Industrial relations reform: Chasing a pot of gold at the end of the rainbow?

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Introduction

Lately there has been a growing recognition of the comparative strength of Australia’s economic performance; and an attempt to understand how this has come about. Peter Hartcher’s book The Sweet Spot and George Megalogenis’s book The Australian Moment are two notable examples. Of course, this recent questioning of the sources of Australian prosperity has a long tradition. Distinctively classified as a country ‘born rich’ from the time of the beginnings of European colonisation, understanding how Australia came to have and maintained its status as a rich country has been a topic of primary interest for economic historians.

In his forthcoming book on the history of the economic development in Australia, Why Australia Prospered, Ian McLean assigns a major role in Australia’s economic success to having made the right policy choices at the right times. ‘The challenge’, he says, ‘has been to make the appropriate choices at key points throughout history, or, where an inappropriate choice appears with hindsight to have been made, to effect a policy reversal or modification to institutional arrangements such that any permanent negative effect…is averted.’

In this talk I want to take up this theme of policy-making in Australia. I want though to put a slightly different spin on the idea of policy being important. I want to argue that, as well as knowing when to change policies, it is also essential to know when not to change policy.

I’ll do this by taking what is an important public policy question in Australia at present, the state of our industrial relations system, and asking whether it is in need of reform. In doing this I am going to have a link to my Harvard experience by drawing on some research I did in my time at Harvard, preparing a survey of the Australian labour market in the 2000s for the Reserve Bank’s decade review of the Australian economy, and which I have built on for this talk.

You can probably guess from my title that I am going to answer ‘No’ to the question I have posed about whether our industrial relations system is in need of reform.

I should begin, however, by explaining a little more specifically what I will be answering ‘No’ to. I am not saying that the industrial relations system a country adopts has no effect on its economic performance. I am also not saying that there are no industrial relations reforms in Australia’s recent past that have affected our economic performance.
What I do want to say with the title is that I think current talk of a crisis in industrial relations in Australia, and idea that there are potentially huge gains to overall economic well-being from further reform to the industrial relations system, are misplaced.

To set my topic in context I’ll begin with what I think is a representative sample of media coverage on industrial relations in Australia in the past six months:

On December 17 last year an article in the Australian Financial Review described that: ‘Business says the weak growth [in productivity] is because Labor’s Fair Work Act limits workplace flexibility and the ability of executives to manage.’

Quoted in the AFR on December 14 in 2011 AIG group chief executive Heather Ridout said ‘the new law (FWA) introduced barriers to productivity growth and labour flexibility. AIG members said FW gave unions too much power. Unions were pursuing unreasonable wage claims, penalty rates had risen and there was more pattern bargaining.’

On January 27 this year an article in The Age Business section reported that: ‘As Australia haemorrhages jobs in the manufacturing and service sectors, leading business figures claim a more flexible labour market may be the key to riding out the storm.’

More recently, articles in The Age have reported that ‘Unfair dismissals to continue to rise under the Fair Work Act…’ (February 1); and ‘Days lost from strikes and lockouts nearly doubled last year’ and quoted Australian Mines and Metals Association Chief Executive Steve Knott as saying that ‘The Fair Work Act is feeding this increase in industrial disputation…’ (March 9).

To tell you my conclusions at the outset, my response to the question I have asked about IR reform will make four main points:

First, a review of economy-wide data on labour market and macro-economic outcomes finds little evidence of effects of changes to Australia’s industrial relations system in the 2000s.

Second, I think this finding is explained by those reforms in the 2000s having been primarily distributional in their consequences, with little impact on the aggregate labour market macro-economic performance in Australia. However, there does seem to be some evidence of an effect from the reforms to Australia’s IR system that occurred in the 1990s.

Third, I want to argue that one way to understand concerns being expressed about Australia’s IR system at present is the same way as we now interpret arguments for protection against international trade: That when a group (employers or unions) argues for a policy reform this is likely to be because they think the reform will make them better off; but there cannot be any presumption that the reform will improve the overall well-being of society.

As a result of my review, I want to suggest that reform of Australia’s industrial relations system should not be an area of policy-making priority for governments.

My talk is going to proceed as follows. First, I will say something briefly about what I mean by an ‘industrial relations system’. Second, I’ll examine the evidence about the effects of changes to Australia’s industrial relations system in the 2000s. Third, I’ll conclude by suggesting several reasons why I believe industrial relations reform should not be a priority.
Industrial relations in Australia

What I take ‘industrial relations system’ to mean is the regulatory structure that governments introduce that affects what would otherwise be the employment agreement or relationship between an employer and employees.

Several aspects of a regulatory structure can be distinguished – which are represented in this figure (Figure 1). First, regulations can affect the bargaining unit through which employers or employees negotiate an employment agreement – for example, regulations can promote collective bargaining by workers through facilitating the formation and role in bargaining of trade unions. Second, regulations can affect the process of bargaining to reach an agreement over the conditions of work – for example, whether there is a role for a third party such as Fair Work Australia; or whether strike actions or lock-outs are allowed. Third, the locus of wage bargaining – for example, enterprise-level, industry-level, individual-level – can be directed through the regulatory structure. Fourth, regulations can mandate standards in the employment agreements negotiated between an employer and employees – for example, by imposing minimum wage conditions.

Significant reform of Australia’s industrial relations system commenced in the late 1980s and 1990s. A series of reforms (including the Industrial Relations Amendment Acts (1992, 1994) and the Industrial Relations Reform Act (1993)) encouraged the spread of enterprise bargaining, allowing a collective agreement for an individual enterprise registered with the Industrial Relations Commission (IRC) to replace the award that would otherwise apply to those workers, provided a no-disadvantage test was met. Awards were defined to constitute a ‘safety net’. New unfair dismissal provisions were also introduced.

The Workplace Relations and Other Legislation Amendment Act (1996) introduced further reform: scope for agreements with individual workers; restrictions on the role of unions and multi-employer agreements; a reduced role for the award system, with the IRC restricted to setting minimum wages and conditions regarding 20 allowable matters, and no scope to arbitrate on matters above the minimum safety net; outlawing of union preference clauses, and discrimination in favour of union members; and limits on the right to strike.

In the middle of the 2000s the new Work Choices system was introduced. This system expanded the flexibility for negotiating new agreements by abolishing the no-disadvantage test, and restricting the safety net in awards to 5 minimum standards. A Fair Pay Commission was established to set minimum wage rates. Some restrictions on agreement content and union rights were introduced, and the scope for unfair dismissal claims against ‘small’ employers (100 or less employees) was removed. The scope of Federal industrial relations regulation was expanded using the corporations power of the Constitution.

Subsequently in the late 2000s the Fair Work Act was introduced. It abolishes individual agreements, introduces requirements for parties to engage in collective bargaining in ‘good faith’, and restores the ‘no disadvantage’ test in the form of a ‘better overall’ test. The Act initiates a process of award modernisation to create a
reduced number of standardised awards that are consistent with a set of Common National Employment Standards (NES). A greater role is provided for unions in agreement-making and for multi-employer agreements. Unfair dismissal conditions have been restored under ‘adverse action’ provisions. The 12-month window for preservation of wages and conditions for transferring employees is removed, and the coverage of these provisions has been expanded to include out-sourcing. Referred powers from the states mean that all private sector workers (except in WA) are covered by the legislation

Effects of the 2000s reforms?

What have been the effects of Australia’s industrial relations system on outcomes in the economy? To answer this question I will examine a variety of economy-wide measures of labour market outcomes and macro-economic performance:
1. Wages growth
2. How the labour market adjusts
3. Labour productivity
4. The distribution of earnings
5. Industrial disputes

Before I get into looking at the data, it is important to say something about this exercise of trying to identify the effects of our industrial relations system.

How to do empirical analysis of the effects of Australia’s industrial relations system has been the perennial $64M question of Australian labour economics. The complexity of the Australian IR system and the difficulty of distinguishing the effects of the IR system from other determinants of labour market outcomes make the task problematic. In the case of Work Choices and Fair Work these problems are intensified by the short life-span of these systems. And whereas we might like to have data that allowed us to match workers to the institutional unit to which labour market regulation applies (such as the enterprise or award bargaining unit), instead we have only data on industry-level or economy-wide outcomes.

So you might be asking – Why am I about to spend the next 20 minutes trying to do this sort of empirical analysis? There are two main reasons. First, as I showed earlier, claims have been made that, for example, the Fair Work Act is having an effect on some of these economy-wide outcomes. So looking at the economy-wide data can tell us: Are these claims supported? In this sense, even an answer that says ‘We can’t tell’ is an important addition to the current policy debate. Second, notwithstanding the problems I just mentioned, we do believe that a country’s industrial relations system is an important determinant of what happens in its labour market. So it is a sensible approach to at least begin an analysis of the effects of that system by looking at economy-wide outcomes. Where changes observed in economy-wide outcomes are sufficiently pronounced, and where the timing of those changes matches the timing of reforms to the industrial relations system in Australia, then it may be possible to draw (in an appropriately cautious way) some lessons about the effects of the IR system.
In my talk I am going to present only charts of data on the labour market outcomes. But I’ll also discuss where I have done further statistical analysis to support the points I want to make.

I’ll begin with wages growth.

First, I have looked at the aggregate rate of growth in wages in Australia. This figure (Figure 2) presents data on the annual rate of change in average weekly ordinary time earnings for full-time males in Australia from 1983-84 to 2010-11 graphed against the rate of unemployment for the corresponding time period. Presenting the data in this way is what is known as a Phillips curve representation. It tells us about the trade-off that exists between unemployment and inflation in the economy. There are two points I want to make about the graph. First, look at the section labelled ‘post 1997-98’. You will see that I have distinguished the Work Choices observations and the Fair Work observations. The point I want to make is that there is very little difference in wage outcomes between these eras. It does not seem that there is economy-wide evidence that the shift from Work Choice to Fair Work has affected the rate of wage inflation. This finding is confirmed by regression analysis of the Phillips curve relation that I have undertaken. The second point I want to note is that there has been a shift inwards and flattening of the Phillips curve relation between that happened in the mid to late 1990s. This represents an improvement for the Australian economy: a shift to a lower inflation environment and one where wage growth seems less sensitive to demand conditions. There are a variety of potential explanations for this shift and I don’t think there has been enough analysis to say conclusively which was the most important – But it is worth noting that part of the explanation may be the shift to enterprise bargaining that happened in the mid-1990s.

Second, the way that the IR system might facilitate spill-overs in wage outcomes between workers in different sectors, what is referred to as pattern bargaining, has always been an important aspect of analysis of the consequences of IR in Australia. At present, a potential manifestation of pattern bargaining would be to have spill-overs in wage outcomes from the ‘booming’ mining states to the ‘non-booming’ other states.

Here, as a rough way of addressing the role of pattern bargaining in wage-setting, I have looked at wage growth in the mining and non-mining states in Australia in the period since the current mining boom began in mid-2004. This figure (Figure 3) shows the annual rate of change in average weekly ordinary time earnings for full-time persons in Australia from 2004-05 to 2010-11 graphed against the annual rate of change in employment. The idea is to get a feel for whether wage outcomes have differed between the mining and non-mining states, and to see to what extent the outcomes relate to differences in the rate of growth in labour demand. The data do appear to show distinct patterns between the mining and non-mining states: The mining states have had higher rates of employment growth and higher wage growth, and the non-mining states have had lower rates of employment growth and lower rates of wages growth. A simple regression model of the relation between wages growth and employment growth suggests that, conditional on employment growth, wage growth has been higher in the mining than non-mining states. By contrast, pattern bargaining effects might be expected to cause a higher rate of wage growth in non-mining states for any given rate of employment growth. Using the same model there
is also no evidence of wage growth rising in the non-mining states in the Fair Work era. So I take this as some evidence that pattern bargaining spill-overs from the mining to non-mining states have not been extensive.

Another way to look at this question is to go back to the last mining boom of the late 1970s and early 1980s. In this figure (Figure 4) I show the annual rate of change in average weekly ordinary time earnings for full-time persons in Australia from 1978-79 to 1982-83 graphed against the annual rate of change in employment. You can see the higher inflation environment in which we lived in that period. What you also notice is that there is more mixing of the observations of the mining and non-mining states. In this case the same type of simple regression model suggests that, conditional on employment growth, wages growth in the non-mining states was higher than in the mining states. This is consistent with what we might expect if there were spill-over effects on wage-setting from the mining to non-mining states. So we can also say that the evidence for spill-over effects in wage setting from mining to non-mining states seems to be weaker in the current mining boom than the previous boom in the late 1970s and early 1980s.

It is often suggested that a country’s industrial relations system will affect the degree of flexibility in the labour market, or the way that the labour market adjusts. As my second category I will consider various measures of labour market adjustment in Australia in the 2000s.

First, I consider how the Australian labour market has adjusted in downturns. In this figure (Figure 5) I show how adjustment to the recent GFC episode happened. What is notable is that employment remains stable, and instead the adjustment to the downturn occurs via a decrease in working hours. This tells us that employers responded to the decrease in demand in the GFC by cutting back the average hours their employees worked, rather than by laying off workers. Does this tell us that Work Choices imparted a new flexibility to the Australian labour market? Let’s look a bit more at the data. In the next figure (Figure 6) I show a similar graph, but for the period back to the start of the 2000s. What we observe is that the same pattern – hours adjusting more than employment – occurred in the early 2000s ‘tech wreck’ downturn. So maybe this has always happened? In the next graph (Figure 7) I compare the 2000s downturns with the two previous major recessions of the early 1980s and late 1980s/early 1990s. It does seem that the 2000s have been different. Much more of the ultimate adjustment to the downturn happens via average hours worked than through changes in employment. However, it is also important to note that the downturns in the 2000s were much milder than the previous episodes. In any downturn employers may initially try to avoid laying off staff, and instead will respond to lower demand by reducing the hours worked by their employees; but the downturn becomes sufficiently severe they will have to lay off workers. Looking at this figure suggests that this may be part of the explanation for the difference between the 2000s and the earlier downturns.

Overall I would say that: first, there is some evidence that the labour market adjusted differently to downturns in the 2000s than occurred previously – but importantly this pattern of adjustment was evident before Work Choices; and second, some part of the different patterns of adjustment may just be due to the downturns in the 2000s being milder.
Second, I look at dynamics in the labour market to consider a specific issue to do with effects of our IR system. Employment protection laws are often seen as an impediment to labour market flexibility: making it more difficult for an employer to dismiss workers, and hence reducing the incentive to hire new workers. As I noted in giving an overview of the recent IR reforms, through changes to unfair dismissal regulations, Work Choice can be regarded as having reduced the degree of employment protection to workers in small to medium sized firms, and Fair Work as increasing protection to that group of workers.

So is there any evidence that the IR reforms affected the likelihood of a worker being dismissed or an unemployed person being hired? To look at this question I use data on monthly transitions between different labour market states – employment, unemployment and being out of the labour force – from the late 1990s to the present. (Ideally we would like to have separate data on flows at firms with less than and more than 100 workers, since this was the cutoff in firm size for firms being affected by changes to unfair dismissal laws. But unfortunately we don’t have this data.) Using the data on flows I am able to calculate, for example, the proportion of unemployed persons who move out of unemployment into employment each month. I use new data on flows by disaggregated age groups just recently made available by the ABS – These data are useful because if we thought that unfair dismissal laws would have an effect it would probably be on the youngest age groups in the population.

I begin by looking at flows out of unemployment. Do the introduction of either Work Choices or Fair Work seem to be related to changes in the rate at which workers moved from unemployment to employment? From this figure (Figure 8) it is difficult to see any effect. For example, look at the period after the Fair Work Act. For the group in the population aged 20 to 24 years the rate of exit from unemployment does decrease in this period. However that decrease continues a trend that began well before Fair Work was implemented. In some further regression analysis of these data I have tried to control for the effect of the business cycle on flows out of unemployment to try to more precisely identify any effect of the IR system, but do not find any significant effect. The same finding holds with sensitivity analysis for dating the timing of implementation of the IR systems.

In the next Figure (Figure 9) I then look at flows out of employment. There is a similar story – either eyeballing the data or from regression analysis. Changes in the rate at which workers flowed out of employment do not seem to be significantly related to the IR system in place.

What I conclude from both these pieces of analysis is that any effects of the IR system on flows into employment or out of unemployment are being swamped by other influences.

As a final perspective on flexibility I look at patterns of structural change in employment in the Australian economy. This figure (Figure 10) presents indices of structural change in employment between industries and between states. As a preliminary comment you might be interested to see that the extent of ‘churn’ in employment between industries and states in recent years has not been exceptional by
historical standards. My main point though is to note that it does not seem possible to discern any effect of the different IR systems on the extent of structural change.

My third category is labour productivity. In this table (Table 1) I show the annual average rate of growth in labour productivity for 5 year periods from 1991 to 2011. I have used labour productivity rather than a MFP measure for several reasons – first, I want to be able to make my own combinations of productivity measures for different combinations of industries (which I do using the same method as Saul Eslake in his 2011 Grattan Institute report); second, the labour productivity measure incorporates potential effects of the IR system on capital deepening; and third, I think there is a trade-off in using MFP – arguably it is a purer measure of the change in efficiency, but getting this measure is dependent on the problematic process of measuring capital. I should also say that, in order to be able to include the most up to date data from the National Accounts, I have constructed my measures by calendar year – so, for example, when I say 2010-11 I am meaning the growth between the 2010 and 2011 calendar years. I use 5 year intervals so that I can compare intervals of similar length, with the final period encompassing the eras of Work Choice and Fair Work.

I have calculated three measures of labour productivity – for what the ABS calls the ‘16 Market sector industries’ and the smaller group of ‘12 Selected industries’ that excludes several service sectors where measurement of value added might be regarded as problematic. I also calculate labour productivity in a set of ‘9 industries’ that exclude agriculture, mining and utilities – three industries where the Productivity Commission argues that labour productivity has been affected by one-off factors in the 2000s.

Looking at this table I want to make a couple of points. First, you see that low labour productivity is not a phenomenon that has just happened in the past 2 years. Whichever measure is used, labour productivity in the past 5 years is about 1 percentage point lower per annum than the preceding 5 years, and lower when compared with the 1990s. Second, it is evident that, while the general time-series pattern remains similar, the choice of industries to use for calculating labour productivity can cause quite a difference in the size of the rate of growth in productivity estimated. Excluding the ‘PC3’ does cause a higher rate of growth in labour productivity; but since this effect extends back to the late 1990s, it does not seem to explain much of the decline in labour productivity that has occurred.

It is also possible to look in a bit more detail at the Work Choice and Fair Work era. In this figure (Figure 11) I do this by showing the annual rate of growth in labour productivity from 2004-05 to 2010-11. Again, you get a feel for how the estimated rate of labour productivity is sensitive to the set of industries included.

How should we interpret this in terms of the Work Choices and Fair Work IR systems? Even if you thought that the IR system was the only factor causing changes in labour productivity I think it is difficult to draw strong lessons. For example, looking at the series for the 12 selected industries, from 2006-07 to 2010-11 the rate of growth in labour productivity has moved within the band from 1 to 1.5 percent.

Of course, if you wanted to include 2005-06 as part of the Work Choices era you could get a higher estimate of average labour productivity growth in that era – But
this seems problematic since Work Choices was only introduced at the end of the first quarter in 2006. And then it would still be necessary to explain the lower rates of growth in productivity in the years immediately after. In fact, the high rates of growth in 2005-06 seem mainly to be explained as the working out of very low rates of growth (about zero) in 2004-05 when there was very rapid employment growth.

[As an aside, I also wanted to say something briefly about the faster rate of growth in labour productivity in the 1990s. What seems to have become in folklore the main explanation for this improvement is the microeconomic reform agenda in Australia in the 1980s and 1990s, including changes to Australia’s IR system in the mid-1990s.

But it is very important to note that we have very little direct evidence of effects of labour market reform on labour productivity in the 1990s. Instead, what is usually presented is evidence by exclusion. For example, the Productivity Commission in its submission to the 2009 House of Representatives Select Committee Review of productivity wrote that: ‘The removal of these [other] possible explanations as likely causes of the surge in productivity leaves the reforms of the latter part of the 1980s and 1990s as the prime candidate.’

When I read an argument made this way I always think of Raymond Chandler’s detective Philip Marlowe who says in ‘Playback’: ‘There are things that are facts, in a statistical sense, on paper…And there are things that are facts because they have to be facts, because nothing else makes sense otherwise.’ It is an approach that might work in detective stories, but as Keith Hancock has recently noted, can be fraught in real life: ‘reliance on the process of elimination entails a risk of overlooking something and also requires you to be sure that your grounds for rejecting each alternative and all of them together are cogent.’]

The fourth category of outcome that I want to look at is the distribution of earnings. Have the changes to our IR system in the 2000s had any apparent effect on how equally earnings are distributed? There are many ways to look at this question, here I just present two (I have looked at other ways and found the same answer).

First, in this figure (Figure 12) I show the ratio of weekly earnings in main job for males working full-time – comparing between workers at the 80th percentile of the earnings distribution and at the 20th percentile of the earnings distribution. It can be seen that the ratio has steadily increased from the late 1980s to the present: In 1988 the ratio was 1.88, and in 2010 it was 2.25. When you look at the way that inequality has increased at a fairly steady rate throughout the 2000s, I think it is difficult to attribute much of an effect to the IR system.

Second, in the next figure (Figure 13) I show changes to real (CPI-adjusted) earnings in the 2000s for workers earning the minimum wage. I compare that series against changes in real earnings for a worker at the bottom of the earnings distribution and a worker receiving average earnings. This figure is intended to evaluate whether the IR reforms in the 2000s, each of which introduced a new method for setting minimum wages, affected minimum wage outcomes. It can be seen that over the whole of the decade real earnings of workers earning minimum wages increased by less than average earnings or low-paid workers from the general working population. Notably, however, in the period after the introduction of Work Choices the real minimum wage
increases by a similar amount to the growth in real earnings for low-paid workers from the general working population. It was in the period before the introduction of Work Choices that the gap between minimum wages and earnings of low-paid workers from the general population occurs. Hence it seems reasonable to conclude that minimum wage adjustments in the Work Choices and Fair work eras have been commensurate with wage changes for the general population of low-paid workers in Australia.

The last category of possible effects that I will consider is industrial disputes. It has been suggested that the Fair Work Act has caused an increase in industrial disputes. What do the data say? In this figure (Figure 14) I show days lost to industrial disputes per thousand workers in 2009 to 2011. (One important point in looking at data on industrial disputes is to be sure to control for the size of the workforce. Days lost to industrial disputes may increase just because the workforce is larger; but what we really want to know about is the incidence of industrial disputes – information that we obtain by dividing days lost to disputes by the number of workers.) It does seem that strike activity in 2011 is higher than in previous years. But let’s take a slightly longer perspective – back to 2006. In the next figure (Figure 15) I do this, as well as distinguishing between the Work Choices and Fair Work eras. The average days lost in the Fair Work era is slightly higher than in the Work Choice era; although this difference is not large. It is too early to say for sure how the transition from Work Choices to Fair Work is going to affect the level of industrial disputation.

What we can say, however, is that in both phases the level of industrial disputes in Australia has been very low by historical standards. In this figure (Figure 16) I go back to 1985 to make this point. Viewed from this longer-run perspective, the current low levels of days lost to industrial disputes is part of a long-run trend in that direction. This may to some degree reflect the effect of labour market institutions – for example, that the same decline in strike activity has occurred simultaneously across many countries has led to some analysis suggesting that it is a reflection of declining trade union density. But it seems difficult to give IR reforms of the 2000s a major role in this process.

What do I take from this analysis?
First, that it is difficult to argue that there is economy-wide evidence that changes to Australia’s IR system in the 2000s have affected labour market outcomes or macro-economic performance. Whether you think that this is because there are no effects, or because it is just difficult to measure the effects, the message is the same – There is no economy-wide evidence to support claims that changes to the IR system, such as the introduction of the Fair Work system, have affected outcomes like productivity or wage flexibility.
Second, to the extent that recent IR reforms have mattered, it seems that the action was in the 1990s, the period that saw the initial introduction of enterprise bargaining.

What I want to do now is address two supplementary questions that you might ask that relate to the analysis I have just presented.

My first question is to ask: You have said that the reforms to Australia’s IR system in the 1990s might have had some effect, but that in the 2000s there is no evidence of effects on economy-wide outcomes. Why hasn’t there been an effect?
I think that the explanation is the scale and type of changes made in the reforms of the 2000s compared to the 1990s.

My view is that the reform that has had most consequences for Australia’s macro-economic performance was the shift in the locus of wage-setting to enterprise bargaining that commenced in the 1990s. It was the shift to enterprise bargaining that I think introduced greater flexibility in wage-setting within and between enterprises. By contrast, the 2000s reforms do not seem to have brought this depth of change.

As some evidence on the relative effects of the reforms on the locus of wage bargaining, by May 2004 Australia had shifted to a situation where only 20% of workers were covered by awards with over 40% of workers being covered by registered enterprise agreements; whereas in the next 6 years these proportions changed only minimally, to about 15% and 44%.

Previous cross-country research supports the idea that the shift in the locus of wage bargaining should be considered a major change in Australia’s industrial relations system, and that this change would be expected to improve economic performance. The Calmfors-Drifill-Freeman (CDF) hypothesis posited a U-shaped relation between economic performance and the degree of centralisation in wage bargaining in a country. Countries with either highly decentralised or centralised wage-setting systems would have the best performing labour markets, and countries ‘in the middle’, where the locus of wage bargaining was for example at the occupation or industry level would perform worst. To the extent that the introduction of enterprise bargaining shifted Australia from the middle of the centralisation range to the decentralised end of the range, the CDF hypothesis would therefore predict improved labour market performance. It is also likely that the relation between economic performance and the degree of centralisation in wage bargaining becomes increasingly important as exposure to international trade increases, as happened in Australia from the 1980s onwards.

More recent research and commentary also supports the idea that the ‘big reforms’ to labour market regulation in Australia happened in the 1990s. A paper by Richard Mitchell, Peter Gahan and co-authors presents the findings from a leximetric study of the evolution of labour law in Australia and concludes: ‘Contrary to what many might expect, our results suggest that Australian labour law has been relatively stable…and that the most significant changes occurred under the Keating government in 1993, rather than the more recent Work Choices or Fair Work reforms.’

Other commentators have expressed what I interpret to be a similar view; in particular with regard to Work Choices. Saul Eslake for example has recently written in his chapter for the 2011 RBA conference volume that that Work Choices reforms ‘…were not, primarily, ‘productivity enhancing’; and George Megalogenis in The Australian Moment has argued that, referring to wage setting as a source of inflationary pressure: ‘Work Choices sought to solve a weakness in the Australian economy that no longer existed.’

Instead, I think the types of reforms made in the 2000s have been primarily distributional in their consequences. I would argue that their main effect has been on
the bargaining power and hence relative shares of the gains from productive activity accruing to the owners of businesses and to workers; rather than on the total size of those gains. I think it is possible to make this argument by considering the nature of the reforms, and what empirical evidence is available.

Again taking the example of Work Choices on which most has been written. I don’t think it can be argued that Work Choices caused a major change in the locus of wage bargaining, but I think it can be argued to have affected bargaining power of workers and employers. Removal of the no-disadvantage test and a smaller number of allowable minimum conditions; and a restricted role for trade unions - shifted the balance of bargaining power towards management and away from workers. In an article previewing the effects of Work Choices Mark Wooden concluded: ‘The legislation clearly shifts the balance of power in the employment relationship more towards the employer.’

There is also supporting empirical evidence that the change in bargaining power was manifested in new employment agreements that – at least for workers with low bargaining power – appeared to worsen their conditions of employment. Of course it must be remembered that registered individual agreements remained a relatively small fraction of methods by which pay and conditions were set.

[Perhaps it is also reasonable to treat as evidence of the distributional effects of Work Choices the test of ‘political revealed preference’ in 2007 where the Commonwealth government introduced a new ‘Fairness test’ as a substitute for the no-disadvantage test that it had previously removed. And it is also important to note that the limited evidence on effects of Work Choices is partly due to an absence of data. As one example, after a bruising initial encounter with the Senate Estimates Committee on Employment, Workplace Relations and Economics discussing data on a sample of Australian Workplace Agreements, the Employment Advocate announced at the next meeting of the committee he attended that the practice of reviewing the agreements had been discontinued.]

For reasons of time I have not directly addressed the example of Fair Work – But I believe a similar argument on its distributional consequences can be made.

My second question is: If you are right about IR reforms in the 2000s having only limited effects on economy-wide outcomes, then why is there so much discussion about IR reform being necessary for improved economic performance in Australia?

To an economist, behaviour is driven by incentives. So an economist would say that all we can infer from the fact that a particular group argues for a policy change is that that group expects to be made better off by the change. It does not in any way mean that society as a whole will be made better off.

In very simple terms there are two ways that either business owners or workers can be made better off. First, there can be an increase in the total size of gains from productive activity. So that even if, for example, each group only keeps the same share of those gains, they are both now better off. Second, the total size of gains from productive activity may stay the same (or even decrease), but one group can still be made better off if it can increase its share of the gains from production sufficiently.
The important point is that in both these situations the group that gains would have an incentive to argue for the policy reform that caused the change.

This is the big lesson we learned from the tariff debate in Australia from the 1960s to 1980s. As my colleague Max Corden has written in his excellent book of essays *The Road to Reform* ‘...the tariff system as it existed in the 1960s and early 1970s was fundamentally irrational, other than as explainable in political or pressure group terms. There was really no sound basis from a national interest point of view for protecting one industry...relative to others’. Employers and workers in particular industries argued for protection, not because it would benefit the economy as whole, but because it would benefit that industry.

While recent developments may show that we have not been completely weaned from protectionist sentiment, my own judgment is that there is now a fairly general understanding that claims for protection against international competition represent special pleading.

The puzzle to me is that the same ideas of underlying behaviour – that a group is likely to advocate policy based on its private interest rather than public interest – does not currently seem to extend to the topic of industrial relations reform. Claims that industrial relations reform is necessary for improved economic performance in Australia are reported with great credulity, and little questioning of the motives of the claimants. This ignores entirely the distributional consequences of industrial relations reform; which in the end is I think the answer to my second question.

My final question is: What should we do?

I have already given my answer to this question, which is that I do not see the need for major reform of Australia’s industrial relations system.

If we can’t see adverse effects in the economy-wide data, and in the absence of any convincing systematic empirical evidence, I think we should adopt a cautious approach to policy reform. This is the point I have tried to make with the evidence I have presented in my talk.

There are also some other considerations I would like to mention.

One is adjustment costs. Every time we change a major policy such as our industrial relations system we cause large adjustment costs. I have never seen an attempt to calculate the costs of adjusting to a new regulatory structure. But the one common criticism made of Work Choices and Fair Work in review articles – from both the perspectives of employers and workers - is the extra regulatory burden they have introduced; and the amount of time and resources needed to ‘learn’ how to operate under the new systems. In this table (Table 2) I show data from surveys undertaken by the Australian Human Resources Institute of their members on effects of the introduction of Work Choices and Fair Work – The common story is one of extra work.

I think that too often policy-makers suffer from what I label the ‘Ikea fallacy’. We see the furniture in the store and think how good it would look where we live. But we
forget about the costs of putting it together. Similarly with policy. Policy-makers are
great at visualising what they think will be the end product of policy reform; but not
so good at taking into account the adjustment costs (which are a real cost of the
reform to society) in getting there.

Second, if the outcome from any future reform would be to adversely affect
distributional outcomes without a definite prospect of improving efficiency or overall
well-being, I think this is a further reason for caution.

Third, I think there is an opportunity cost of time spent on policy reform in industrial
relations that needs to be taken into account. Governments have only so much time to
devote to policy making. So it is important that they choose the areas where policy
reform can have the most value added for our society. In my judgement IR reform
should not be on this list.
Figure 1: The industrial relations system

The System of Wage Regulation in Australia

- **b** process – compulsory arbitration/role of industrial tribunals
- **c** locus of wage determination
- **a** promotion of collective organisation
- **d** regulation of outcome
- **wage bargaining**
- **employer**
- **workers**
Figure 2: Phillips curve, Australia, 1982/1-1983/1 to 2010/4-2011/4

Figure 3: Rate of change in employment and rate of increase in AWOTE (full-time persons), 2004/1-2005/1 to 2010/4-2011/4
Figure 4: Rate of change in employment and rate of increase in AWOTE (full-time males), 1978/1-1979/1 to 1982/4-1983/4

Figure 5: Employment and hours worked, Australia, 2007/3 to 2010/3
Figure 6: Employment and hours worked, Australia, 2000/3 to 2010/3

Figure 7: Percentage change in aggregate monthly hours worked and total employment by quarter after commencement of downturn
Figure 8: Monthly flows out of unemployment to employment, Persons, Australia, 1997/12 to 2011/11 (13-month moving average)

Figure 9: Monthly flows out of employment (to unemployment or OLF), Persons, Australia, 1997/12 to 2011/11 (13-month moving average)
Figure 10: Structural change in the industrial and geographic composition of employment, Australia, 1985-86 to 2010-11 (August)

Table 1: Average annual rate of growth in labour productivity, Australia, 1991 to 2011 (calendar year)

<table>
<thead>
<tr>
<th></th>
<th>Market sectors (16)</th>
<th>Selected sectors (12)</th>
<th>Selected sectors minus agriculture; mining; utilities (9)</th>
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<tr>
<td>1991-1996</td>
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<td>2.8</td>
<td>2.6</td>
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<tr>
<td>1996-2001</td>
<td>2.85</td>
<td>2.6</td>
<td>3.0</td>
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<td>2001-2006</td>
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<td>2006-2011</td>
<td>1.1</td>
<td>1.25</td>
<td>1.55</td>
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Figure 11: Annual rate of growth in labour productivity, Australia, 2005-06 to 2010-11 (calendar year)

Figure 12: Ratio of earnings, 80th and 20th percentiles, Full-time workers in main job, Males, Australia, 1982 to 2010 (August)
Figure 13: Changes in real earnings, 2000 to 2010, Australia

Figure 14: Industrial disputes, Days lost per thousand employees, Australia, 2009 to 2011
Figure 15: Industrial disputes, Days lost per thousand employees, Australia, 2006 to 2011

Figure 16: Industrial disputes, Days lost per thousand employees, Australia, 2006 to 2011
<table>
<thead>
<tr>
<th></th>
<th>Work Choices</th>
<th>Fair Work</th>
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<td><strong>the complexity of</strong></td>
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<td><strong>employment arrangements?</strong></td>
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<td>9.8</td>
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<td>56.2</td>
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Figure xx: Trade union density, Australia, 1976 to 2010