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# 1 Enhancing labour force participation: issues and challenges

**Policies to raise labour force participation can potentially make an important contribution to Australia's future prosperity. A number of indicators point to significant opportunities for improving participation rates in Australia. However, it is important not to view participation as an end in itself. The policy objective is to improve overall community wellbeing, having regard to people's preferences and the costs and benefits of any reform initiatives (including the spillover effects of changes in participation rates). Policy measures in a number of areas, at both the Commonwealth and State/Territory levels, impact on participation decisions. Sometimes these measures unintentionally discourage or impede participation. Developing effective policy responses to tackle such impediments raises a number of challenges, including the need to take explicit account of broader policy objectives and trade-offs, to understand the characteristics of the target group(s) relative to the existing workforce and to realistically assess the timeframe for benefits to materialise.**

Australia's economic performance over the past decade and a half stands out not only by historical standards, but also among OECD countries. With 16 years of continuous output growth, Australia has achieved substantial increases in average household incomes. Moreover, unemployment is currently at its lowest rate since the early 1970s and labour force participation is at a post-WWII high.

Notwithstanding this almost unprecedented economic success — in part reflecting wide-ranging economic reforms since the early 1980s — governments have recognised that there is both a need and the potential for further improvements to Australia's economy (see, for example, COAG 2006a).

As is now well established, the ageing of Australia's population will simultaneously diminish per capita income growth through reduced growth in labour supply and substantially increase future demands on our health and aged care services. In addition, as current debates about global warming and water security make clear, Australia faces significant additional costs if it is to improve environmental outcomes and encourage a more sustainable pattern of resource use. Over and above

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these domestic pressures are the ongoing imperatives for improved performance in an increasingly integrated and competitive global economy.

These challenges put a premium on addressing remaining constraints to realising Australia's productive potential and thereby improving living standards into the future. The National Reform Agenda (NRA), endorsed by the Council of Australian Governments (COAG) in February 2006, is directed at progressing a wide-ranging and ambitious program of reform to achieve these ends (COAG 2006a).

In previous annual reports, the Commission has stressed the importance of pursuing reforms that would enhance Australia's productivity, as the major driver of per capita income growth. The *Intergenerational Reports* (Australian Government 2002, 2007a) and the Commission's own study for COAG on the *Economic Implications of an Ageing Australia* (PC 2005), emphasise that improving workforce participation can also make an important contribution to Australia's future prosperity — potentially offsetting much of the impact of population ageing — and this objective is an integral part of the NRA.

In assessing the scope to increase labour force participation, it is important not to view participation as an end in itself. For example, many people in Australia work until they have accumulated sufficient resources for a comfortable retirement. In contrast, labour force participation of the elderly is high in poor countries because people there have no alternative but to continue working.

There are reasons for some Australians preferring not to participate in the workforce, or wishing to lessen their involvement, that are entirely consistent with community wellbeing. They include the benefits from participating in education and training; caring for children and older family members; undertaking volunteering activities; retirement; and, more generally, enjoying leisure activities. Although those involved in these activities are typically recorded as 'economically inactive', the activities generally give rise to socially valuable outputs and contribute to the growth of the economy over the medium to longer term. For example, the ABS (2001) has estimated that the value of unpaid child care was equivalent to around \$20 billion in 1997 (or 4 per cent of GDP). Similarly, volunteering has been estimated to generate economic value in the range of \$11–\$42 billion (PC 2005). And time out for education and training can be amply repaid in higher productivity.

People's choices are affected by incentives that determine the relative reward from working compared with other activities. The resulting choices often have consequences which spill over to the wider community. These spillovers can have quite important impacts on the community. For example, some of the benefits of higher participation include reduced poverty and inequality, greater social harmony and reduced crime, as well as lesser burdens on the charitable sector and social

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welfare budgets, and higher tax receipts to support the provision of government services like education and health.

Overall, the policy objective is to improve community wellbeing having regard to peoples' preferences as well as any relevant spillover effects to society arising from individuals' decisions. From this broader economic perspective, reform is about promoting efficient choices that yield outcomes in the longer term interests of the community as well as the individuals concerned. In particular, it is important to ensure that participation decisions are not unnecessarily distorted by welfare and tax arrangements or by other rules and regulations.

In this annual report, the Commission looks more closely at the scope to increase Australia's labour force participation rates and the potential gains from doing so. The chapter then focuses on some key policy areas to illustrate the challenges in developing effective policies to improve participation outcomes.

## **How much scope to increase participation rates?**

Various benchmarks can be used to provide a broad indication of the scope for Australia to raise its labour force participation rates. These include ABS measures of the 'underutilisation' of labour resources and trends in labour market inactivity over time, as well as international comparisons of labour force participation rates. Each of these suggests that there is scope to increase Australia's labour force participation rates. Moreover, there is good evidence that such an outcome would be consistent with some peoples' strong preferences. That said, more analysis is needed to determine whether the implied increases are achievable and appropriate.

### **Underutilisation of labour**

The degree to which the available supply of labour is efficiently used is an important economic and social issue. The unemployment rate, while widely used, is an incomplete measure of labour underutilisation. Reflecting this, the ABS has developed two broader measures for this purpose: the labour force underutilisation rate (which covers the unemployed and underemployed) and the extended labour force underutilisation rate (which covers underemployed workers; the unemployed; and two groups of people marginally attached to the workforce) (box 1.1).

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### Box 1.1 **ABS measures of underutilised labour**

Underutilised labour is made up of three components: underemployed workers, unemployed people and marginally attached people.

#### **Underemployed workers**

Underemployed workers are employed people who want, and are available for, more hours of work than they currently have, including:

- people employed part-time who want to work more hours and are available to start work with more hours, either in the reference week or in the four weeks subsequent to the labour market survey (*part-time unemployed workers*); and
- people employed full-time who worked part-time (less than 35 hours) in the reference week for economic reasons (such as, being stood down or insufficient work being available) (*full-time underemployed workers*). It is assumed that these people wanted to work full-time in the reference week and would have been available to do so.

#### **Unemployed people**

Unemployed people are defined to include people aged 15 years and over who were not employed during the reference week, and:

- had actively looked for work at any time in the four weeks up to the end of the reference week and were available for work in the reference week; or
- were waiting to start a new job within four weeks from the end of the reference week and could have started in the reference week if a job had been available.

#### **Marginally attached people**

People not in the workforce can be divided into those who are marginally attached to the workforce, and those who are not. People who are marginally attached to the workforce may satisfy some, but not all, of the criteria required to be classified as unemployed. Those with characteristics similar to the unemployed are classified by the ABS as having a relatively strong attachment to the workforce. They are made up of two groups — people actively looking for work, but not available to start work in the reference week, but available to start work in four weeks; and discouraged job seekers — those who indicate that they want to work and could start work within four weeks if offered a job, but who are not actively looking for work for reasons directly associated with the labour market. The main reasons reported by discouraged job seekers for not looking for work are: they believe they would not find a job because they would be considered too old by employers, there were no jobs in their area or line of work or they believe they lack the necessary skills or experience.

Other individuals in this category have a weaker attachment to the workforce. For instance, some individuals may want to work and be available to work, but are not actively looking for work because they are looking after a family member or children. Hence, the availability of these individuals is conditional on a change in their personal circumstances.

*Source:* ABS (2006a, 2007).

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In September 2006, over 1 million Australians were classified as unemployed or underemployed, representing 9.8 per cent of those constituting the potential labour supply. Of course, the perceived extent of labour underutilisation is considerably lessened when the quantity of extra hours potentially on offer (that is, the extra volume of labour available) is used rather than a simple head count — the underutilisation rate falls from 9.8 to 5.9 per cent. Even so, these figures highlight that a sizeable number of Australians who are currently not working would like to do so, and that many others would like to work more than they currently do.

- The September 2006 data show that 524 600 people were *unemployed*. The majority (almost 70 per cent) were seeking full-time work. Those aged 15-24 years were the largest group of unemployed people — some 40 per cent — and had the highest proportion of people seeking part-time employment.
- Some 544 600 were *underemployed* in the sense that they indicated that they wanted and were available to work more hours than they were actually working. Reflecting the prevalence of part-time work amongst women, they accounted for nearly 57 per cent of underemployed workers. Amongst part-time workers, around 73 per cent of men said that they would have preferred full-time work compared with around 50 per cent of women.

In September 2006, nearly 14 per cent of Australians aged 15 years and over and not in the workforce (751 600 people) were classified as having a *marginal attachment to the workforce* (box 1.1). Amongst these, 93 400 people (or around 12 per cent) were classified as having a *strong marginal attachment to the workforce* — sharing similar characteristics to those of the unemployed and, arguably, close enough to be effectively classified as unemployed. Most of these potential workforce participants were women — nearly 62 per cent — and most (70 per cent) held a strong preference for part-time work.

Australia's rate of labour underutilisation, using either of the broader ABS measures, has declined considerably since the early 1990s, partly in response to the strong growth of the economy. Much of this decline reflects a fall in the unemployment rate.

The loss of output arising from frustrated job seekers and those available and willing to work or to work more hours potentially represents a waste of the nation's economic potential. Reflecting this, governments around the world have become increasingly focused on lessening barriers to workforce participation.

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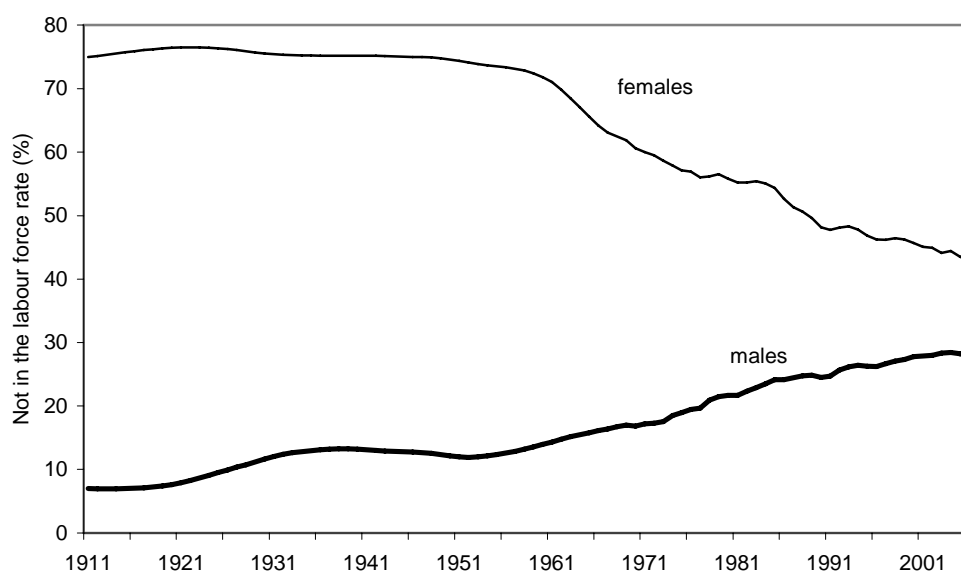
## Trends in labour market ‘inactivity’

Measures of the extent of underutilisation of labour do not fully capture the scope for raising Australia’s labour force participation rate. Also relevant are trends in labour market inactivity over time (that is, changes in the number of people outside the labour force — the economically ‘inactive’). Across Australia’s labour market over the last century there have been disparate trends in labour market inactivity, including on a gender basis (Lattimore 2007).

For example, since the late 1950s, the likelihood of a woman not being in the labour force has nearly halved, reflecting a rapid rise in the labour force participation rate for females. In contrast, there has been a four-fold increase in the propensity of males to be outside the labour force, albeit from a low base (figure 1.1). About one quarter of the increase in male inactivity since 1910-11 can be attributed to population ageing, with the remainder reflecting trend changes in age-specific inactivity rates.

As observed earlier, some labour market inactivity is desirable, involving activities consistent with increasing overall community wellbeing. Some inactivity reflects factors which make participation in the labour market difficult or impractical, such as low levels of education/skills, limited work experience and injury/illness. Some of these influences or causes of inactivity may be amenable to change through

Figure 1.1 Trends in labour market inactivity, 1910-11 to 2005-06<sup>a</sup>



<sup>a</sup> Labour market inactivity rates are defined as the share of civilians of a given age (15 years and over) not in the labour force (that is, not in a job or actively seeking one). Note that early data are based on cubic splines fitted to the data.

*Data source:* ABS labour force data and interpolation by the Productivity Commission for gaps in early series.

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‘corrective’ policy actions in areas like education and training, health promotion and disease prevention. Hence, an understanding of the scope to lessen labour market inactivity requires a comparison of outcomes under existing inactivity rates with a realistic counterfactual that takes account of work preferences and whether potential changes are achievable, as well as being appropriate from a community wellbeing perspective.

## **How does Australia compare?**

International comparisons of labour force participation rates are often used as a reference point to identify whether there is scope to raise participation in Australia. Such comparisons on their own do not, however, provide a basis for judging whether closing any participation gap would enhance community wellbeing. More information is required to make such an assessment, including knowledge of peoples’ underlying preferences for work and the extent of any spillover effects, as well as judgements about the influence of inter-country differences in policy settings on observed participation rates and the respective merits of policies considered to be influential in contributing to a higher participation rate.

Australia’s overall labour force participation rate has increased over the last 25 years — from 61.3 per cent in 1980 to 64.4 per cent in 2005. Data published by the OECD reveal that while Australia’s aggregate participation rates for males and females were above the OECD average in 2005, this hides relatively low participation rates for three broad demographic groups: males aged 25 to 54 years; women aged 25 to 44 years; and males and females aged 55 to 64 years.

Closer analysis of OECD data by Commission researchers indicates that some of the observed differences in participation rates arise from variations in statistical practices between countries (Abhayaratna and Lattimore 2006). The researchers undertook an analysis of the impact on participation rates of key statistical differences in the handling of defence personnel, institutionalised populations, missing data for some age brackets and paid maternity leave across OECD countries. While Australia’s relative position rose somewhat when these statistical differences were taken into account, significant differences in adjusted participation rates for key age groups across the workforce remained.

- For males aged 25 to 54 years, Australia’s ranking rose slightly from 25<sup>th</sup> to 23<sup>rd</sup>.
- For females aged 25 to 44 years, Australia’s adjusted ranking was 20<sup>th</sup> compared with a published ranking of 23<sup>rd</sup>.
- However, for people aged 55 to 64 years, Australia’s rank remained at 14<sup>th</sup>.

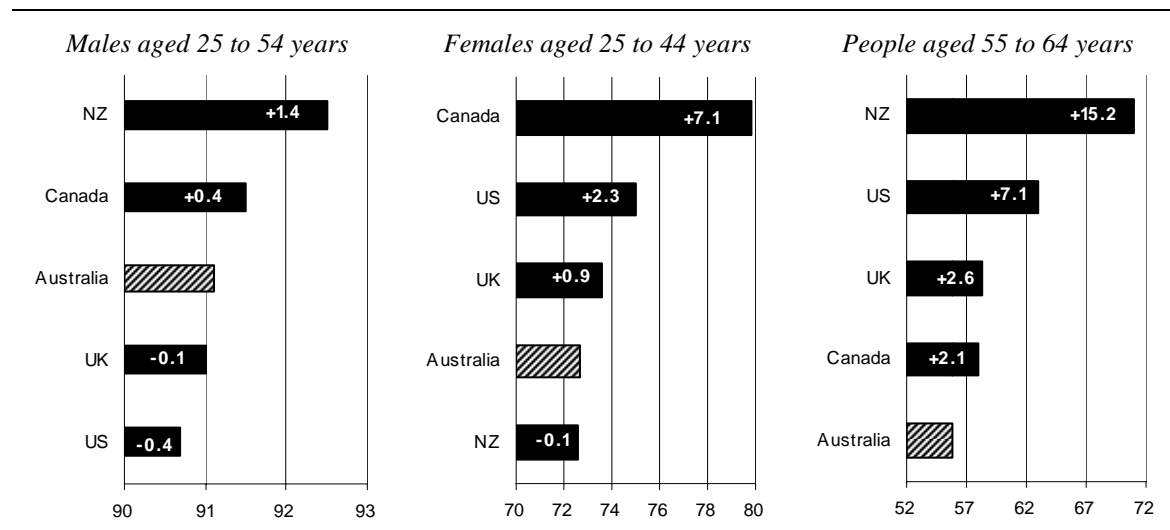
In aggregate, workers in these three labour market groups accounted for about 70 per cent of Australia's labour market in 2005.

Replicating the (adjusted) labour force participation rates for the highest-performing broadly-comparable OECD country for each of these age groups, points to the *potential* for a significant increase in Australia's aggregate labour force participation rate. Countries which are generally seen as being broadly comparable to Australia include Canada, New Zealand, the United Kingdom and the United States. On this basis, the potential increases in participation rates from closing the participation gap with the highest performing comparable OECD country are as follows:

- for males aged 25 to 54 years, an increase in participation to New Zealand's rate would increase the workforce by around 60 000
- for females aged 25 to 44 years, an increase to Canada's rate would increase the workforce by some 210 000
- for people aged 55 to 64 years, an increase to New Zealand's rate would expand the workforce by around 330 000 (figure 1.2).

In all, closing these observed gaps would see the number of people participating in the Australian workforce growing by some 600 000 persons, raising Australia's aggregate participation rate by almost 4 percentage points. Whether realising such an increase is achievable or appropriate would of course require further investigation, including an assessment of the influence of different policy settings on participation decisions.

**Figure 1.2 Differences between countries in selected participation rates**  
Per cent



Source: Derived from Abhayaratna and Lattimore (2006). Data for 2005.



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## The potential gains from increased participation

Assessing the potential economic gains from policy initiatives directed at increasing labour force participation is far from straightforward. In December last year, following a request from governments, the Commission reported to COAG on the potential economic and fiscal impacts of the NRA, including the gains potentially available from achieving higher workforce participation and labour productivity (PC 2006b). This proved to be a challenging exercise, due to lack of detail about the nature and extent of reforms associated with the NRA and a lack of evidence on workforce and productivity changes that could be achieved. Consequently, the estimates should be seen merely as exploratory projections of what is potentially achievable, rather than as forecasts of what necessarily would be achieved over the life of the NRA. Moreover, the effects in some key areas were calculated gross of costs of the required policy interventions: not all would necessarily pass a benefit-cost test.

The NRA embraces three reform streams — competition, regulation and human capital. The human capital stream is directed at increasing the effectiveness of the health system in achieving health outcomes, and at improving workforce participation and labour productivity through specific initiatives in the health, education and training, and work incentive areas. In seeking to quantify the workforce participation and productivity effects the Commission had regard to: international comparisons of participation rates (like those outlined above); various forms of supporting analysis to try to clarify the scope for change; and demographic modelling to isolate the likely contributions from the different elements of the human capital stream.

Analysis of the potential maximum gains available from the human capital stream suggests that full implementation of policy measures consistent with the intent of the NRA could generate significant (gross) economic gains for Australia over the next 25 years. In particular, an increase in workforce participation of around 4.9 percentage points could be possible — potentially offsetting the projected impact of ageing on the aggregate participation rate over this period. Some other key findings from the Commission's analysis included:

- Most of the potential increase in the workforce is likely to result from changes to work incentives. Many of the policy levers in this area are a Commonwealth responsibility and include family tax arrangements, disability support pensions and superannuation.
- Fully implementing the health and education and training elements of the NRA could also potentially raise the level of workforce productivity by

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one percentage point over the next 25 years. Health, education and training are shared Commonwealth, State and Territory responsibilities.

- Projected higher workforce participation and productivity could raise effective labour inputs substantially — quality-adjusted hours worked could rise by around 8 per cent from levels that would otherwise apply.
- Projected higher participation levels are estimated to raise GDP by around 6 per cent, while higher productivity of incumbent workers is estimated to raise GDP by nearly 3 per cent — after the effects of the reforms bite and following a period of adjustment.
- With higher GDP, real per capita household disposable income and consumption, as well as government revenues, would also increase (PC 2006b).

These estimates of the impact of changes in workforce participation and government's fiscal balances focus on the maximum potential changes in *market* activities (that is, those arising from changes in participation in paid employment). As such they do not take into account the impact of change on the non-market activities of households (such as reductions in unpaid child care, other carer activity and volunteerism) and the direct household and government costs of achieving higher workforce participation. And, to repeat, the estimates did not net out the costs of the programs (eg for health promotion/disease prevention); nor account for any consequent program savings (eg for disability support pensions).

A key challenge in identifying the potential for policy changes to promote better (that is, welfare enhancing) workforce participation outcomes is the need to identify the benefits and costs of policies directed at lessening or removing impediments to individuals realising their work preferences.

## **Challenges in realising better labour force participation outcomes**

Past research, including by the Commission, has identified a wide range of influences on people's workforce participation decisions — both about whether to work and the number of hours worked. Policy settings across a diverse number of areas impact on participation decisions. They include taxation, superannuation, aged and disability support pensions, child care payments, workforce regulation and education and training. On occasion, these policy settings inadvertently discourage or impede participation. This implies that an effective approach to the challenge of realising better participation outcomes will require a broadly-based and continuing policy response.

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Potential policy actions can be grouped into three broad areas:

- improving the *capacity* of people to work
- improving *incentives* to work
- creating more *flexible* institutional arrangements.

Governments have already undertaken a number of policy initiatives over the last decade or so in each of these areas. For example, to improve people's capacity to work, the Australian Government has expanded funding for health promotion and disease prevention and has introduced various measures directed at improving education and training outcomes. In terms of work incentives, it has reduced personal income tax, modified family benefit tax arrangements, modified various aspects of the income support system (including the welfare-to-work changes), and altered the superannuation system. It has also made changes to workplace relations regulations to improve the flexibility of the labour market and expanded funding to improve access to affordable child care.

The following discussion draws on a selection of policy measures, covering the three broad areas mentioned above, to illustrate some of the challenges in developing effective policy initiatives to improve participation outcomes.

## **Improving the capacity of people to work**

Health and education are crucial contributors to 'human capital' — the changing bundle of skills, knowledge and capabilities that each individual possesses. Human capital is central to people's wellbeing and their capacity to engage with the community. It is also a key determinant of their labour market experience, because it is associated with their productivity and, hence, the demand for their labour. There are some important interdependencies between health and education, since improved educational outcomes generally make a positive contribution to peoples' health status.

### *Health promotion and disease prevention*

Poor health affects the quality of peoples' lives and, beyond this, can lead to periods out of work, reduced labour productivity and early retirement or premature death. This is unavoidable in many cases, but the incidence and severity of some diseases and illnesses can be significantly lowered by reducing contributing risk factors, including lifestyle choices.

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Health promotion and disease prevention initiatives form a component of the NRA, as agreed to by COAG in February 2006, covering seven chronic diseases — cardiovascular, cancer, serious injury, depression and anxiety, type 2 diabetes, end-stage renal disease and musculoskeletal (COAG 2006b).

Labour force participation rates are consistently significantly lower for people with chronic diseases. The gross participation losses associated with several identified chronic diseases is estimated by the Commission to have been around 400 000 full-time equivalent employees or 5.8 per cent of the working-aged population in 2005. The largest estimated participation losses (including informal carers) are associated with mental illness. The participation rates for those reporting mental illness are 29 percentage points lower than for others (PC 2006b).

Determining how much of the losses related to chronic disease could be avoided through new cost-effective health promotion/disease prevention initiatives is contentious. Indeed, there are a number of challenges associated with trying to link improved health outcomes to such initiatives:

- many factors influence health and it is not straightforward to isolate the effects of prevention initiatives
- there are typically long time lags before improvements stemming from such initiatives become evident
- results for small controlled trials may not be readily replicated in the broader community
- the proportion of chronic disease that may be avoidable through modifying risk factors and early intervention measures varies markedly across diseases.

Research by the Commission, taking these factors into account, suggests that while potentially achievable reductions in the prevalence of chronic disease may be significant, the workforce-related effects are likely to be relatively small in aggregate, although significant for some groups. For example, a relatively high proportion of the current disease burden for mental illness and type 2 diabetes affects people of working age (PC 2006b).

An ‘outer-envelope’ scenario, designed to illustrate the potential (maximum) gains from new health promotion/disease prevention initiatives, suggests that by 2030, such initiatives could expand the workforce by 175 000 full-time equivalent employees — representing an overall participation increase of around 0.6 of a percentage point. The estimated potential gain, ignoring program and implementation costs and potential savings in acute care costs, comprises additions to the workforce arising from reduced incapacity and mortality, and an associated reduction in the number of carers. The largest potential participation-related gains

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are expected to be in the areas of mental illness, type 2 diabetes and cardiovascular disease (PC 2006b).

Although COAG has yet to determine the nature and scale of intended NRA health promotion/disease prevention initiatives, it has settled on a disease-by-disease approach to developing specific initiatives and has nominated type 2 diabetes as an initial priority (COAG 2006b). While this approach has obvious practical advantages, it also has drawbacks. Decisions about overall program design and resourcing, including where to focus resources and the appropriate mix of promotion/prevention strategies, need to be formulated having regard to the full range of opportunities for lessening the impacts of chronic diseases, rather than on a disease by disease basis.

Cost-effective spending on health promotion and disease prevention could be expected to generate significant cost savings to other areas of the health budget over time through an associated reduction in acute-care costs. Reductions in the burden of chronic disease would clearly also yield other benefits, the most important of which is an improvement in the quality of life of the affected individuals.

### *Education and training*

Improvements to education and training aimed at equipping more people with the skills required to participate in the workforce, are another important element of the human capital stream of the NRA. Four areas have been targeted: early childhood development, literacy and numeracy, transitions from school to further education or work, and adult learning (COAG 2006a).

Literacy and numeracy skills are strongly correlated with students staying at school to year 12 — and the higher workforce participation and earnings that result from improved educational outcomes. Indeed, a number of studies indicate that the labour force participation experiences of the young are likely to be enhanced by improved literacy and numeracy and by the completion of Year 12 education or its equivalent. For example, Lamb (1997) finds that high literacy and numeracy skills are related to better labour market outcomes at age 19, while Hillman (2005) confirms that young people without Year 12 education, who are in the lowest quarter of school achievers, are more likely to experience multiple periods when they are neither in the labour force nor in full-time education.

The OECD's Program for International Student Assessment (PISA) survey provides a basis for assessing Australia's performance in literacy and numeracy. On these measures, average schooling outcomes for Australia are above those of the OECD average, but the distribution around this average displays greater variation in

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Australia than in many other countries. In 2003, for example, 30 per cent of Australian 15 year olds did not achieve at least a PISA Level 3 score for reading literacy, and 33 per cent did not achieve at least a Level 3 score for mathematical literacy (OECD 2004). Attempts at explaining differences in education attainment and developing appropriate policy responses to address them, highlight the importance of variation across students within schools rather than inter-school differences.

In recent years, Australian governments have implemented a range of initiatives to encourage more students to complete the later years of schooling. School retention rates for 15-19 year olds have increased over the past 5 years by 3 percentage points for males and 2 percentage points for females.

There are, however, some confounding influences that make it hard to assess the role of education in improving participation outcomes, particularly for vulnerable groups that are often the targets of policy. People who undertake education tend to differ significantly from people who do not. For example, people with higher abilities, social skills and motivation are more likely to choose more education ('self-selection') both because it identifies their greater capabilities and because they are more able to gain additional skills than are less capable people. This is obviously relevant for the decision by children whether to continue in school in years 11 and 12 as well as to participate in tertiary study. People in economically and socially deprived areas may have weaker labour market prospects and lower-quality educational opportunities, which simultaneously reduce attainment rates and participation rates. People are selected to undertake further education on the basis of prior test scores, which in turn are related to inherent ability and participation prospects (Lattimore 2007).

Hence, a focus on the higher labour force participation rates of people with higher educational attainment is likely to overlook the unmeasured effects of individual traits that also shape labour force activity. This is problematic for policy makers because they are typically interested in the benefits of extending education to groups different from those who currently obtain higher educational attainment rates.

A further consideration in judging the likely impacts of policy interventions is that the links between educational attainment, participation and productivity are likely to change over time. A number of factors contribute to this. For example, people's preferences for work may change. There is evidence that participation rates fell among younger males and rose among younger females between 1981 and 2001, irrespective of the level of educational attainment (Kennedy and Hedley 2003).

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Reflecting these considerations, policy initiatives in this area are likely to benefit from greater experimentation with new approaches or techniques for reconnecting young people with the education system.

## **Improving incentives to work**

Arrangements which impact on personal finances, including tax, income support and retirement/superannuation provisions, are devised to pursue a variety of policy objectives. However, aspects of their design can create disincentives to work. Around 2.7 million people or some 20 per cent of the working age population receive income support, including sole parents, the unemployed and the disabled. This support provides a safety net for those unable to work as well as for those who can only work to a limited extent. Even so, welfare dependence has become an important issue for social policy, reflecting its adverse effects for the recipients as well as the wider community.

Notwithstanding significant reforms to those arrangements in recent years, and some significant complexities, there would appear to be scope for further improvement. Two commonly cited examples are reforms to the tax/income support system to lessen the disincentive effects of high effective marginal tax rates (EMTRs) and scope for further refinements to income support measures such as the disability support pension (DSP).

### *Addressing high effective marginal tax rates*

Australia's income support system does not feature universal entitlements, instead targeting those in need. This is generally regarded as a strength, as it limits the cost of income support to taxpayers and avoids the payment of benefits to those able to look after themselves. However, targeting can also significantly diminish incentives to (re)enter work, as benefits are withdrawn relatively quickly and liability for income tax reduces the increase in income received from commencing employment or working extra hours. This gives rise to relatively high EMTRs that reduce the effective supply of labour.

Reflecting the breadth of the income support and tax systems, these disincentive effects can extend to a large segment of the working age population. Groups primarily affected include couples with dependent children (family tax benefit), mature age workers (age pension) people with disabilities (disability support pension) and the unemployed (newstart and other allowances).

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Clearly, there are policy trade-offs here, as some disincentive effects are an inevitable consequence of targeting income support. Even so, the extent of such disincentives can be magnified by the design of the income support and tax systems.

The McClure Report (2000) identified inadequate incentives for some forms of workforce participation as one of four shortcomings of Australia's income support/tax systems. In subsequent budgets, the Australian Government has introduced various changes, amongst other things, to reduce relatively high EMTRs and so improve incentives for work. Specifically, reductions to marginal income tax rates, increases to the thresholds at which these rates apply and reductions in the withdrawal rates for various benefit payments have reduced disincentives to work. For example, prior to 2000-01, families faced a 50 percentage point increase in their EMTR from the withdrawal of the family benefit above the base amount. Reductions to the withdrawal rate have since reduced this to an increase of 20 percentage points. Increases to the 30 per cent tax threshold and a sizeable increase in the low income tax offset have also improved incentives to work, notably for secondary income earners who are relatively responsive to changes in tax. Finally, a number of reform initiatives, including the 'Better Super' arrangements, are intended to provide stronger incentives for older workers to maintain their connection with the workforce (box 1.2).

A number of studies have sought to estimate the magnitude of EMTRs using data covering tax rates/thresholds and various income support measures. Many of these do not capture the effects of recent initiatives to lower high EMTRs. A recent study, using income tax rates and social security rules applying in January 2007, found that the most common EMTR categories were zero, 30 to 40 and 40 to 50 per cent. Nevertheless, it was estimated that about one in five family types faced EMTRs in excess of 50 per cent (that is, above the top marginal rate of income tax inclusive of the Medicare levy). Two family types — couples with dependent children and sole parents — accounted for some 60 per cent of these relatively high EMTRs (Kalb 2007b).

Financial disincentives associated with relatively high EMTRs influence the participation decisions of people at all income levels. However, the evidence suggests that labour supply responses to changes in these disincentives are largest for single parents and married women, particularly those on lower incomes, as well as for people nearing retirement. In general, labour supply responses become smaller as income rises so that at higher income levels the net impact of the substitution and income effects is negligible. In contrast, the substitution effect tends to dominate at lower income levels, yielding a positive labour market response (that is, encouraging work or the supply of additional hours) from a reduction in EMTRs.



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**Box 1.2 Work incentives of older workers**

For older workers, financial incentives embedded in the income tax system as well as public pension and superannuation schemes play an important role in shaping retirement decisions.

Means testing of Australia's age pension reduces the incentive to work in older age owing to interactions with the effect of income tax when combining the age pension with work. The Australian Government introduced a pension bonus scheme to partially address low mature age participation in July 1998. The scheme provides a tax-free lump sum to people who defer take up of the age pension for up to a maximum of five years. The tax-free lump sum is equivalent to 9.4 per cent of the forgone pension entitlement. By June 2006, around 104 000 people had registered for the pension bonus.

Even so, various studies show that further reforms to pension and superannuation arrangements could provide greater work incentives for participation by older workers. For example, Burniaux et al. (2003), in a study of these arrangements across the OECD, observe that a shift to actuarial neutrality in the Australian age pension could lift aggregate participation by one percentage point. Actuarial neutrality implies an effective increase in pension benefits from delaying retirement.

Operating from 1 July 2007, the 'Better Super' changes were designed to increase retirement incomes, simplify the taxation of superannuation, and give more flexibility and choice in how superannuation can be accessed (Australian Government 2007b). Additionally, the changes were intended to improve incentives to work and save. However, some analysts have questioned whether, on balance, the changes would have this effect (see, for example, Freebairn 2007).

Other studies have sought to evaluate potential reforms to the income support and tax systems aimed at encouraging work and reducing welfare dependency. For example, a study by Buddelmeyer et al. (2006) found that different reforms are effective in solving different problems and often have varying impacts across the income scale — some taxpayers who were previously 'losers' can benefit from changes while others become 'losers'. For example, reducing the withdrawal or taper rates on social security allowances reduces EMTRs for some households while raising them for others. Raising the tax free threshold and reducing the bottom marginal tax rate reduces EMTRs for those on lower incomes, but is relatively expensive in terms of revenue forgone, as the tax cuts also benefit those on higher incomes. Adopting a more targeted approach involving an increase in the low income tax offset or introducing a tax credit for earned income helps to reduce EMTRs for taxpayers with lower incomes, but at the cost of increasing EMTRs for many middle income earners. Further, an increase in the low income tax offset is, in general, relatively attractive to secondary income earners, whereas a tax credit provides stronger work incentives for sole parents.

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Thus, the available evidence suggests that there is some scope to lessen Australia's relatively high EMTRs and thereby improve incentives for work. It would seem appropriate before taking further steps, however, to assess the outcomes of recent initiatives to lessen the disincentive effects of Australia's income support and tax systems. Allied to this, it would be helpful to undertake further research to identify the areas offering the largest potential gains in terms of work incentives and labour market responses, for the least cost to government revenue and adverse flow-on effects to non-target groups. That said, it would be important to recognise the broader policy objectives of the income support and tax systems, as the optimal outcome under a targeted income support system will inevitably involve some disincentive to work.

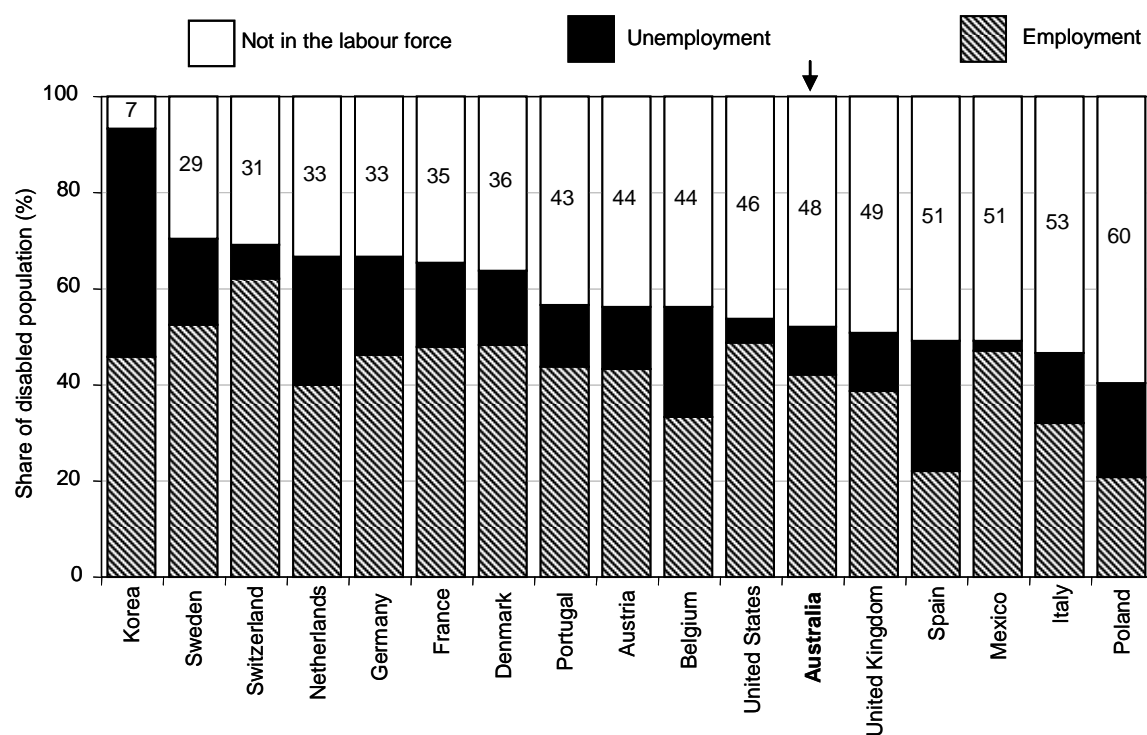
#### *Improving the design of income support — the disability support pension*

A major factor underlying the increase in labour disengagement by males aged 25-64 years has been the growth in the DSP (Lattimore 2007). Indeed, this pension has become a major form of support, and an increasingly costly one. Around 50 per cent of all men aged 25-64 years outside the workforce receive the DSP. In 2004-05, its budgetary cost neared \$8 billion, compared with \$4.6 billion for the main unemployment allowance (Newstart).

While unemployment benefit payments and the number of recipients have declined since 2001-02, payments for the DSP have risen strongly. Yet this growth cannot be attributed to either population ageing or an increase in general disability rates. The most plausible drivers seem to be a diminished receptiveness within the economy to employment of people with lower skills and disabilities, accentuated by the incentives associated with the pension itself. The DSP is a relatively attractive benefit compared with alternatives, encouraging entry and discouraging exit. Further, it has not, historically, been combined with significant early rehabilitation efforts or systematic attempts to re-engage people in the labour market. Consequently, moves from the DSP to jobs are rare. As noted below, however, policy has been changing on a number of fronts recently and this may reverse some past trends.

Many people with a disability could participate in the workforce if the work environment facilitated their involvement. While about one-third of pension recipients have profound disabilities, the remainder have moderate or lesser limitations. The rate of labour participation among people with disabilities varies significantly across OECD countries, suggesting scope for their greater engagement in Australia (figure 1.3).

Figure 1.3 **Labour force engagement of people with disabilities**  
 OECD countries, late 1990s, aged 20-64 years



Source: OECD 2003.

In a recent assessment of cross-country practice the OECD (2003) found that no country exemplifies best practice across the board. It endorsed approaches that:

- break down ('unbundle') the sharp distinction between people with disabilities who receive disability benefit and others who often receive little or no specific disability assistance, so as to remove the adverse incentives and inequities that arise where a sharp line of entitlement for a larger benefit applies
- take individual circumstances into account in designing packages of integration involving, for example, training and job search elements
- promote early intervention such as rehabilitation and appropriate training to facilitate integration
- involve employers in re-integration processes through incentive mechanisms (including appropriate anti-discrimination provisions)
- increase the quality of administration of programs and provide 'one-stop' shops.

Some of these approaches have been followed in Australia. For example, Australia has disability discrimination legislation, and this has been recently upgraded following a review by the Productivity Commission (PC 2004, Ruddock 2005).

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Centrelink provides a 'one-stop' service and its model is being emulated elsewhere. New assessment and administrative arrangements are being applied as part of the 2005-06 welfare-to-work reforms. Further, responsibility for the DSP has been shifted from the Department of Family and Community Services to the Department of Employment and Workplace Relations, to signal that people with disabilities need to be seen as part of the wider workforce, rather than as a distinct group.

Despite the obvious attractions of breaking down the sharp distinction between people with disabilities who receive a benefit and others who receive little or no benefit, its practical feasibility and impacts warrant closer analysis. Appropriately designed pilot programs should be considered, given that any changes could cost or save billions of dollars and have far-reaching consequences for the disabled.

There are other ways to advance reform. One would involve assessing the outcomes of the recently introduced welfare-to-work initiatives for the DSP, as well as other forms of income or social support for those outside the workforce, with a view to identifying ways of enhancing the effectiveness of these reforms. A second step might be to consider ways of increasing the number of recipients on these forms of income support who work while receiving benefits.

It is important, however, that scope for gains from any reforms be kept in perspective. The social and, to a lesser extent, budgetary gains from welfare reform are likely to be important. Even so, the impacts on Australia's overall economic performance would be modest, at least in the medium term. This is because the people involved tend to be less productive, have higher unemployment risks and, when employed, work fewer hours than those already in the labour market (PC 2005, 2006b). However, this should not preclude efforts to improve their engagement in work. Indeed, it is their wellbeing, rather than economic growth, that should be the primary target of policy in this area.

### **Creating more flexible institutional arrangements**

The last decade and a half has witnessed significant changes to the regulation of workplace relations in Australia. These have largely been directed at facilitating the more flexible organisation of work according to the circumstances of individual enterprises and workers. Greater flexibility in work options also expands employment opportunities, particularly among young people, mothers, and mature-aged workers. Several factors are likely to be influential in this regard, including continuing changes to workplace regulations in areas like occupational licensing, attitudinal changes to promote and facilitate a better life-work balance, and improved access to and affordability of quality child care.

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With marked increases in labour force participation for women over the last decade or so, including those who return to work soon after having a child, the ability of households to balance family and work responsibilities has assumed growing significance. The choice between continuing to work or withdrawing from the labour market is influenced by a variety of institutional arrangements, including access to appropriate child care, parental leave and flexible working arrangements. Weaknesses in these arrangements can have pervasive effects on households in terms of shaping the participation experiences of parents, especially women, as well as the wellbeing of children. Poor quality care in early childhood has been shown to have adverse impacts on a child's subsequent development and health. Child poverty rates are considerably higher for jobless single parent households and for households where only one parent works.

### *Improving child care arrangements*

As observed earlier, participation rates for women aged 25-44 years in Australia are below those of comparable OECD countries, pointing to potential for increased participation amongst this group of women. Much of this apparent gap appears to be related to whether women have children. Participation rates for women without children are comparable with men of a similar age, but participation is relatively much lower for those with children and even lower for women without partners. Moreover, reductions in participation associated with child rearing are more pronounced in Australia, suggesting that there may be a need to address barriers to re-entry to the workforce by women.

Some of this participation gap may reflect women's differing preferences about caring for their own children, or differences in their assessments of the suitability of outside care as a substitute for home care. Many studies confirm the importance of *quality* care, whether by parents or others, in the early years of a child's development. However, survey data reveals that just over half of women who were not in the workforce in September 2005 indicated that they wanted to work, although not actively seeking employment (ABS 2005). Amongst women who cared for children in the survey month, the cost and quality of child care were seen as barriers to participation for about 30 per cent, while a further 10 per cent reported that they could not access child care. However, more than 50 per cent of non-working women indicated that their main reason for not working was that they preferred to care for their own children.

Across the OECD there is clear evidence that the generosity of support for child care affects the workforce participation rates of women. Subsidies for child care in Australia are low by OECD standards. Focusing on the participation implications alone rather than the broader question of whether increased expenditure would

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enhance community welfare, Burniaux et al. (2003) estimate that if Australia's expenditure on child care were increased to the OECD average, the participation rate of women aged 25-44, would increase by 3 percentage points. The evidence suggests a larger impact for full-time relative to part-time employment (Jaumotte 2003).

Australian research also suggests a positive (though smaller) relationship between women's participation and government expenditures that lower child care costs, with stronger stimulatory effects for lone parents and lower-income households with pre-school children (see, for example, Doiron and Kalb 2005; Rammohan and Whelan 2006; Kalb 2007a). A possible explanation for this relatively small positive relationship may, in part, be that problems with the availability of child care lessen the responsiveness of participation decisions to changes in the price of child care alone.

As noted, the quality of available child care is also likely to influence the willingness of households to substitute formal care for their own. Some have seen this as another area for attention in Australia (see, for example, Rush and Downie 2006; Kalb 2007a).

The case for government support of child care is contentious. Some have argued, for example, that the decision to have children is voluntary and there is no justification for financial support. There are alternative arguments. First, while the effective nurturing and development of children yields benefits to the individuals concerned and their families, they also have spillover benefits for society while lessening the disposable incomes of households. The family tax benefit is provided, in part, in recognition that where a woman elects to remain outside the workforce to provide home care, the income of the household is reduced. Second, responsibility for child care often falls to women, and repeated or extended breaks from the workforce can make re-entry difficult, with flow-on effects in terms of reduced household and retirement incomes. This barrier can be lessened by providing households with access to an alternative to parental care. It may also be argued that on grounds of equality of opportunity, low-income households need access to affordable and quality child care so they and their children are not disadvantaged relative to high income households; also, such access may reduce costs for the wider community in terms of child poverty and welfare dependency and, possibly, crime.

Reflecting these arguments, governments often pursue multiple objectives in the areas of family support and child care. Clearly, these objectives acknowledge a role for parental choice, and are not simply directed at encouraging higher workforce participation per se. Indeed, support measures such as the family tax benefit may reduce the incentive for women to participate in the workforce. In contrast, child care subsidies reduce the cost of formal child care, thereby raising the return to paid

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work and encouraging women to substitute paid work for home care. That said, identifying the appropriate policy regime in this area is far from straightforward. In part, this arises because of the considerable scope for differences of emphasis in relation to concerns about gender equity, household inequality and poverty, and child wellbeing.

The policy debate surrounding the desirability of public support for child care raises a number of issues akin to those associated with the private/public funding of higher education. Both activities yield benefits that are captured by individuals and their families. Both activities also generate spillover benefits for society. Finally, both activities involve uncertainty and risks with respect to an individual's or household's future economic fortunes.

In the case of higher education, society provides a public subsidy to meet some of the costs, but requires a significant private contribution as well. However, prospective students are offered the choice of paying full fees for their courses or making their contribution on a deferred basis through the higher education contribution scheme. The charge associated with this scheme is in effect a risk-sharing income-contingent loan which enables the student to borrow up-front to finance their education and then to repay the loan subject to their future level of income. Hence capacity to pay sets the repayment obligation. There would appear to be merit in examining the scope for improving the take-up of child care and associated labour force participation outcomes through equivalent loan arrangements for child care.

Moreover, as the NRIWG (2006) noted in its report to COAG on possible reforms in the area of human capital for the NRA, there are concerns that the child care market may not be functioning as efficiently as it should. In the Commission's view, given its economic and social significance, there is a case for thoroughly investigating both the performance and financing of child care in Australia.

## **Summing up**

Policies to improve labour force participation can enhance Australia's future prosperity and mitigate the adverse impacts of population ageing. However, higher participation is not an end in itself and it is important to assess policy initiatives from a community wellbeing perspective, one which takes account of peoples' underlying preferences as well as the spillover effects of changes in participation on the wider community. In this sense, it is important that all the associated costs and benefits are taken into account.

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There are three main areas for policy attention: improving the capacity of people to work, enhancing incentives to work and creating more flexible institutional arrangements. An examination of a selection of policy measures covering these areas illustrates some of the challenges in developing effective policy responses. Key among these are:

- ensuring that any policy measures take explicit account of the multiple objectives and policy trade-offs that often apply
- understanding the characteristics of the target group(s) relative to the existing workforce, including any likely productivity differentials
- realistically assessing the timeframe in which policy impacts might occur, which can be protracted in areas such as health promotion/disease prevention and education.

Such challenges underline the value of policy experimentation, including pilot testing of programs, and learning from the experiences of different jurisdictions. As recognised by COAG in relation to the human capital stream of the NRA, tackling policy-related impediments to labour force participation will require actions by all governments in Australia.