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Introduction: Welfare And The Labour Market: A New Frontier For Reform? Essays in Honour of the late Professor Fred Gruen

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Abstract
This paper introduces the papers based on a series of lectures held by the Centre for Economic Policy Research at the Australian National University in 2001 to commemorate the wide-ranging economic contribution of the late Professor F.H. ('Fred') Gruen. The theme of the lectures was 'Welfare and the Labour Market: the New Frontier for Reform?' This topic is of great contemporary policy interest as, for some time now, successive Australian governments have been attempting to build a constituency for welfare reforms that will fundamentally influence the nature of Australia's welfare system and the values upon which it is built. Specifically, there is sustained emphasis on moving away from income support towards facilitating economic independence of welfare recipients by market work. The papers which comprise this special issue of the ***Australian Journal of Labour Economics*** *set the scene for an informed, objective and comprehensive Australian work to welfare debate.*

Preface
In May 2001 the Centre for Economic Policy Research at the Australian National University held a series of lectures to commemorate the wide-ranging economic contribution of the late Professor F.H. ('Fred') Gruen. The topic chosen was *Welfare and the Labour Market: the New Frontier for Reform?* This topic is of great contemporary policy interest as, for some time now, successive Australian governments have been attempting to build a constituency for welfare reforms that will fundamentally influence the nature of our welfare system and the values upon which it is built. Specifically, there is emphasis on moving away from income support towards facilitating economic independence of welfare recipients by market work.

Fred Gruen would have loved to contribute to the lectures: they are policy relevant; he played such an important role in the promotion and economic

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analysis of the welfare state and its implications for poverty alleviation; and he was also interested in the delivery of efficient and equitable labour market outcomes. As noted by Peter Saunders 'Fred Gruen was one of the few Australian economists of his generation who took an interest in issues associated with the welfare state, both in Australia and how we compare internationally. Over the last decade, more and more economists have followed his lead, and their views and influence have become increasingly dominant in assessments of the role and impact of the social security system, and in the design of social policy generally' (page 507).

The important distinction between 'equity' and 'efficiency' was a major theme of Fred Gruen's contribution to economics - particularly in the latter part of his career - and both objectives are important in the development of labour and welfare policies. The development of good policy in these areas requires a significant breadth of approach: attention to economics, history, politics, culture, institutions and 'good' values are all necessary ingredients. It is this breadth that gave Fred Gruen's policy contributions substance and longevity.

Background

Australian policy makers are proud of their record of economic reform, a process actively pursued for over thirty years. Tariff reform was one of the first, and Fred Gruen was a member of the group that introduced the 25 per cent across-the-board tariff reduction in 1973. Policy reform then moved to deregulation of financial markets and, more recently, with respect to the pursuit of competition policy and labour market reform.

Some part of policy makers' satisfaction arises because achieving reform is both politically difficult and widely used as an indicator of effective government. Importantly, policy reform often apparently leads to some good outcomes. Over the last decade, for example, real wage and labour productivity growth have lifted from the low growth rates of the late 1970s and the 1980s and returned to the higher growth experience typical of the 1950s and 1960s. The satisfaction with the macro performance can be seen in the papers presented at the Reserve Bank Conference on 'The Australian Economy in the 1990s' where a visiting U.K. academic described our macroeconomic outcomes as the Australian 'Miracle' (Bean, 2001).

The reform process began in earnest during the early 1970s when the proportion of people of workforce age on income support was around one in twenty. Afterwards the full-time employment-population ratio began to fall and unemployment to increase. Some of the impetus for subsequent reforms therefore can be seen as attempts to restore full-time employment levels. However, Gregory (2001) argues that the failure to deliver adequate full-time employment has contributed importantly to the fact that in 2003 just over one in five Australians of workforce age are receiving income support from the welfare system.

There is clearly now a need for informed consideration of policy change, and economists generally agree that the new reform frontier is the overlap between the labour market and welfare policy. The future areas of policy development and debate are as follows.

First, there is widespread concern that the incentive structure between work and welfare is not quite right. For some of the low skilled, the income gap between full-time employment and welfare support is too small. One response has been to increase the incentives to find work by reducing real income support for the unemployed, relative to male total average weekly earnings, through indexation arrangements. Another has been to reduce the marginal effective tax rates for those who combine income support with labour market involvement to encourage more part time employment. Pensions, however, are still indexed to average real wage growth, and have moved substantially above unemployment allowances.

Second, even given the above, the principal contemporary objective is to significantly reduce the number of people accessing income support rather than to reduce payments. Consistent with this, most political support is for marginal changes, such as the introduction and extension of mutual obligation, and for a more efficient job placement and training network for the unemployed.

Third, few economic advisers believe that these reforms alone will be sufficient to bring about a significant change in income support numbers. Job employment growth must increase but there is no clear and shared vision as to how this might be done. Is more labour market reform required? If so, it is probably too radical to be widely accepted in the community at this point.

The major focus of our welfare system is income support and poverty alleviation and it has traditionally been seen as a response to the need to offset the adverse income effects of unemployment. But, over the last decade, in terms of absolute numbers and rates of growth, unemployment is no longer the major part of our welfare system. Recently the growth of lone parents and those with a disability have overwhelmed unemployment numbers (Gregory, 2001).

The key issues are: has Australia got the balance right between labour market and welfare reform; and how far and how fast should we proceed in each area? These are the difficult questions. The papers in this volume, with their close linking of welfare and labour markets, help move us along in this process.

The International Setting

The major external intellectual underpinning for change is emanating from the U.S., with its experience of welfare reform and the Earned Income Tax Credit. This is discussed in the paper by Robert Haveman, in which it is accepted that welfare reform must be discussed in the context of labour market incentives and institutions. He contrasts the labour market/welfare systems of the U.S. (characterised by flexible wages, low minimum wages, short periods of welfare entitlement, low replacement rates and income support directed towards those in low paying jobs) with those of Western Europe (with high replacement rates, rigid wage structures, long periods of entitlement and high minimum wages).[1]

Haveman argues that the divergent employment/real wage paths of these two types of economies since the mid-1970s can be explained as follows. The U.S. has had strong employment growth because it has had virtually no real wage growth, on average, and very large falls in the wages of the low skilled. In this view welfare reforms, and low levels of income support, ensure that wages for the unskilled fall when there is declining demand, influencing welfare recipients to accept jobs when they become available.

Europe, in contrast, has had little employment growth because real wage growth has been high. Haveman argues that there is high unemployment of the low skilled because income support is too generous and low skilled wages have not fallen sufficiently to create jobs. Australia is clearly in the European set - although in Australia replacement rates are lower and the labour market is more flexible.

Haveman is clearly critical of the European system but he is not an unqualified admirer of the U.S. system. He approves of the U.S. employment generating properties but is not satisfied with its low wage outcomes for the unskilled.

He makes two reform proposals. The first is an Employer-Based Marginal Employment subsidy that would provide financial incentives to employers who hire low skilled workers over and above the numbers they would otherwise hire. While this seems to make economic sense, a difficulty lies in administration to ensure proper targeting.

Haveman's second recommendation is for an Employee-Based Wage Subsidy program such as the EITC (or what is generally referred to as 'in work benefits'). This is a tax credit phased in over an initial range of low earned family income and withdrawn across a higher range of earned family income. There is thus an employment incentive effect for very low income families to enter the labour market and a disincentive employment effect for families with low to middle incomes who face higher marginal tax rates as the income tax credit is withdrawn with earning increases. But both groups gain additional income for a given amount of work.

[1] Haveman's classification system is a little more complex than this. He defines Western Europe as France, Germany and the Scandinavian countries. The North Atlantic model includes the U.S., U.K. and the Netherlands.

With the EITC there are several other policy concerns raised by Haveman. One is that there must be a large movement of income source from the employer to the government because such schemes allow real wages to fall. Also, the EITC involve potentially substantial increases in disincentives at the points at which support phases out. Haveman suggests therefore that such a policy substitution seems economically unworkable with high benefit levels. This leaves him with the position that there is no alternative but to reduce the generous public benefits available to the unskilled or to adopt a range of tight targeting which favours some low income workers but not others.

In the U.S., this is now the main form of welfare assistance. And similar schemes have been adopted in the U.K., Denmark and the Netherlands and proposed for Australia. (The papers by Peter Dawkins and Patricia Apps consider the merits and otherwise of such a system for Australia.) In all the policy suggestions the European (and Australian) unskilled will be worse off than they are now unless the act of work has sufficiently strong positive effects to generate much higher lifetime income. This might happen through investments in additional human capital generating future earnings growth, an issue analysed in Chapman, Jordan, Oliver, Jordan and Quiggin (2001).

Bobbi Wolfe also discusses the U.S. reforms. She adopts a more micro approach, provides more detail as to policy design, and describes the recent history of the movement to Temporary Assistance for Needy Families (TANF). Her paper begins by noting the marked difference in philosophy underlying the current system and that which went before. The pre-TANF policy was based on an acceptance of the need to provide a minimum level of living through public transfers. It was thus an income support system. The new system is based on the belief that all able bodied individuals and families should be economically independent and self-reliant. The value of work, independence and self-reliance are the key underlying values.

The change in philosophy in the U.S. has led to reduced income for those who are not working and increased rewards for work effort. A much larger share of the welfare budget is now spent on work related expenditures such as child care, public sector job provision where no jobs exist (something that is missing in Australia), and subsidising and providing health insurance. Wolfe argues that the new U.S. system is not simply one of cutting benefits, but involves redirecting expenditure towards job finding, and subsiding low-income employment. Indeed, the evidence suggests that the new system involves greater public outlays than the system it replaces.

The U.S. reforms differ by state. Wolfe discusses the Wisconsin reforms and concludes that they lead to only marginally higher employment rates. There has also been a substantial drop in earnings per employed person leaving welfare, but this has been compensated for by the EITC. The reduction in welfare rolls has been substantial. Although it is too early to be sure of the success of the policy - evaluation is complicated and there is a need to see how well the system works in a depressed labour market - the prevailing view is that the reforms have worked well.

Outcomes for children are an issue under a system where lone mothers need to spend substantial time in paid work. However, preliminary evidence suggests that young children are not suffering from welfare reform on average. But Wolfe suggests that there is some evidence of negative effects for adolescents.

In-work benefits, and substantial welfare reforms, have been adopted in a number of European countries. Dan Finn provides a general outline of the reform process in the U.K., a particularly interesting case since the labour market and welfare changes have gone further towards a U.S. system than for any other European country.

Finn examines in detail the radical changes introduced to labour market program intervention in the U.K. since 1997. As with many other countries the essence of these developments has been to move the unemployment benefit system much more towards active participation, of both the unemployed and government agencies. It has entailed very significant changes in the rights and responsibilities of the jobless, the level and nature of taxes and benefits, and the activities and institutional make-up of government intervention. The 'New Deal' is apparently just that.

A theme of the paper is that these developments have been informed by a wealth of experience from other countries. The requirements for active intervention by both parties – policy known broadly as a 'mutual obligation' – can arguably be traced to the Swedish approach of the 1960s, although it is likely that Australia's 'Job Compact', introduced as part of '*Working Nation*' in 1994, was part of the contemporary model encouraging U.K. reforms.

Indeed, in 1996 the U.K. labour market had many characteristics similar to the conditions preceding the major but short-lived changes introduced in Australia in 1994.[2] This all changed in the U.K. with a series of policy reforms targeted initially at young (less than 25 years) unemployed, but now being extended more broadly. A unique aspect to the U.K. experiment has been the institution of the 'Gateway', a period in which those with high or expected high unemployment duration work closely with an adviser to consider appropriate options, such as retraining or community service. At the end of the period, an employment or training activity needs to be undertaken, or future benefits are jeopardised.

[2] That is: long-term unemployment was very high (in both absolute numbers and as a proportion of all unemployment); there was a smattering only of poorly integrated labour market interventions; the system was basically passive, involving few direct obligations on the part of the jobless; and the tax/benefit arrangements did not reward individuals sufficiently for making the step from unemployment to employment.

These aspects of changed intervention have been accompanied by revisions to tax policy designed to diminish the potential for poverty traps. This takes the form of tax credits for low income individuals, contingent on employment (similar to the U.S. reforms). There has also been considerable change with respect to the form of delivery of assistance. As has been the case in recent Australian labour market intervention, private sector organizations have been involved in the delivery of job assistance.

Finn notes that evaluation of these reforms is ongoing, with mixed results so far. In aggregate there has been a marked decrease in unemployment since 1997, and an even bigger fall in long-term unemployment numbers and proportions. But it is probably the case that there have been modestly positive outcomes only for targeted individuals that can be attributed directly to program and welfare reform.

It is difficult to assess the success of the U.S. and U.K. welfare reforms in terms of employment growth and welfare number reductions, because of simultaneously strong macroeconomic performances. This issue is taken up by Black, McKinnish and Sanders, who point out that between January 1993 and March 1999 in the U.S. the number of welfare recipients reduced by nearly half from 14.1 million to 7.3 million but over the same period the U.S. economy created an additional 14 million jobs.

They note that the U.S. Council of Economic Advisers suggests that 35 per cent of the reduction in welfare rolls can be attributed to welfare reform and 10 per cent to the reduction in unemployment. Other economists have reached similar conclusions. But there is a recent cohort of studies, using more dynamic specifications, which suggests 75 per cent of the decline in caseloads is due to the increase in economic growth.

Black et al. focus on long term effects of two large employment shocks in different regions in the U.S. in which the coal and steel industries were large employers of unskilled labour during the 1970s and 1980s. They show that welfare participation responds very strongly to the long-term availability of high paying jobs for low skilled workers. This leads them to believe that the effect of strong employment growth during the period of welfare reform during the 1990s has been grossly underestimated. In other words, welfare reforms alone have not been the major factor in the large reduction in the number of welfare recipients.

The role of the economy is one of the key issues to be resolved. The strong growth in the U.S. economy during the period of welfare reform was the ideal environment for change, but in many ways the test of the new system will come during the next serious downturn.

The Australian Environment

Saunders helps set the general welfare reform scene for Australian policy analysis by noting that there is no strong link between unemployment and poverty, nor does there seem to be a strong link between changes in unemployment and changes in poverty across countries. For example, the unemployment rate in Finland increased from 3.2 to 16.3 per cent during the early 1990s with very little change in poverty. In the U.S. during the early 1990s there was falling unemployment and rising poverty. The lack of a clear relationship is attributed partly to the differences between countries concerning both their operations of welfare systems and degrees of wage flexibility. He stresses that labour market institutions and the design of welfare systems should not be separated in policy discussions.

He suggests that one reason for the lack of clear links between unemployment, poverty and inequality is the increasing importance of two income families. Although low wage earnings are concentrated at the bottom of the income distribution, they are also found in the upper reaches of the distribution of family income. When one family member is unemployed another may be employed, although Saunders notes the growing familial concentration of joblessness.[3]

Finally, he notes that neither income distribution nor poverty is mentioned in the McClure Report and emphasises that the welfare debate in Australia has increasingly moved the focus away from these issues towards the need for employment in its own right. He argues that debate is increasingly similar to that in the U.S., with politicians stressing the need for a welfare system encouraging self-reliance and independence rather than to meet poverty, inequality and income support objectives.

Peter Dawkins was a member of the Reference Group on Welfare Reform (2000) and a signatory to the 'Five Economists' open letter' to the Prime Minister on October 1998.[4] The letter argues the case for the introduction of an EITC and minimum wage cuts. At the heart of his analysis is a concern for the incentive structure faced by welfare recipients.

To illustrate the point, he presents a number of examples. One is a couple family with no children who move from welfare support to a $500 a week full-time job for one member. However, this increases the net income of the family by only $73.66, which is highly suggestive of excessive effective marginal tax rates in Australia. Dawkins also believes that it is essential to reduce the wages of the low skilled to encourage job creation, and this is where an EITC comes in. A tax credit will be substituted for the wage fall to leave the individual with the same level of income. Dawkins proposes a move from an emphasis on income support, as the purpose of the welfare system, to an emphasis on self-reliance, work and independence.

Dawkins summarizes work by the Melbourne Institute that indicates

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[3] The unemployment rate of a married man with an unemployed spouse is around 19 per cent in Australia. For a male with an employed spouse the unemployment rate is around two per cent.

[4] The others are John Freebairn, Ross Garnaut, Michael Keating and Chris Richardson.

that the introduction of an 'in-work' benefits scheme that they propose would produce small negative effects on married women's labour supply, small but positive effects on other low income groups, but a more substantial positive effect for lone mothers. He suggests a five per cent increase in lone parent labour supply might be expected from the 'in-work' benefit scheme he argues for and that the consequent reduction in expenditure would be large enough to almost fully recoup the up front cost of the tax credit for lone parents.[5]

In the following paper, Patricia Apps takes a very different stance. Apps is a severe critic of an EITC program and presents her detailed criticisms in the context of the Family Tax Credit proposed by the Australian Labor Party at the time of the 1998 election. Her analysis focuses on two parent families and suggests that an EITC is a fundamentally flawed reform due to the nature of the income test and the consequent redistribution of the overall tax burden. According to Apps there are the following difficulties.

First, because the credit is withdrawn on family income, it raises effective average and marginal tax rates for second earners in low to median wage families working long hours to improve their standard of living. This results in a redistribution of the overall burden of taxation towards these families. Apps judges this to be inequitable.

Second, it is argued that the tax credit expenditure on families receiving benefit will far exceed any possible reduction in expenditure on income support. The reform thus raises the question as to how it will be funded. Some commentators have argued that this should not be financed through an increase in the top marginal personal tax rate and if this constraint is applied Apps' analysis of a revenue neutral reform shows that the cost of the program then falls predominantly on the group of low to median wage families. Her conclusion is that with such changed arrangements high income families would largely escape the additional taxes needed to fund the reform.

Third, Apps argues that an EITC program will have a negative effect on employment and also on economic growth. While a credit withdrawn on family income reduces effective tax rates for primary earners over the phase-in range, they increase them for secondary earners who typically are found to have more responsive labour supplies, reflecting the fact that, with the presence of children, home production becomes a close substitute for market work. The argument is that as secondary earners withdraw from the workforce, or substantially reduce their hours of work, they switch to less

[5] There are about half a million lone parents of which 20 per cent are employed full-time. A five per cent increase in labour supply of lone parents, assuming they all took full-time work and left the income support system, would reduce the number of lone parents receiving income support from around 400,000 to 395,000. This seems a remarkably small gain for such a radical new program and hardly seems worthwhile. Perhaps the real gains from the Five Economists plan would be delivered by the wage reduction for the low paid and that the 'in work benefits' was a mechanism to help bring that wage reduction about.

efficient home production of goods and services they previously purchased, and so their demand for market output falls. In addition, Apps predicts that household saving will also fall because, ceteris paribus, two earner households are found to save significantly more than single earner households. Both of these effects contract the economy.

The final paper, by Patricia Apps and Ray Rees, addresses the issue of population ageing. They make a valuable contribution by emphasizing that the recent and on-going changes in the Age Dependency Ratio (ADR) should not be analysed in isolation of other connected changes in demography and economic behaviour. They point out that, to a significant extent, the increase in the ADR will be accompanied by a reduction in the number of children as a proportion of the working population, the Child Dependency Ratio (CDR). And it is not difficult to imagine a set of circumstances where the extra public cost of an increasing ADR can be offset by a falling CDR. The policy issue therefore may well be to direct the savings in one area to the increased expenditure in the other, rather than to promote radical changes in the way in which pension schemes are financed.

They also emphasise that while the cost to the public purse of ageing is important, it is by no means the total cost. In this context they place considerable emphasis on the private cost of supporting children, which includes, importantly, the costs involved in the use of the mother's time in home child care. With time use surveys Apps and Rees have estimated that the total average cost of supporting a child is thirty per cent more than it costs to support an average individual aged over 65 years. This reinforces their view that the economic/political problem is the re-allocation of resources rather than the increased demand on resources generated by an aging population.

What might be the best way to bring about this shift in resources? They argue that it is a natural step to focus on the economic behaviour of women since changing fertility is the direct cause of the changing population structure. A lowering of the ADR means that women can reassess their allocation of time between home production, child care and the labour market.

In discussing this issue the authors return to some of the themes of the earlier paper of Apps. Specifically, it is suggested that arrangements be modified to ensure a diminution of the very high marginal tax rates on women who are secondary earners. They also suggest that fertility trends can be changed through more adequate provision of child care in the context of this better designed income tax system.

Concluding Comments

Over the last decade or so there has been a very significant change in the nature and form of policy debate concerning both labour market and welfare policy. It now seems naive, at best, to consider one without the other, but this is precisely what used to happen. The recognition of the inextricable links between income support and employment conditions is an important and positive development and it motivated the Gruen Lecture series.

The interaction between social security and the labour market takes several forms. One is that the maintenance of a given level of material well being can be achieved through different levels and combinations of after-tax earnings and welfare payments. This suggests, for example, that if real wages at the bottom of the wage distribution are reduced in an attempt to increase employment through labour cost reductions, there must be a level at which this becomes ineffectual because of the existence of the social safety net. This has justified in part the authors' focus in this issue of the Journal on labour supply behaviour in general, and poverty traps and associated policy tools more specifically.

A second sense in which labour market outcomes and welfare are connected relates to the role of job growth and its role for income distribution. That is, when economies cease creating enough jobs to reduce unemployment, many family incomes fall, and it is those with the lowest skills who are most affected. In other words, it is inevitable that welfare rolls lengthen and social security payments increase when employment growth falters. That there is a trade-off between employment strength and welfare outlays is a critical policy point, and it should not be surprising that the discussion and promotion of policies such as an EITC linked to wage reductions become more pronounced after long periods of high unemployment.

The welfare reform debate has now gone much further than this, however. Questions of the appropriate arrangements for qualifying for labour market programs, the role of effective marginal tax rates more generally, and the correct way to deliver targeted assistance are all fundamental issues in a proper consideration of the nexus between welfare and work. But while there have been significant changes in these areas in Australia, it is important to record there has not yet been a policy revolution, at least not when many other countries are considered as benchmarks.

The country that casts the longest shadow is the U.S. with an apparent spectacular success to the beginning of the 2000s with respect to job creation and reduced welfare rolls. The U.S. experience prompts two key questions for Australian analysts: to what extent did welfare reform contribute to the job growth; and, does welfare reform and job creation of this magnitude require an economy like the U.S. with significant income inequality and low unskilled wages?

There are many issues yet to be considered in depth for the Australian welfare to work debate. The U.S., for example, has put in place a welfare system with time limits, but this is hardly an issue here. Australian payments remain activity tested and indeed have become much more so in recent years, but the additional step of maximum qualifying periods is not on the drawing board. Such a change would be very radical in an Australian context.

A final issue is the philosophical (but ultimately practical) underpinning of our welfare system. In Australia, welfare has traditionally been motivated by a concern with income distribution and alleviation from the effects of unemployment. However, recently and particularly in the U.S. and even the U.K., the basis and form of welfare have been seen to be mainly to do with increasing employment, self-reliance and independence. There is evidence that Australian policy is moving in this direction, beginning with mutual obligation and now moving towards a stress on self reliance and the value of labour market work in its own right.

These are very big issues for contemporary economic and social policy. The papers which follow set the scene for an informed and objective analysis in the area and in so doing mark the formal beginning of a comprehensive Australian 'work to welfare' debate. The discussion has important roots traceable in part to the influence of Fred Gruen.

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