtain a new position.

19. Professor Webber suggests that *"even greater inequity would be produced in the absence of regulation, in laissez- faire market processes"*.[15] This is an attempt to set up a straw man – the Commonwealth is not arguing for such a scenario and supports the current TCR standard.

20. Furthermore, severance pay acts to disadvantage former insiders who have lost employment in the primary sector. Canziani and Petrongolo argue that larger firing costs will reduce the re-employment

[14] OECD Employment Outlook June 1999 'Employment Protection and Labour Market Performance', p89.
[15] Exhibit ACTU 8, Tag 2, paragraph 1.3.

prospects of dismissed workers by increasing the ‘stigma’ associated with job loss. In an environment with low firing costs, being fired is relatively more common. Hence, dismissed workers carry a weaker signal about their productivity.

21. As firing costs increase, however, dismissal becomes more uncommon. Consequently, it sends a much stronger adverse productivity signal to which employers are more likely to respond. Canziani’s and Petrongolo’s research into the Spanish labour market shows that the increased stigma generated by higher hiring costs mostly affects older workers. Canziani and Petrongolo find that workers who lose their job through a costly firing procedure have worse re-employment prospects than those who terminated a fixed-term contract or voluntarily quit their previous job.

22. It is highly likely that retrenched workers in Australia would also suffer from greater ‘stigma’. If the costs of retrenchment are greatly increased, then those firms which need to make retrenchments will probably try harder to gain greater productivity benefits from workforce adjustments. Consequently, recruiting firms will be concerned that applicants who have been retrenched may have been selected on the basis of individual performance. This could occur even if retrenchment occurs through no fault of employees – for instance, through a ‘last out, first in’ selection process.

23. As Professor Webber states, firing and redundancy is not the same thing in this context. [16] As stated above, however, the findings of Canziani and Petrongolo in relation to firing costs are likely to also apply to workers that have been made redundant. Firing and redundancy are different processes but they can produce the same perceptions in the minds of prospective employers regarding the productivity and employability of previously employed jobseekers. The findings of Canziani and Petrongolo should not be dismissed despite differing conditions such as stricter regulations in the Spanish labour market.

24. Webber claims *“the stigma experienced by retrenched workers at recruitment stems from negative perceptions of work practices in their previous workplace”*. [17] Canziani’s and Petrongolo’s results show that those who lost their job through some costly firing procedure have worse re-employment prospects than others, and this is likely to apply to

[16] Exhibit ACTU 8, Tag 2, paragraph 1.4.
[17] Ibid.

retrenched workers also. Prospective employers are likely to perceive that the productivity of retrenched workers was particularly poor if their previous employers were prepared to use time consuming and expensive procedures in removing them from their workplaces.

Costs of unemployment

25. The fact that the evidence shows that higher retrenchment costs tend to increase the length of unemployment counts strongly against the ACTU's claim. The ACTU's own evidence acknowledges the detrimental impacts of post-retrenchment unemployment.[18]

26. Unemployment imposes very serious costs on individuals and society.[19] Though the research does not always reveal the direction of causality, it generally identifies a close relationship between unemployment and well-being and living standards in the broadest and most complete sense of the term.

27. Unemployment has a considerable impact on the individual. Job loss causes trauma.[20] Unsuccessful job search leads to frustration and discouragement.

28. The skills of unemployed people depreciate as they remain out of work, out of practice and lose professional contacts in the workplace. Sen suggests that unemployment may generate a loss of cognitive abilities as a result of the unemployed person's loss of confidence and sense of control.[21] A lack of success in the labour market is likely to diminish an individual's sense of worth and psychological well-being.

29. Social psychologists connect unemployment to mental health in many forms including depression, anxiety, low self-esteem and strained personal relations.[22] The discouragement that is induced by unemployment can leave unemployed persons resigned to their situation and passive.

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[18]Webber, M. and Weller, S. 'Retrenchment and Labour Market Change' Exhibit ACTU 2, Tag 1, paragraph 59.
[19]Ibid.
[20]Headey, B. 'The Psychological Impact of Unemployment' in P Saunders and R Taylor eds. *The price of prosperity: the economic and social costs of unemployment*, 2002, Chapter 11, pages 213-225.
[21]Sen, A. 'Inequality, unemployment and contemporary Europe' *International Labour Review*, 1997, Vol 36, No 2.
[22]Darity, W. and Goldsmith, A. 'Social Psychology, Unemployment and Macroeconomics' *Journal of Economic Perspectives*, Winter, 1996, Vol 10, No 1.

30. In contrast, employment provides a time structure within a person's day, implies regularly shared experiences and contacts with people in the workplace, links individuals to goals and purposes beyond their own and it encourages participation.[23]

31. Unemployment has also been linked to poor health through, for instance, bad diet and illegal drug use.[24]

32. The impact of unemployment goes beyond the individual. It can weaken the harmony and coherence of relationships such as within families and lead to social exclusion.

33. Unemployment has implications for the wider community. Saunders suggests that areas of high unemployment become increasingly prone to crime.[25] This acts to drive potential businesses and key local services away, further entrenching regional disadvantage and unemployment. As families struggle to cope with the personal crises resulting from unemployment, they withdraw from social life and community interaction.

34. Weatherburn's examination of crime in Australia shows that when unemployment is concentrated within an area it cuts young people off from access to information about legitimate income-earning activities.[26] Also, unemployment tightens economic stress on families with dependent children. This can disrupt the parenting process and increase the risk that children exposed to this disruption will become involved in crime later in life.

Wage setting

35. The level of severance pay can affect wage pressures which will influence the state of individual firms and the broader labour market. Overall, if excessive severance pay tends to trap a portion of the

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[23]Reference to Jahoda, M. 'Economic Recession and Mental Health: Some Conceptual Issues' *Journal of Social Issues*, Fall 1988, Vol. 44, pages 13-23, in Darity, W and Goldsmith, A 'Social Psychology, Unemployment and Macroeconomics' *Journal of Economic Perspectives*, Winter 1996, Vol 10, No 1.
[24]Morrell, L., Taylor, R. and Kerr, C. 'Unemployment and young people's health' *Medical Journal of Australia*, 1998, Vol 168.
[25]Saunders, P. 'The impact of unemployment on poverty, inequality and social exclusion' *The Price of Prosperity: The Economic and Social Costs of Unemployment,* 2002.
[26]Weatherburn, D. 'The impact of unemployment on crime' *The Price of Prosperity: The Economic and Social Costs of Unemployment,* 2002.

population in long-duration unemployment or a pattern of cycling between unemployment and temporary jobs, this may result in an increase in the non-accelerating inflation rate of unemployment (NAIRU). The unemployed become less job-ready and therefore less able to exert a moderating influence on wages through competition in the labour market.

36. An increased NAIRU means inflationary pressures emerge in the economy more quickly as the unemployment rate falls, placing a limit on sustainable economic growth.

37. According to Lindbeck and Snowner an increase in firing costs raises the power of insiders.[27] They have greater ability to extract high wages with less fear of layoff. Blanchard and Summers also argue that wages are negotiated to cater to the incumbents.[28] The consequences are reduced hiring and lower employment than would have otherwise occurred.

Level of employment

38. Large severance pay requirements can result in a labour market that is unable to quickly achieve the volume of workforce adjustment required in response to new technology and other forms of structural change. In a dynamic economy some firms are expanding, some contracting, some exiting and others entering the market at any point in time. The claim to increase severance pay will restrict the economy's ability to respond to changing economic conditions and therefore result in a less efficient use of resources.

39. Some researchers have found that rigidities caused by EPL such as severance pay could lower the overall level of employment. Lazear found there is a significant impact on the labour market from severance pay and that increases in severance pay substantially lower the number of jobs in an economy.[29] Severance pay also reduces the size of the labour force, but not by enough to leave unemployment rates unaltered. Lazear estimates that an increase from zero to three months of severance pay

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[27]Lindbeck, A. and Snower, D. 'Wage Setting, Unemployment, and Insider-Outsider Relations' *American Economic Review* May 1986 cited in Lazear, E 'Job Security Provisions and Employment' *The Quarterly Journal of Economics* August 1990.

[28]Blanchard, O. and Summers, L. 'Hysteresis and the European Unemployment Problem' *NBER Economics Annual* 1986 cited in Lazear, E 'Job Security Provisions and Employment' *The Quarterly Journal of Economics* August 1990.

[29]Lazear, E. 'Job Security Provisions and Employment' *The Quarterly Journal of Economics* August 1990.

would raise the unemployment rate by 5.5 per cent in the United States. Other studies, however, indicate the impact of redundancy pay on the unemployment rate will be minimal, with the major impact being on the composition of employment and unemployment as outlined earlier.

40. Hopenhayn and Rogerson's general equilibrium model shows a tax on dismissal causes firms to be more cautious about job creation and thereby reduces the need for job destruction, with the net result that firms end up making fewer adjustments to their workforces.[30] Further, they find that a tax on job destruction encourages firms to use resources less efficiently. Large welfare losses result because productivity drops and fewer resources are devoted to the market sector of the economy. Any diminished ability to reallocate labour in a flexible manner would tend to lower aggregate productivity levels and growth prospects. Hopenhayn and Rogerson find that a tax on dismissals equal to one year's wages reduces long-run employment by roughly 2.5 per cent.

41. Whilst Professor Webber states *"the price of labour is only one determinant of the number of jobs in an economy"*,[31] it is a very important determinant. Webber refers to Card and Krueger[32] in saying the relationship between wage levels and the number of jobs is complex and non-linear. However, there is an extensive critique of Card and Krueger's research which was presented in the 2002-03 Safety Net Review.[33] Critics have challenged both the methodology underpinning Card and Krueger's analysis, as well as the applicability of their results to other countries. In fact, Card and Krueger themselves emphasise the fact that employment losses can result from increases to a minimum wage already set at a high level. They state that their evidence only applies to a *"moderate range of minimum wages, such as those that prevailed in the US labour market during the past few decades"*. It is also important to note that the negative impact on employment that could result from the ACTU's TCR claim is not offset by any element that is likely to have a positive impact on employment.

42. Further, under cross-examination Professor Lewis discusses the economic and employment impact that will result from the increased cost of the ACTU's claim.[34]

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[30]Hopenhayn, H. and Rogerson, R. 'Job Turnover and Policy Evaluation: A General Equilibrium Analysis' *Journal of Political Economy* 1993 vol 101 no 5.
[31]ACTU Exhibit 8, Tag 2, paragraph 1.5.
[32]Card and Krueger 'Myth and Measurement- The New Economics of the Minimum Wage' 1995, 2000.
[33]Commonwealth Submission, Safety Net Review 2002-03, Chapter 5.
[34]Transcript, 23 June 2003, PN4023-4029.

[Mr Watson] Yes. Now at the - can we go to your first paragraph in 25. You say there the sentence:

Thus any impediments to retrenchments, that is increased costs, would be expected to reduce the ability of firms to restructure and therefore reduce the efficiency of the economy.

Do you see that statement?

[Professor Lewis] Yes.

[Mr Watson] I want to suggest to you that there is no material difference in the efficiency of the New South Wales economy as compared to the efficiency of the rest of the Australian economy?

[Professor Lewis] I could not judge.

[Mr Watson] You could not judge. I want to suggest to you that so far as you are aware there is no difference in the efficiency of South Australian small business, as opposed to small business elsewhere?

[Professor Lewis] Sorry, no.

[Mr Watson] And your statement in paragraph 25 regarding a possible reduction in economic efficiency as a result of increases in retrenchment by pay is not based on any empirical Australian study of the matter?

[Professor Lewis] The statement is based on - partly on economic theory and partly on the empirical evidence on the demand for labour which says that when the costs of labour go up it does cause a reduction in employment.

[Mr Watson] This is - this is the thesis which you have advanced, particularly in relation to minimum wages, that all - all increases in costs have a necessary consequence in the reduction of demand for labour?

[Professor Lewis] That is correct.

(Transcript, 23 June 2003, 4023-29)

Conclusion

43. Redundancy pay appears to have its greatest impact on the dynamics and composition of unemployment. Severance pay reinforces the power of insiders, and at the same time increases the persistence of unemployment by further excluding outsiders because it increases adjustment costs for firms. The barriers to labour market flexibility and the unemployment of particular groups within the labour market that will result from the ACTU's claim are unacceptable. An increase in the TCR standard is not compatible with the competitive labour market that firms and the Australian economy require to prosper.

44. The ACTU's claim will adversely affect the labour market by stifling its operation, despite Professor Webber's assertions to the contrary.[35] Professor Webber raises the issue of the complexity of the labour force with, for example, gender based segmentation being affected by factors other than severance pay. To assert other factors matter is not the same as saying increased severance pay increase does not matter. The Commonwealth is not arguing other factors won't affect employment levels in general or employment of particular groups. What the evidence presented by the Commonwealth does indicate, however, is that increased severance pay will negatively affect employment.

[35] Exhibit ACTU 8, Tag 2, paragraph 1.6.

ATTACHMENT D: FLEXIBILITY, ADJUSTMENT AND INNOVATION

> *…today's environment is full of uncertainty, market changes, changing workforce demographics, social and political pressures and not least of all technological advances making today's organisation one of constant change.* [1]

Economy wide implications

1. The Australian economy, like all capitalist economies, is characterised by a process of continual structural change that enables it to evolve and adapt.

2. The Bureau of Labour Market Research (BLMR) describe this process:

> *Structural change occurs continuously in most economies. It results from many factors including economic growth, changes in technology, and variation in societal attitudes and the international environment. It leads to changes in production, output and income composition of the economy, and is revealed in the redistribution of output, employment and wealth between industries, occupations, regions, social groups and individuals.* [2]

3. Technological change, for example, largely drives economic growth through a process of 'creative destruction' with new technologies inducing more productive and efficient investments but at the same time destroying the economic feasibility of earlier ones. In this sense technological change is a broad process which encompasses new products and services, new production and distribution processes and new forms of organisational structure.

4. Structural change leads to the destruction of jobs in some industries while others are created, often in different industries and requiring

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[1] Luks, A. & Slavery, L. (2000) 'Organisational change: The Australian experience,' *The Journal of Management Development*, Vol. 19, p. 309.
[2] Bureau of Labour Market Research (1987) *Structural Change and the Labour Market,* Research Report No.11.

different skills. Although structural change is an integral part of the economy in terms of raising living standards and economic prosperity, its redistributive effects mean that some individuals will be disadvantaged, while others will benefit.

5. It is important to note, however, that this restructuring of economies and labour markets isn't necessarily associated with serious and entrenched unemployment problems. If social and institutional factors which are conducive to change exist in a growing economy, such problems can be minimised. A specific example is the massive restructuring that occurred in Europe in the 1950s and 1960s. A huge exodus of labour from the agricultural sector was accompanied by very little unemployment.[3]

6. While structural change does involve costs, resistance to it will inevitably lead to longer term adjustment problems and structural imbalances. The BLMR notes this by stating:

> *…policies which attempt to resist pressures for change by insulating the affected sectors through assistance of one form or another…[are] usually detrimental to the rest of the economy and [are] often self deflating in the longer term.*[4]

Firm and industry level implications

Competitiveness and innovative activity

7. The capacity of businesses to remain competitive in a dynamic economic environment depends largely on their ability to adjust internal capacities quickly. This ability is often fostered through firms adopting and undertaking innovative activity, which often results in lower costs, better products, more efficient processes and ultimately allows firms to remain competitive and survive.

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[3] Jackman, R., Layard, R. & Nickell, S. (1991) *Unemployment: Macroeconomic performance and the labour market*, Oxford University Press, New York.
[4] Bureau of Labour Market Research (1987) *Structural Change and the Labour Market,* Research Report No.11.

8. The Productivity Commission (then Industry Commission) highlights the competitive importance of innovation especially with respect to the current environment characterised by rapid globalisation and technological change, stating that:

> *In many industries, R&D is an essential continuing requirement simply to maintain competitiveness in the face of rapid technological change and increasingly sophisticated consumer needs…Firms not only undertake R&D to steal a competitive advantage. They are also forced to innovate to survive.* [5]

9. This suggests that innovative activity does not actually allow firms to experience prolonged increases in profits. Studies discussed below further demonstrate that in many cases firms do not benefit in any substantial way (in terms of economic profit) from the process of innovation.

10. Geroski examines this issue of innovation and firm profitability in some detail. [6] His work outlines two different views held on whether innovative activity results in differences in the profitability between innovating and non-innovating firms. The first is the effect of the specific product of the innovation (product view) and the second is the effect of the process of innovation itself (process view).

11. In terms of the product view, Geroski finds that:

> *…innovation is…likely to have an effect on performance which occurs immediately after its arrival, but this effect is likely to be transitory: profits and growth will be elevated above 'normal' levels for only as long as the innovator can defend itself from rivals.*

12. This suggests that, although innovation can increase the firm's competitive position against its rivals, rents or economic profit that are derived from this are often eroded once other firms begin mimicking the new product or service.

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[5] Industry Commission (1995) 'Research and Development', Industry Commission Inquiry Report No. 44.

[6] Geroski, P. (1994) 'Market Structure, Corporate Performance and Innovative Activity', Clarendon Press, Oxford.

13. Geroski then goes on to find that the process of innovation plays an integral role in the transformation of a firm's internal capacities:

> *…the process of innovation transforms the firm itself, building up its internal capabilities in a variety of ways that create generic differences between innovating and non-innovating firms.*

14. However, these differences are found to only be evident during economic downturns.

> *..large fixed differences in profitability exist between innovators and non-innovators, but these differences are observable only in recessions. That is, innovating firms appear to differ generically from non-innovators in ways which make them less sensitive to cyclical downturns.*

15. This clearly demonstrates that innovative processes implemented by firms play an essential role in assuring that firms have the capacity to remain profitable during times of economic downturn.

16. Geroski explains this by stating:

> *…innovators are more flexible and adaptable. They have the internal capabilities to respond quickly to new technological developments…in many cases, they have organisational structures designed to cope with the challenge of change.*

17. Often new innovations and technologies involve a degree of restructuring not only in the structure of the organisation but of the type and level of work required. In order for this transition to be efficient, firms need to have the ability to adjust their workforce to shed skills that have become obsolete and gain new skills that are required.

18. Innovation is one of the major determinants of GDP growth according to the OECD.[7] Consequently, the possible impact of higher firing costs on innovation is a particularly important issue for this case. The OECD argues that firing costs, along with other forms of EPL, may inhibit the labour turnover needed for successful innovation. The innovative capacity of firms is also influenced by the degree of co-ordination and centralisation in the industrial arena. These characteristics help to determine the extent to which workers can press wage negotiations in order to achieve a greater share of the financial gains which may arise from innovation.

19. In exploratory analysis the OECD finds a significant negative relationship between the severity of EPL and the extent of innovation activity as measured by research (R) and development (D) intensity. This result holds true whether centralisation or co-ordination is included as an independent variable in the regression equation. The OECD concludes that:

> *R&D intensity is relatively high either in high EPL/high co-ordination countries or in low EPL/low co-ordination countries, while other combinations…appear to be associated with lower overall innovative activity.* [8]

20. Australia is classified by the OECD as having a low level of EPL and low co-ordination of industrial relations processes. It is likely, therefore, that innovative activity of firms would be adversely affected by the increased firing costs which would result if the ACTU's claim is successful.

21. It is important to note here that although the ACTU's witness, Professor Webber, dismisses this conclusion as far-fetched, he offers no evidence which refutes the findings of the OECD. In fact, it seems clear from his cross-examination that he doesn't seem to be familiar with either the OECD working paper (2000) or the 2002 Employment Outlook article from which these results are drawn.

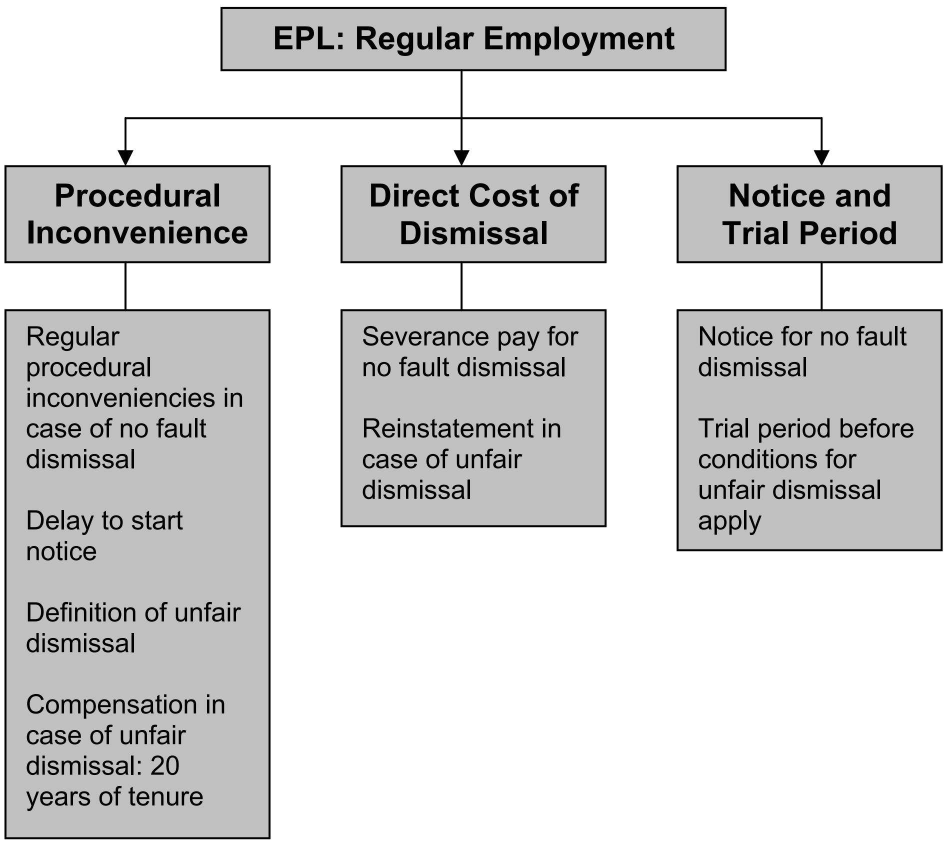
22. The ACTU in its reply submission also dismisses the use of this research due to its exploratory nature and the fact that Australia is not

[7] OECD (2002) 'And the twain shall meet: cross-market effects of labour and product market policies', The Employment Outlook, July, p. 273.
[8] Ibid, p. 280.

included in the more detailed and robust industry-level analysis conducted by the OECD. Nevertheless, the results of this analysis are indeed relevant to Australia. The results show that the impact of an increase in severance pay would be particularly severe in high technology industries in an industrial environment such as that in Australia, marked by low co-ordination.

23. The OECD gives Australia a relatively low EPL ranking among OECD countries. This does not mean, however, that an increase in EPL would not harm innovation in Australia.

Figure 9D.1: Taxonomy of EPL regulations and pyramid of indicators



24. Focussing on firing costs alone, our international position is not so favourable. The OECD places Australia in the tenth position among 18 other OECD countries in terms of the direct cost of dismissal from regular employment.[9]

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[9] Nicoletti, G., Scarpetta, S. & Boylaud, O. (2000) 'Summary indicators of product market regulation with an extension to employment protection legislation', OECD Economics Department Working Papers No. 226, p. 48.

25. Furthermore, the size of severance pay makes a significant contribution to the results which apply to overall EPL in the OECD research. Figure 9.1 presents a taxonomy of EPL for regular employment which the OECD has developed using factor analysis. Factor analysis is a statistical technique which is useful in summarising data. The technique helps to identify common themes or general attributes which can be used to classify specific characteristics of the phenomenon under investigation.

26. In this case factor analysis identified three major groupings of individual measures of EPL. These groupings or factors are – procedural inconveniences, direct cost of dismissal and notice and trial period. Each of these factors includes the specific measures or variables shown in the taxonomy.

27. The overall level of EPL for each country was then calculated using each of the specific measures weighted according to the results of the factor analysis.

28. Severance pay for no fault dismissals accounts for 41 per cent of the variation in the second factor, direct cost of dismissal, which in turn expresses 30 per cent in the overall variation in EPL.[10]

Flexibility and adjustment

29. Firms use retrenchment strategies to adjust to change for a number of different reasons. These range from adapting to technological change, reducing costs and surviving through a recession to innovation and other proactive measures such as ground breaking research and development of fostering the establishment of brand new markets.

30. Downsizing, however, does not always yield the benefits of increased profitability and productivity. Kane's review of the literature on downsizing reveals that some firms retrench as a short term or last resort action.[11] As a consequence, the organisational changes made are not always well planned and improved productivity may not result.

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[10] Nicoletti, G., Scarpetta, S. & Boylaud, O. (2000) 'Summary indicators of product market regulation with an extension to employment protection legislation', OECD Economics Department Working Papers No. 226, p. 44.

[11] Kane, R. L. (1998) 'Downsizing and HRM Strategy: Is there a relationship?' *International Journal of Employment Studies*, Vol. 6, No. 2, October, page 49.

31. Nonetheless, managers who have cut staff reported that, in the face of tighter markets and rapid technological change, if companies do not undertake measures such as downsizing to improve competitiveness and productivity, they will be forced to close down.[12] Other evidence confirms that firms that maintained or regained profitability in spite of deterioration in the economic environment *"did so only through effective retrenchment strategies".*[13]

32. Successful retrenchment is not restricted to firms facing organisational decline, with some opting to downsize proactively to better respond to future competitive threats.[14] Moreover, Australian research reveals that a majority of large firms gain a significant benefit from retrenchment. Some 80 per cent of surveyed executives reported that downsizing led to improved labour productivity, with about half finding that the gain was to a major extent.[15] There was no clear evidence found, however, of downsizing leading to improved rates of profit. Crockett explains this by stating:

> *While it seems reasonable to assume a close relationship between higher labour productivity growth and higher profits, the latter is known to be influenced by many other factors such as the assets of the company, market share, capital intensity, change in revenue and the firm's concentration ratio.* [16]

33. This demonstrates that, although retrenchments and downsizing yield important savings and lower costs in terms of higher labour productivity, longer term profits aren't necessarily achieved.

34. Severance pay and other firing costs have a negative impact on firm flexibility by restricting the adjustment of labour. A study conducted by Abraham and Houseman on whether employment protection inhibits labour market flexibility specifically looks at this issue of levels of severance pay and the effect on the adjustment of labour to changing

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[12] Savery, L. K. and Luks, A. (2000) 'Organizational change: The Australian *experience' The Journal of Management Development*, Vol. 19, No. 3, page 309.
[13] DeDee, J. K. and Vorhies, D. W. (1998) 'Retrenchment Activities of Small Firms during Economic Downturn: An Empirical Investigation', *Journal of Small Business Management*, July, page 49.
[14] Dawkins, P., Littler, C. R., Valenzuela, Ma. R. and Jensen, B. *The Contours of Restructuring and Downsizing*, 1999, page 11.
[15] Ibid page 92.
[16] Crockett, G. 'Can we explain Australian labour productivity growth? Some evidence from AWIRS', Curtin University of Technology.

levels of demand.[17] The study uses Germany, France and Belgium as examples of countries with high levels of severance pay and the US as an example of a country with low levels. Parallels can be drawn between Australia and the US in terms of having lower levels of employment protection and, specifically, severance pay – hence the results from this study are relevant to this claim.

35. The results of the study show that:

> *In the employment adjustment models…….the differences between the estimated European adjustment coefficients and those for the United States are uniformly large and statistically significant. The larger European coefficients imply that employment adjustment there is substantially slower than in the United States.*

36. In the study they used the example of the manufacturing industry to demonstrate this and found that the implied median lag for labour adjustment was three quarters in Germany, 10 quarters in France and three quarters in Belgium, whereas the majority of the adjustment in the US occurred in the current quarter. The study also found that, for the majority of industries studied, the speed of hours adjustment in Germany was also significantly slower than in the United States although to a much smaller extent.

Conclusion

37. Whether for reactive or proactive reasons, retrenchment is one essential strategy used to allow the efficient and effective adjustment of workforce size in order to adjust to changing circumstances. If granted, the ACTU's claim will greatly decrease a firm's ability to operate efficiently and productively through the use of retrenchments. Increased severance pay will increase the costs associated with the adoption and development of innovations and the adjustment of inefficient organisational structures. Ultimately, this claim will hinder the competitive and productive development of not just the national economy but also the industries and firms that operate within it.

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[17] Abraham, K. & Houseman, S. (1994) 'Does employment protection inhibit labor market flexibility? Lessons from Germany, France and Belgium,' in Social protection versus economic flexibility, ed. by Blank, R., The University of Chicago Press, Chicago.