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Michael Keating

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THE ROLE OF GOVERNMENT IN WORK AND WELFARE

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THE ROLE OF GOVERNMENT IN WORK AND WELFARE

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Societies (and therefore governments) typically have three objectives for work and welfare:

- sustained income/economic growth per capita
- employment growth (and job security?)
- a just distribution of income along with access to certain basic services

There may be tensions between these objectives. For example, maximising economic growth can require structural adjustment which results in people losing their jobs. Or employment growth may require increased wage flexibility which results in greater wage dispersion and inequality.

Views about the role of government reflect to some extent differing assessments regarding the significance of these tensions as well as different views about the desirable balance between these three objectives. Also priorities can change over time.

In practice not all policy tensions or conflicting priorities will necessarily be resolved at any time. The art of government is at least as much about managing apparent policy contradictions as resolving them. Indeed this capacity for compromise, involving trade-offs mixed with a certain amount of ambiguity, may be essential to the functioning of a pluralistic democracy where sometimes people in the end have to agree to differ. Thus from a government's point of view consistent application of a clear statement of its role would be more likely to invite problems than to resolve them. Instead governments tend to limit themselves to statements of values and possibly some principles which allow room for manoeuvre.

Never-the less this paper tries to sketch out the appropriate role for government with respect to the three objectives of income growth, employment and income distribution based on an assessment of what is required to achieve them.

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The Australian Settlement

In what Frank Castles described as the “wage-earners’ welfare state”, Australia has traditionally looked to the industrial relations system to achieve many of the demands for welfare and the distribution of income rather than to the State. This is unusual. In most other countries the State has organised pension schemes, for example, even when they are industry based. This in turn is thought to be the reason why welfare in other countries is typically related to the previous income and length of service and is much less tightly means tested.

By contrast, in Australia the labour movement, in particular, looked to the industrial relations system to safeguard the position of low-paid workers, and was less interested in protection against income loss. Accordingly the welfare system has been viewed as a safety net, to be restricted to those who for one reason or other are considered not able to participate in the active labour force. Some elements of this traditional stance still remain. Superannuation was introduced as part of awards and the recent claim for a “living wage” is underpinned by a notion of welfare. On the other hand can the economy remain competitive in a more open globalised world and achieve full employment if the labour market is asked to perform a welfare function as well as equilibrating the supply and demand for labour?

In the past the Australian approach to welfare and employment was largely supported by the economic rents earned in the efficient resource-based export industries; rents which were transferred via protection to support high wages and employment growth in manufacturing and services. Growth in incomes per head was very much a secondary consideration, and over the last century Australia has dropped down that international league table. Very significant government regulation was necessary to sustain this system, but it made limited demands on government revenue and expenditure. Hence there was the illusion of small government. This “Australian Settlement” as it has been termed by Paul Kelly, was however, dependent on the continuation of the economic rents generated by the resource-based industries. When these dried up it was inevitable that the role of government would need to change to allow a strategy more in tune with the new market realities.

The key question facing Australia today is can we shift to more market-based policies while allowing the government a role to intervene to achieve a better balance between income growth, employment and equality than would be dictated by the market working on its own?

Government and the Market

At present the Government's strategy for engaging markets is focused on improving the supply side of the economy and has two main arms:

- labour market flexibility
- other micro-economic reform

Labour market flexibility is often described as the way to reduce unemployment and increase employment, but many critics are concerned about the possible implications for income distribution. Micro-economic reform is intended to increase productivity and competitiveness and in this way improve economic growth. At the same time, policies to improve productivity are often also presented as the means to increase real wages. In that case, however, they risk a loss of employment, at least in the industries affected. Indeed micro-economic reform will only result in more jobs in those industries if the benefits of productivity growth flow disproportionately to customers through lower prices or to profits so that employers have an incentive to expand operations at the same price. Growth in other industries would then also be enhanced to the extent that their input costs are in turn lowered, although there is a concern that even comparatively flexible labour markets may experience some difficulty in facilitating the transfer of the labour displaced through micro-economic reform to where the new jobs are being created.

While the term has never been clearly defined, this strategy could be described as "economic rationalist", implying as it does a minimum role for government and the maximum role for the market. Whether this minimalist role for government is sustainable or not probably depends upon whether the strategy can deliver the promised benefits in terms of growth and at what cost in terms of at least transitional unemployment and increased inequality.

Already the government is under pressure, even from many of its own supporters, to intervene more, especially under the rubric of "industry policy". The difficulty with this form of intervention, however, is that any industry policy which provides assistance to one industry is almost invariably at a cost to another. This would seem to require the advocates of industry policy to define the set of circumstances which would logically justify such discrimination. But, apart from some instances of externalities (which are typically not confined to a particular industry), this test has not yet been met and many doubt that it ever can be.

Instead if the role of the State is to extend beyond the minimalist position of facilitating the establishment and operation of competitive markets, then it is probably better to focus on: (i) the most obvious area of market failure as represented by unemployment, and (ii) the extent and manner by which the distribution of income can be modified to achieve greater equality than provided by the market.

In order to answer these questions it is necessary in the first instance to turn to a closer examination of the labour market.

Recent Labour Market Trends

The outstanding feature of the Australian labour market is that unemployment is too high. An understanding of the reasons for this and the record of job creation is central to a better assessment of the role for government. The key stylised facts are:

- First, Australia's record of job creation has been good since 1983, except for the recession in the early 1990s and in the last year or so when demand and output have again slowed. Indeed during the 1980's Australia achieved the fastest job growth among the member countries of the OECD.
- Second, the problem is that to some extent they have been the wrong sort of jobs relative to the needs of the people becoming unemployed and their skills. Australian job growth has been characterised by a rapid growth of part-time jobs, but these have been largely taken up by women and students from outside the work force. They therefor do not lead to a commensurate reduction in unemployment. The problem is that not enough new full-time jobs have been created, particularly during the 1970s and early 1980s. Nevertheless between 1982–83 and 1995–96 the number of full-time jobs grew at an annual average rate of 1.2 per cent, almost matching the growth of the working-age population which grew at an average annual rate of 1.4 per cent, while GDP grew at an average annual rate of 3.4 per cent.[1]

[1] In the 1990s, while there has been little growth in full-time employment since the previous peak in mid 1990, economic growth has only averaged an annual rate of 2.75 per cent and individual years of strong growth have been accompanied by reasonable employment growth.

- Third, the distribution of earnings has become more unequal, particularly for males. For example, over the period from 1979 to 1995, for males the first income decile's earnings dropped about six percentage points and the ninth income decile's earnings increased by about six percentage points relative to the median (see Table 1).

Table 1
Australia Trends in Earnings Dispersion*, 1979–1985

Year	Males		Females		Persons	
	D9/D5	D5/D1	D9/D5	D5/D1	D9/D5	D5/D1
1979	1.69	1.62	1.50	1.60	1.67	1.64
1980	1.70	1.60	1.53	1.66	1.70	1.67
1981	1.74	1.64	1.51	1.65	1.68	1.68
1982	1.73	1.65	1.55	1.70	1.73	1.67
1983	1.68	1.64	1.60	1.72	1.71	1.69
1984	1.67	1.64	1.59	1.70	1.69	1.71
1985	1.62	1.61	1.58	1.67	1.66	1.64
1986	1.70	1.64	1.63	1.67	1.71	1.68
1987	1.70	1.64	1.61	1.64	1.68	1.67
1988	1.72	1.68	1.59	1.66	1.72	1.68
1989	1.68	1.67	1.59	1.64	1.70	1.69
1990	1.62	1.68	1.59	1.65	1.66	1.69
1991	1.74	1.64	1.62	1.62	1.71	1.66
1992	1.79	1.63	1.62	1.58	1.72	1.64
1993	1.76	1.64	1.59	1.58	1.72	1.62
1994	1.77	1.66	1.59	1.60	1.75	1.64
1995	1.75	1.68	1.60	1.58	1.77	1.65

* D1 and D9 refer to the upper earnings limits of, respectively, the first and ninth deciles of employees ranked in order of their earnings from lowest to highest, and D5 is defined similarly and thus corresponds to median earnings

Source: Taken from OECD 1996 Table 3.1

- Fourth, Australia's rate of short-term unemployment is about the same as for the US, but Australia like many European countries has a significant problem of long-term unemployment while the US does not (see Table 2)

What conclusions can be drawn from these stylised facts and what are their implications for policy? First, there are two possible explanations of the increased inequality of the distribution of earnings. In principle this could reflect a widening of relative wage rates. Alternatively with no change in relative wage rates the distribution of earnings could be expected to widen if job growth was concentrated at the high and/or low ends of the earnings spectrum. Unfortunately with the information currently available there is no way of attributing exactly between these two explanations.

Table 2
Total Unemployment by Duration (%)

	1994			1995		
	<6 months	>6months	>12months	<6 months	>6months	>12months
Australia	4.17	5.51	3.52	4.16	4.40	2.64
Austria	2.45	1.14	0.66	2.55	1.09	0.63
Canada	7.25	3.14	1.54	6.94	2.58	1.31
Czech Rep	2.31	1.60	0.84	1.70	1.88	1.10
Denmark	3.74	4.39	2.61			
Finland				9.09	8.19	5.58
France	4.85	7.81	4.85	3.72	8.25	5.46
Germany	3.11	5.37	3.72	2.88	5.45	4.02
Greece	2.63	7.00	4.86			
Ireland	3.11	11.29	9.00			
Italy	2.55	9.35	7.23	2.61	10.05	7.96
Japan	1.88	1.01	0.49	1.94	1.20	0.57
Netherlands	2.20	4.71	3.00			
N.Zealand	4.44	3.69	2.39	3.62	2.29	1.35
Norway	3.10	2.37	1.53	2.82	2.15	1.32
Portugal	3.15	3.89	2.94	2.88	4.76	3.72
Spain	6.42	17.71	13.54	6.38	16.56	12.96
Sweden	4.93	3.04	1.37	4.98	2.71	1.21
Switzerland	1.84	1.76	0.98	1.64	1.61	1.05
Turkey	2.72	5.40	3.57			
UK	3.34	5.79	4.15			
US	4.86	1.24	0.74	4.63	0.97	0.54

Source: Derived from OECD "Labour Force Statistics"

Gregory (1993) has suggested that the widening of the earnings distribution mainly reflects a disproportionate increase in the number of low-paying jobs, and to a lesser extent high-paying jobs, along with a "disappearance" of traditional middle-level jobs, although for families this was partly offset by increased part-time work by the spouses of middle income earners. On the other hand, Belchamber (1996) has argued that this interpretation of the changing dispersion of full-time jobs is dependent on the assumed growth of the median wage, and that on other plausible assumptions the growth in jobs was skewed in favour of high level jobs rather than against middle level jobs. Karmel et al (1993) also concluded that the change in the distribution of jobs over the period 1978–90 was better characterised as a "disappearing tail", and this interpretation is supported by occupational data which shows that employment growth has been concentrated in the top half of the skill distribution (Aungles et al, 1993 and Karmel, 1995). However, a comparison of 1982 with 1993–94 does show an unequivocal decline in the proportion of full-time jobs in the range from 75 to 125 per cent of the then median wage in each year. (Harding, 1997 Table 1).

Whichever, of these different views is preferred they do agree that there has been a change in the distribution of jobs which would tend to result in a more unequal distribution of earnings. On balance, the alternative explanation that the increased disparity of earnings is due to a widening of relative wage rates seems likely to be less significant. The most significant changes relative to the median wage have probably been an increase in relative wage rates for fast growing part-time employment and also for executives at the top of the earnings distribution, while relative wage rates for juniors and males in low-paid jobs may have fallen a little, although most of this fall for low-paid males was probably prior to 1983.

This leads on to the second conclusion to emerge from the stylised facts and that is that in so far as there have been changes in relative wage rates these seem unlikely to have caused unemployment. Instead the increases in the relative pay of part-time employees and executives and a relative decline in pay for those in low-paid jobs may well reflect some response to the relative pressures of demand and supply. In that case they have probably helped to sustain employment. However, while changes in relative wage *costs* do not seem to have been responsible for the increase in unemployment this does not mean that they may not be part of the solution.

The third and most important conclusion from Australia's recent experience is that if economic growth matches its potential, and provided there is the necessary wage restraint, then it is possible to create sufficient full-time jobs to hold and then reduce the rate of unemployment. In particular, while increased international competition, technological progress and structural adjustment have resulted in some job losses in some industries, the evidence suggests that the economy can grow strongly enough to more than offset these losses. At most technological progress and structural adjustment may have played a part in the disappearance of middle level jobs, but increasing competition from low-wage countries has not prevented the relatively rapid growth of low-paid jobs.

More generally, these possible sources of job losses do not appear to have become markedly more important in recent years despite some perceptions to the contrary. Otherwise they might have been expected to be reflected in an acceleration of labour productivity growth and there is little evidence of significant structural improvement in labour productivity, especially after allowance for changes in unit labour costs. Instead structural changes to the economy, technological progress and increasing trade have been underpinning economic growth since the industrial revolution and government intervention to slow them down might well lead to less job growth on a *net* basis.

Wage Flexibility

The outstanding feature of Australian experience is that following two wage explosions in 1974–75 and 1981–82 and a couple of associated recessions there is now a legacy of long-term unemployed people. Clearly the fact that there were these wage explosions, and that they were subsequently locked in, is itself compelling evidence of wage inflexibility in Australia at that time. However, that inflexibility refers to *aggregate* wage inflexibility and in considering the policy options it is useful to distinguish this from *relative* wage flexibility.

Thus during the 1980s, the Accord was essentially focused on improving aggregate wage flexibility, even at a cost to relative wage flexibility if need be. In effect aggregate wage flexibility was to be achieved by using productivity gains as they arose to work-off the inherited excess real wage costs and thus restore the profit share over time. Workers were to be "compensated" for their restraint by improvements to the social wage. While that strategy was generally successful in achieving its immediate aims, by the end of the 1980's Australia was still left with a real wage (and level of productivity) which was about 25 per cent higher than in 1970 for full-time jobs. As Gregory has concluded "compared to 1970, there is now a new high wage, low full-time employment equilibrium in Australia with a higher proportion of people unemployed." (Gregory 1995 p219).

By comparison over the same period in the United States there was little increase in either productivity or the real wage. Instead the growth of incomes (or GDP per capita) in the US was largely matched by employment growth. Relative to Australia Gregory has suggested that the US has foregone a real wage increase of 35 per cent since 1966, with most of the gap opening up between 1973 and 1975. However, the counterpart is that the US never experienced the same rise in unemployment which has eventually led to the very difficult problem of long-term unemployment in this country.

It is this difference in the problem posed by long-term unemployment which is perhaps the most important difference between the two countries' labour markets. The US largely avoided Australia's problem of long-term unemployment because it never experienced a wage explosion. However, aggregate wage flexibility in Australia may have improved during the Accord, and possibly since. Indeed, there is some evidence that aggregate wages may now be more responsive to unemployment in Australia than in the US, and in the long run the response of employment to a change in real wage costs at the national level may be about the same in both countries.[2] It remains doubtful, however, whether the Australian labour market is responsive to the rate of long-term unemployment as distinct from short-term unemployment. Rather as Lewis and Ross (1996, p.76) concluded from their survey of the Australian literature:

> the literature on aggregate wage adjustment suggests that wages adjust quite well to changes in the demand and supply of labour but not in the classical sense of removing unemployment. Rather, wages adjust to equate the 'effective' demand and supply of labour. Unemployment, or, at least, long-term unemployment, arises because workers are no longer part of the effective labour supply, either through lack of skills or through employer screening or through losing insider status.

The difficulty facing Australian policy is that while sustained economic growth is a necessary condition for lowering unemployment it is probably not a sufficient condition. In particular, economic growth will not of itself resolve the problem of long-term unemployment as most of the people concerned would now find it difficult to obtain work even in a buoyant job market. Rather the number of long-term unemployed people tends to operate as a capacity constraint, which limits the potential for economic growth unless complementary action is taken so that they become readily employable.

Of course it could be objected that there is always some price at which long-term unemployed people would be competitive and obtain employment. The

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[2] A recent OECD study found a semi- elasticity of real wages with respect to unemployment of -1.0 for the US compared to as much as -4.0 for Australia, and a long-term employment elasticity with respect to the real product wage of -1.0 for both countries (OECD, 1994 Part II, pp2&4).

argument here is that having created a problem of long-term unemployment, the remedy lies in an adjustment of relative wages and if necessary a change in wage determination arrangements to produce greater relative wage flexibility. Once again, however, the simple-minded presumption that relative wages in Australia are inflexible is not supported by empirical evidence. In fact a number of studies have concluded that relative wages are about as responsive to shifts in the demand and supply for labour in Australia as in other countries.[3] The difficulty is the magnitude of the likely reduction in relative wages needed to re-employee many long-term unemployed people and whether that relative wage rate would be socially acceptable, especially as people's potential for work seems to deteriorate the longer they are unemployed. Over time unemployed people tend to lose their skills, and their morale and attitudes to work can also suffer, so that the wage at which they are competitive will tend to decline the longer they remain unemployed.

Practical experience of the size of the reduction in labour costs deemed necessary for long-term unemployed people to obtain jobs is provided by the government's own labour market programs. In 1997 wage subsidies for long-term unemployed people ranged from $150 to $325 per week, or about 20 per cent of adult male ordinary time earnings for someone unemployed for 12 months, and rising for longer periods of unemployment, with additional allowances for training, and an even higher proportion of female earnings and (more particularly) of the wages paid in low-paid jobs.

In policy terms what stands out is the order of magnitude of the cuts in wages which would be necessary to restore full employment in this way, even if their exact size is debatable. Moreover it is one thing as in the US to have missed out on a 35 per cent wage increase, it is another thing to experience a cut in living standards of this order. In principle the reductions in wages might be concentrated on low-paid jobs, which would pose less threat to the majority, but in that case the implications for wage dispersion would be far more significant than the US has experienced. By any standards this would be asking the impossible of labour market flexibility, and would have major implications for the welfare system. It is hardly surprising therefor that the supporters of deregulating the labour market never hint at cuts of this order.

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[3] See Norris (1986), Mulvey (1986), Hancock Committee Report (1985), Withers, Pitman and Whittingham (1986) and Coelli, Fahrer and Lindsay (1994).

Instead the only realistic policy to reduce long-term unemployment is to complement economic growth with government intervention to assist the training and re-employment of those people. There are a set of questions about how much of the cost should be borne by the individual concerned and/or their family, and how much assistance should come from the government. The key point at this stage, however, is that the government has an important role in directly intervening in the training and labour markets to ensure there are adequate opportunities for the most disadvantaged to help themselves. Otherwise they may well miss out and gradually become excluded from society at large.

Before turning to these other questions about the scale and form of government assistance it is necessary to briefly consider what can be expected from increased labour market flexibility in the future and particularly the possible implications for the distribution of income.

Future Labour Market Flexibility

In the 1990s both sides of politics have supported increased labour market flexibility, and specifically a shift towards enterprise bargaining, although there has been disagreement about the continuing role of the Industrial Relations Commission and the rights of unions. The principal concern of the critics of this policy is that the new system will offer less protection to those who are industrially weak, and thus encourage greater wage dispersion. On the other hand many of the advocates of labour market deregulation believe that the flexibility of the new system will enhance economic and employment growth.

On one point all participants do seem to be agreed, that weakening the role of the Industrial Relations Commission will result in greater wage flexibility and probably increased wage dispersion. This view seems, however, to be founded less upon evidence than on a presumption of what the Commission *ought* to do; probably deriving from its historical association with the concept of a needs-based basic wage which helped to create an impression that the Commission was there to help protect the "weak". But as the Hancock Committee Review of "Australian Industrial Relations Law and Systems" (1985) commented "this is not necessarily so" (vol.3 p.11). Instead the Hancock Committee found that "The arbitration tribunals have never sought to revolutionise the Australian wage structure by imposing a set of relativities derived from novel concepts. It would be a mistake to conceive of them as giving effect to notions of an ethically ideal distribution of income in lieu of the kind of distribution which characterises most societies and which seems to have a basic relevance to supply and demand" (vol.2 p.173)

As previously mentioned, a number of studies have found that the degree of centralisation of wage determination does not make a great deal of difference to wage relativities.[4] Furthermore the data on the distribution of earnings in Table 1, while not conclusive about changes in relative wage rates, neither do they demonstrate any obvious correlation with the quite significant changes which occurred in wage setting arrangements over the period from 1979 to 1995. In particular, the changes in the distribution of female earnings are very much less than for males which throws further doubt on the influence of the wage determination arrangements.

In fact fairly stable wage structures do seem to be compatible with quite big structural changes in the pattern of demand and supply in the economy. The main reason is probably that labour is typically highly mobile between firms and even between industries. Even where training is involved, future employees do adjust fairly quickly to where the jobs are. Thus with a high price elasticity of supply and often a fairly high elasticity of demand there is not a great deal of pressure for changes in wage relativities. In addition, the biggest structural changes in the demand for labour have probably impacted most on the demand for skills and for service employees and these have largely been met by an increase in education and training and an increase in women's participation in the work force, although in this latter case there has also been a significant increase in women's relative wages over the last thirty years (see Keating 1983).

A related finding by the OECD Secretariat, using simple cross-country correlations, was that there "is no significant tendency for employment to be lower and unemployment higher for inexperienced or low-skilled workers in countries where there are relatively few low-paid jobs available" (OECD, 1996, p.60). Instead the OECD suggests that "factors other than relative wages , such as the overall level of demand or the amount of training received, may be more important for determining labour market outcomes for these groups" (ibid p.94).

Thus the general conclusion from the variety of studies which have examined the influence of the arbitral system is that the change to enterprise bargaining may not make much difference to the degree of wage dispersion.

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[4] See p. 10 above.

Other recent studies, however, have found that changes in intra-industry earnings dispersion in Australia in the 1980s were negatively correlated with average union density and award incidence by industry over that period (Borland and Norris p.93). Borland (1995b) also found that the decline in union density from 45.6 per cent in 1986 to 35.0 per cent in 1994 can explain approximately 30 per cent of the increase in the dispersion of weekly earnings for male employees and 14 per cent of the increase in the dispersion of weekly earnings for female employees which occurred over that period. Nevertheless "the main cause of changes in the earnings dispersion for both male and female employees is shown to have been changes in the earnings dispersion of non-union employees." (p.246).

At the margin union power may have been enhanced by the recognition afforded to unions under the arbitration system, and again at the margin this may have had a modest impact on wage relativities. Where labour is less mobile and the elasticity of labour supply is lower, however, then labour market deregulation could make a difference to relative wages over the medium term. The most obvious such exception is where unions so control the supply of labour that it is not price elastic (for example, in the coal mining and the maritime industries, and some of the professions). In this case deregulation to remove union control could significantly reduce the wage rate and possibly increase employment in these industries. The other possible example where the labour supply might be less elastic is where jobs are relocating and labour is accordingly required to move between regions. Compared to other countries, however, Australia has not had much regional specialisation, and there has been relatively little call upon labour to move between regions in response to changing patterns of demand.

Probably because of their intuitive understanding of how the labour market actually works, most employers have not in fact pushed for enterprise bargaining in an attempt to depress wage rates but rather in order to improve productivity. Employers understand that if they want to maintain their employees' morale, loyalty and cooperation, then the scope for cost reductions through lower wage rates is extremely limited. Other forms of labour market adjustment are cheaper and more effective, particularly in the service industries where demand fluctuates a lot during the year, during the week and even during the day, and where it is impossible to stockpile production. Rather than wage adjustments, what employers are after is to be able to change the way that work is organised and where their flexibility to manage has often been very limited by the prescriptive nature of industrial awards. Changes in the hours of work, for example, to allow greater use of part-time employees and changes in shift provisions can readily deliver cost savings of 20 per cent or more, which are far more significant than any likely changes to wage rates.

This is not to say that wage relativities should be frozen. An efficient economic system must always allow the possibility of relative prices (including the price of labour) adjusting to changes in demand and supply. Arguably the former centralised system of arbitration did for the most part allow the necessary degree of relative wage flexibility and this is a reason why it was able to continue for so long.

Looking ahead, for industries such as coal mining and stevedoring, where the previous economic rents have dried up, their sustainability will depend upon achieving a reduction in the cost of what are by any standards extremely well paid employees. Even in these cases, however, the reduction in labour costs may be achieved by increasing productivity rather than by cutting wages. For the vast majority of full-time permanent employees, relative rates of pay do not seem to have changed much since the adjustment to the wages explosion of the early 1980s, despite progressive freeing up of the wages system. Thus it is not obvious that enterprise bargaining will lead to much change in dispersion of their wage rates in the foreseeable future. Instead the trend towards casualisation of employment and the increasing use of part-time labour could have more significant implications for the distribution of income and well-being.

At this point the main conclusion, however, is that there is a reasonable presumption that the negative effects on income equality from any likely changes in wage dispersion are unlikely to be so great that they could not be offset through the tax and transfer system. As will be shown below this has been achieved since 1982–83 and there is a reasonable chance that this strategy will continue to prove viable. This is a proper role for the government in pursuing the objective of income equality, and it is likely to be much more compatible with the achievement of the other objectives of income and employment growth than direct government intervention to try and compress rates of pay.

The question we now need to turn to is how can the tax and transfer system be best used to achieve the desired degree of income equality.

Government Intervention and Income Equality

In a system where wages are largely market determined there are essentially three ways, which can complement each other, by which the government can intervene to improve the distribution of income:

(i) subsidies to employers to reduce the cost of employing the most disadvantaged,

(ii) an earned income tax credit which would allow employees to maintain their disposable incomes while lowering their wage claims, and/or

(iii) assistance to people targeted according to their means and needs

The rationale for subsidies to employers must be that such an attempt to underwrite a particular wage structure represents an efficient way to achieve a desired distribution of income. In practice that wage structure usually approximates the pre-existing structure, and there is little explicit consideration of whether this is the most desirable relative to needs. More likely it is chosen because of its acceptability. The subsidies, however, are targeted according to the degree of disadvantage experienced by different groups of long-term unemployed persons so as to allow them to compete for jobs. In addition the subsidies are typically combined with other forms of training assistance, including for example child care for sole parents participating in the Jobs, Education and Training Program. The total package, which was expected to cost $2540 million in 1996–97, is designed to assist unemployed people to help themselves back into jobs, in the expectation that they will have a reasonable chance of continuing in employment when their eligibility for assistance has ceased. Thus this so-called "active labour market assistance" offers at least the promise of improved living standards and growth in the medium term, and because it should only continue for a limited time it should be relatively inexpensive over time.

This form of assistance, however, suffers from the disadvantage that it takes no account of the relative *needs* of different groups of employees. In fact a recent study by Richardson (1997) found that only 6 percent of all people who have a low income also have a low wage, and only 14 percent of the people who earn a low wage also live in a low income household. Indeed for those with no dependents the wage is arguably excessively generous relative to needs, especially if they are receiving worthwhile training which in the longer run will improve their income share. Accordingly it is arguable that the subsidies should be less for young people who have no dependents and who are receiving training, and that they should receive a lower training wage commensurate with their relative productivity and the benefits they receive from that training.[5]

On the other hand for those potential employees with families, their needs are higher and the implications of the alternative of a social security pension must also be considered. The rationale for this alternative form of assistance is that the community will want everyone to have access to at least a minimum standard of living. This minimum is set having regard to community norms, which for the basic pension for a single adult is defined as 25 per cent of male total average weekly earnings.

The amount of this social security assistance for those not working effectively puts a limit to the scope for reducing the wages of those who experience most disadvantage in the labour market. At present, for example, the basic pension for a married couple is $290.10 per week which is more than 80 per cent of the minimum wage at $359.40 per week. Any reduction in the minimum wage might well provide insufficient incentive to many unskilled people to undertake low-paid full-time employment, especially if allowance is made for the extra costs associated with working. In addition a reduction in the minimum wage would severely impact on those 14 percent of low income families, and 19 percent of those families with dependent children, whose wages account for a substantial part of their total income. Richardson estimates that there are about 80,000 such low wage workers with dependent children who also have low incomes, as compared with about 130,000 unemployed people who have dependent children and similarly low incomes, and who presumably would be the beneficiaries from a lower minimum wage intended to enhance their employment prospects.

The difficulty is that it is not really possible to adjust wages according to family and other needs and then expect those with the highest needs to compete effectively for jobs. The advantage of using the tax-transfer system to achieve the desired distribution of income is that, unlike the wages system, the amount of income can be adjusted according to their particular needs.

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[5] At present employers receive wage subsidies as an incentive to take on apprentices and trainees, which are partly related to performance, and also depend upon the trainees degree of disadvantage. The training wage reflects a payment only for productive time spent on the job, but this time is assumed to be fully productive unless junior rates have been established.

An earned income tax credit represents perhaps the simplest and least intrusive response along these lines. By reducing the tax paid by those in low paid jobs it can increase the gap between the income from employment and that available under the social security safety net. Accordingly an earned income tax credit could soften any negative impact on living standards from labour market deregulation and introduce *potentially* greater wage flexibility by allowing job seekers to accept a lower wage while still maintaining their after-tax income.

If the earned income tax credit is, however, not targeted and is paid at the same rate to everybody in employment then it is not very different from raising the lowest tax threshold. Indeed at present pensioners have a higher tax threshold than other taxpayers in Australia in order to ensure that full pensioners do not pay tax on their pension income. Thus a means of simplifying the tax system and achieving some of the benefits of an earned income tax credit would be to restore a common tax threshold for everybody at a new higher level. This would, however, be very expensive and would not necessarily provide sufficient incentive for job seekers to accept work at a lower cost to the employer.

It is probably inevitable therefor that any scheme for an earned income tax credit would need to be more targeted. Typically an earned income tax credit increases with income up to a certain point in order to maintain an incentive to take full-time employment rather than part-time employment.[6] The credit could also be differentiated to reflect relative needs at least in part, and most schemes involve withdrawal of the credit as income increases above a minimum threshold. These features, however, increase the complexity and reduce the transparency of the scheme. Most importantly withdrawal of the tax credit increases the effective marginal tax rate and thus involves its own disincentive to additional work over the range of income affected. Furthermore it is arguable that any such effective means test would be more efficient and equitable if it is based on family rather than individual income, in which case the assistance is probably better provided through the social security system and not the tax system.

There will always be room for debate as to the extent of the additional needs which should be recognised by the tax-transfer system, but tighter targeting has been accompanied by greater differentiation of needs, resulting in a proliferation

[6]Even then some people, such as semi-retired people who command a high hourly rate of remuneration, could benefit fully while only working a few hours per week.

of benefits. Today there seems to be a degree of consensus in favour of recognising the number of children and the consumption of rental housing, child care, education and health where the needs of different families with the same income can vary greatly.

In recent years, in order not to disadvantage low income working families, many of these forms of assistance have been extended through the social security system to non-pensioner families. For example, in January 1997 a single income family with a dependent spouse and two children, earning two thirds of average male earnings and renting privately, received 33.3 per cent of their income from government cash transfers compared to only 4.4 per cent of their income in January 1982. Indeed the real earnings of such a family hardly changed over the fifteen years, but because of the substantial increases in cash transfers their disposable income increased by 24 per cent, and after housing costs it increased by as much as 75 per cent.

Most of these cash transfers are withdrawn as income rises, which reduces the cost of the system and makes it highly progressive. However, the assistance in kind, notably education and health, which makes up the balance of the "social wage" is often not means tested. Frequently there is an argument in favour of horizontal equity or that the expenses involved would be difficult for even a middle income family. In addition, the extent to which means tests are now stacked on top of each other so that they often overlap is already resulting in excessively high effective tax rates, sometimes in excess of 100 per cent (for example, see Charts).

For those contemplating the choice between full-time work and no work at all the incentives are probably still adequate. For example, for a two income family the "replacement rate", describing the ratio between the social security benefits which could be available (including rent assistance) and the average earnings (after tax) of a man and a woman employed full-time, is only 31.5 per cent. The potential availability of a social security pension is unlikely to deter such people from pursuing full-time work. However, for a single income family with a dependent spouse and two children the replacement rate is as much as 70.5 per cent of male average ordinary time earnings after tax. Perhaps even more to the point, it rises to 77 per cent of the after tax earnings of those who only receive two thirds of average weekly earnings. As already noted a replacement rate much higher than this could risk inadequate incentives to work after due allowance is made for the cost of working.

In addition, often the decision many of these people are facing is not between no work and full-time work but whether to increase the number of hours they work, either in the form of overtime or as part-time work. For many such people contemplating a marginal increase in their amount of paid employment, effective tax rates would appear to represent a significant disincentive to part-time work or to work additional over-time. Furthermore effective tax rates of about 90 per cent extend over the range of private incomes from around $250 to $600 per week (see Charts and Table 3). This means there is very little increase in disposable income over quite a long range of private income, and that potentially quite a lot of people are affected. Indeed on average about 20 per cent of the lower half of the income distribution, and as much as 35 per cent of the third decile, face effective marginal tax rates in excess of 50 per cent (Harding and Polette, 1995).[7] By contrast no-one in the upper half of the income distribution faces a marginal tax rate of as much as 50 per cent.

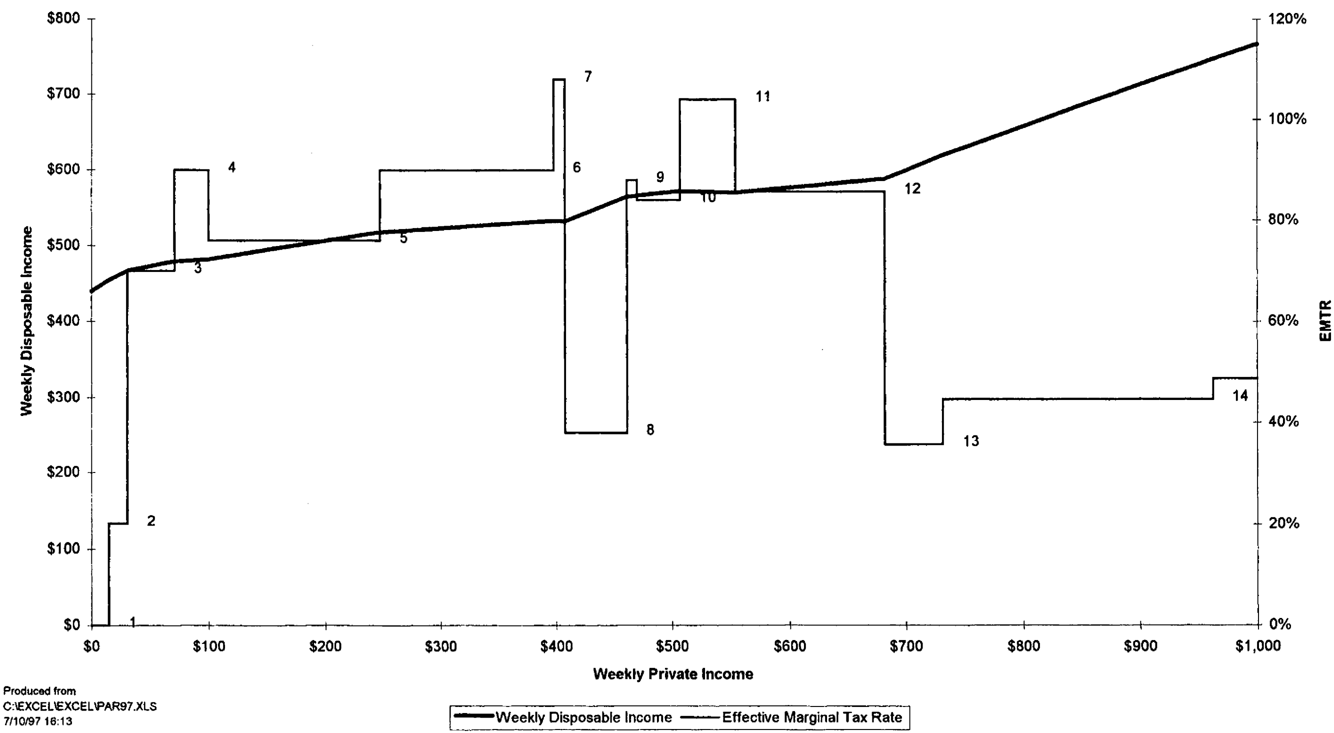
Table 3
Effective Average Tax Rates Over Family Payment Taper Ranges, Different Income Splits

Number and age of children, receipt of RA	Taper range	ETR 100/0 income split	ETR 75/25 income split	ETR 50/50 income split
1 ch < 13, no RA	$417–$485pw	97.0	129.4	120.7
1 ch < 13, RA	$417–$562pw	91.3	101.6	99.5
2 ch < 13, no RA	$429–$564pw	91.5	98.3	96.0
2 ch < 13, RA	$429–$641pw	89.3	93.1	87.1
1 ch < 13, 1 ch 13–15, no RA	$429–$591pw	90.5	96.1	91.9
1 ch < 13, 1 ch 13–15, RA	$429–$668pw	88.9	91.8	85.3
2 ch < 13, 1 ch 13–15, no RA	$441–$670pw	88.9	89.5	82.7
2 ch < 13, 1 ch 13–15, RA	$441–$758pw	88.7	87.3	79.6

Source: David Ingles *Low Income Traps for Working Families*, Centre for Economic Policy Research, ANU, Discussion Paper No. 363, April 1997.

[7] As Ken Oliver of the Department of Social Security has pointed out this is almost certainly an understatement of the number of people affected by high marginal tax rates. This is because the income distribution itself is affected by these rates as people respond to them by reducing their work effort. Ideally what one would like to know is what the distribution of income would have been in the absence of high marginal tax rates, and it might very well have been more equal.

JSA/PgA couple at January 1997
Children under 5 = 1, children 5-12 = 1, children 13-15 = 0,
Paying private rent of $120 pw, 100% of private income to head



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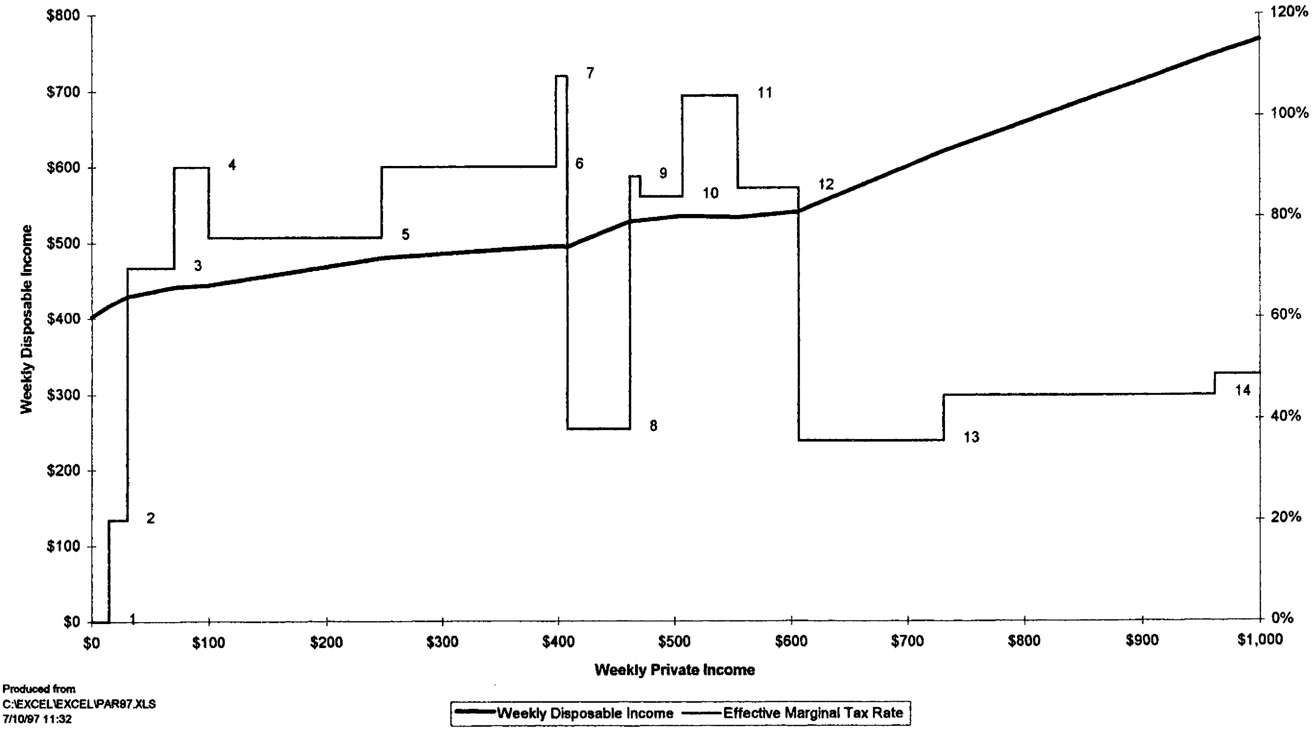
JSA/PgA couple at January 1997
Children under 5 = 1, children 5-12 = 1, children 13-15 = 0,
Paying no rent, 100% of private income to head



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Logically those who favour cutting public expenditure in order to reduce taxes and improve incentives should be very cautious about introducing any further means tests. Already significant numbers of low to middle income families face very high effective tax rates, and unlike many higher income families these people often have the discretion whether to work an extra hour or two. As an alternative it might be possible to pitch the threshold for any new means test at a high level so that few people would be affected, but this would minimise the savings involved to the point where little would be gained.

The Impact of the Tax and Transfer System on Income Distribution

There is a widespread view, supported by a number of expert studies that the distribution of income has become more unequal over the last 15 years or so (Saunders (1993)). As already demonstrated this view is consistent with the evidence of some increase in the dispersion of wage incomes, although it probably reflects more a change in the composition of full-time employment in favour of very high and low paid jobs, rather than a change in relative wage rates. On the other hand this conclusion of increasing inequality is somewhat surprising given the big increases in government funded welfare along with tighter targeting in favour of the poor over the same period. It is of considerable interest therefor that more recent studies, which are both more comprehensive and reflect new data based on a longer time period, have over-turned the earlier study findings and suggest a modest reduction in the overall degree of inequality.

In order to appreciate the evidence it must be recognised that the distribution of full-time wages is at best a very partial guide to the distribution of incomes. First, because of the degree of shared consumption it is generally considered that the family, adjusted for differences in size and the relative costs of different family members, is the appropriate unit for studies of income distribution rather than the individual as is typically used in studies of earnings dispersion. This means, for example, that the increase in part-time employment, which has been concentrated among married women is generally thought to have reduced the inequality of *family* incomes (Harding 1995; Saunders 1993b).

Second, while wages account for some 60 per cent of total household income, changes in the other major components of income can of course also make a significant difference to the overall degree of inequality. Summary measures of inequality, such as the Gini coefficient, suggest that inequality in the distribution of the balance of *private* or market incomes increased by roughly the same extent as for wage incomes (see Table 4).

However, the increase in the inequality of *private* incomes is potentially misleading as it reflects only part of what was a much more comprehensive government policy. That policy favoured the freeing up of private markets in order to promote economic growth and employment, but at the same time it sought to offset any unfavourable effects on income distribution by improvements to the social wage. On the whole this policy seems to have worked as intended. As Table 4 shows at each step of broadening the definition from private income through to social income, inequality as measured by the Gini coefficient declined, and it declined by more in 1993–94 than in 1981–82.

Table 4
Gini Coefficient for Different Measures of Household Income 1981–82 and 1993–94

Income definition	1981–82	Change from previous definition per cent	1993–94	Change from previous definition per cent
Harding (unequivalised)				
Wage & salary	0.500		0.537	
Market income	0.417	16.6	0.476	11.4
Gross Income	0.354	15.1	0.368	22.7
Disposable Income	0.326	7.9	0.320	13.0
Johnson et al (equivalised)				
Private Income	0.489		0.517	
Gross Income	0.366	25.1	0.352	31.9
Disposable Income	0.308	15.8	0.296	15.9
Social Wage	0.255	17.2	0.226	23.6
Final	0.264	(3.5)	0.237	(4.9)

Sources: Harding (1997) Table 3; Johnson et al (1995) Table 3.2

Note: An increase in the Gini coefficient is shown as a (negative) percentage change to indicate an increase in inequality

Thus the distribution of gross incomes which includes government cash transfers is more equal than for private incomes, and in both studies the cash transfers achieved a greater reduction in inequality in 1993–94 than in 1981–82. Income tax which represents the difference between gross incomes and disposable incomes further reduced inequality, but according to Johnson et al it was no more progressive in 1993–94 than in 1981–82 while Harding found that there was a modest increase in the progressivity of the income tax. Both sources show that the distribution of disposable incomes has become more equal, and this conclusion is reinforced in the study by Johnson et al which shows a further improvement in the equality of social incomes which allows for the distribution of the principal forms of assistance in kind, covering education, health, child care, subsidised rental housing, and concessions from government business enterprises. And this conclusion of greater equality is still sustained if allowance is made for the effect on purchasing power of changes in a large number of indirect taxes and tariffs as shown in the Gini coefficient for "Final Income".

These improvements in the Gini coefficient reflect the increase in the share of both disposable income and social income for the lowest 40 per cent of households (Table 5). The former increased from 20.2 per cent in 1981–82 to 21.1 per cent in 1993–94, while the latter increased from 24.0 per cent to 26.1 per cent over the same period. Interestingly it was the improvement in the social wage, rather than in disposable income, which most benefited low-income households. Most of this increase in equality was at the expense of the top 20 per cent of households, although there would be a number of households who would consider themselves to be middle income households who may well have perceived a modest deterioration in at least their relative position.

Table 5

Shares of Real Equivalised Disposable and Social Wage Income Received by Households-Income Groups, 1981–82 and 1993–94

	0–20%	21–40%	41–60% Per cent	61–80%	81–100%	Total
Disposable Income						
1981–82	8.5	11.7	17.3	23.9	38.5	100.0
1993–94	8.7	12.4	17.2	23.7	37.9	100.0
Change (Percentage Points)	0.2	0.7	(0.1)	(0.2)	(0.6)	
Social Wage Income						
1981–82	10.0	14.0	17.6	23.1	35.3	100.00
1993–94	11.1	15.0	17.7	22.8	33.4	100.00
Change (Percentage Points)	1.1	1.0	0.1	(0.3)	(1.9)	

Source: Johnson et.al., 1995, Table 3.3 and 3.4

It is also interesting to note that the private income of working families typically fell in real terms between 1981–82 and 1993–94, but that this fall was always more than offset by government intervention so that their disposable income and social wage rose in real terms for each type of working family (Table 6). Furthermore this enhancement in government assistance was biased in favour of families where there was only one worker and who on average have lower incomes. Sole parents gained most proportionately, and couples with three or more children gained relatively to those with only one or two dependents (See Table 6).

Future Role of Government

Economic growth is fundamental to the provision of work and welfare. In addition this paper has argued that the government must combine two approaches to direct intervention in the pursuit of full employment and a fair distribution of income. First the government has a role in the provision of active labour market assistance in the form of training and work experience to enable the most disadvantaged to re-establish themselves in employment. This assistance is not only for equity reasons, it is vital to improved economic performance and reducing unemployment. Economic growth on its own will not succeed in restoring full employment, and active labour market programs can enhance economic growth.

Second the government has a role through the tax and transfer system in achieving a more equitable distribution of income. Furthermore, this role has become more demanding in recent years. A combination of wage restraint by trade unions, deregulation of product markets, technological change, structural adjustment and possibly a shift to enterprise bargaining has meant that less reliance can be placed on work and the industrial relations system to achieve the desired distribution of welfare. In response the distribution of welfare has been deliberately broadened to encompass the social wage and governments have extended their role in providing cash assistance to those in work but whose family needs cannot adequately be met through their earnings.

These changes in the government's role are already quite significant. Nevertheless the question arises whether the government should not be taking on an even greater role, especially in relation to the distribution of welfare.

Table 6
Average Unequivalised Real Income for Groups of Units Australia
1981-82 and 1993-94

Income unit group, year	Proportion of units	Private $ 1989-90	D/P* %	Disposable $ 1989-90	S/P** %	Social Wage $1989-90
Sole parents, at work						
1982-82	1.9	418	91.1	381	119.4	499
1993-94	2.5	376	106.4	400	147.8	554
Couples with one or two dependents, one worker						
1982-82	9.5	665	74.1	493	88.4	588
1993-94	5.6	632	79.1	500	99.4	628
Couples with one or two dependents, two workers						
1982-82	7.4	932	75.4	703	87.2	813
1993-94	9.3	912	78.1	712	98.0	848
Couples with three or more dependents, one worker						
1982-82	3.5	635	79.4	504	108.2	687
1993-94	1.7	606	88.9	539	127.4	772
Couples with three or more dependents, two workers						
1982-82	2.6	910	78.4	713	102.0	928
1993-94	2.9	870	80.5	700	109.7	954

* D/P is Disposable as a percentage of private income
**S/P is Social wage as a percentage of private income

Source: Johnson et.al, 1995, Table 4.14

Consistent with its original focus on those who were unable to work the Australian welfare system remains highly targeted. Mitchell, Harding and Gruen (1994) have shown that the Australian cash transfer system is the most efficient among a group of similar OECD countries in that as much as 50 per cent of the total outlays went to those below the "poverty line" whereas in the other countries only 40 per cent or less went to those in "poverty", and as little as 23 per cent in Sweden. One concern, however, has been whether the Australian system is effective, or whether because of its high selectivity too many people are left with too low an income. Certainly as measured by the size of government outlays, the Australian transfer system, along with the United States, is apparently the least generous among a group of similar OECD countries (see Mitchell, Harding and Gruen, 1994). A number of people have then gone on to argue that the Australian system lacks generosity precisely because only a few people benefit so that it has a very narrow support base. (see for example Saunders, 1994)

Unfortunately international comparisons of generosity provide little guidance of what is best for Australia. What matters most are the outcomes achieved in terms of the percentage of families who still remain with undesirably low incomes. As Mitchell, Harding and Gruen have shown, judged by this standard, "Australia's predominantly income-tested system produces an outcome similar to the social insurance systems of France and the mixed systems of Canada and the UK — with each of these countries varying in their levels of generosity." (Mitchell, Harding and Gruen, 1994, p. 333)

There are two main reasons why Australia can achieve a relatively satisfactory outcome for relatively low expenditure. First the highly targeted Australian system is very efficient. Furthermore, as Whiteford (1997) has shown, comparing a targeted system with a more universal system can give a misleading impression of the relative amount of redistribution achieved if the period of comparison is as short as one year. For example, Falkingham and Harding (1994) found that in the targeted Australian system 38 per cent of the benefits received by individuals over their lifetime are paid for at another stage of their lives, while 62 per cent represent redistribution between individuals. However, these proportions are exactly reversed in the United Kingdom, with only 38 per cent of benefits representing a redistribution between different individuals. So that the Australian system achieves a lot more redistribution between people for the amount expended than the other countries with comprehensive welfare systems.

Second, quite apart from the relative efficiency of the Australian social security system, the needs for assistance are lower in Australia than in many of the similarly developed countries. This partly reflects the degree of compression of the Australian wages distribution relative to other countries, but as noted, this may continue to widen somewhat in the future.

However, the influence of the "workers' welfare state" has not been confined to a focus on wages. Whiteford (1997) has suggested that the Australian system with its emphasis on achieving welfare goals through work wherever possible has encouraged much greater self-provision, particularly for retirement. By contrast the European system of social insurance may "crowd out" private provision, partly because of the high social insurance contributions demanded. To the extent that these are regressive this may in turn lead to a more compressed distribution of the usually quoted pre-tax earnings in these countries, whereas the distribution of earnings after payment of these contributions is often wider. Whiteford cites, for example, a study by Whiteford and Kennedy (1995) which "found that older people in Australia, Canada and the United States had the lowest receipt of government transfers, but had the highest level of income from private sources such as property and investments, as well as much higher levels of home ownership. Moreover, home ownership is much more equally distributed in the smaller welfare states than in the larger welfare states." (Whiteford, 1997 p.26). This Australian tradition of self-provision through private saving may have weakened in the last twenty years or so, but one response has been the system of compulsory contributions to superannuation which has been introduced over recent years.

Conclusion

In Australia the role of government in the distribution of welfare assistance has traditionally been limited to helping those who, for various specified reasons, were not financially employed. Improvements in assistance over time, however, and now the commitment to maintain the basic pension at 25 per cent of average weekly earnings, have meant that assistance to the unemployed is increasingly setting a floor to the level of the minimum wage. As a result the government more than ever must take account of the implications of its social policies for the labour market.

The response has been to extend assistance to the "working poor". This is best done through targeted assistance which recognises the additional cost of children, rental housing, education and health.

This strategy may have permitted some downward flexibility in wages. Without the improvements in the social wage over the last fifteen years or so the wages paid by employers might have been somewhat higher, particularly for the low paid. In this sense the extension of the social wage represents a modest subsidy to employment. It has also reduced the disincentives which would otherwise be a by-product if increased assistance had been limited to those on very low incomes.

The probable direction of future changes in the labour market will very likely put pressure on government to proceed further in this direction, but any widening in the dispersion of wage rates is likely to be sufficiently modest that the cost of offsetting it through the Budget should be manageable. If necessary raising the additional finance for targeted assistance, including through training and labour market programs, would be a much more efficient and even equitable way of preserving equity than tinkering with the wages system.

In the longer term enhanced self-provision by many retirees, which they are increasingly forced to take as a pension, could undermine support for the present highly redistributive system. In addition, it might also be asked whether we can afford to target so tightly now that the Australian welfare system is moving to cover low-paid workers as well as those deemed unable to work. Any difficulties in this respect are likely to grow as the distinction between employment and unemployment is becoming increasingly blurred with many low-income families taking advantage of casual and part-time job opportunities. As a result the Australian social security system will probably become more reliant on income testing and less on work testing.

The most desirable way to meet this challenge would be to sort out the very high effective tax rates now facing many low-income people, either in or on the fringe of the work force, as a consequence of overlapping means tests and their interaction with the tax system. Certainly this seems a far more important element of reform of the taxation system than reducing income tax, and it would cost very much less. Furthermore, even if this meant a modest reduction in the present very high efficiency of the Australian tax-transfer system this would seem a small price to pay if it helped sustain an efficient and flexible labour market.

In effect the choice is between using the tax-transfer system to redistribute from higher incomes while at the same time promoting self-help, or alternatively accepting greater inequality as the counter-part of increased wealth and employment. While every effort should be made to ensure that the tax-transfer system operates efficiently and effectively, can society afford not to use the fiscal system as the link between an equitable distribution of income and the re-integration of the unemployed, and especially those most disadvantaged, into employment?

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