

TOWARDS FULL EMPLOYMENT IN NEW ZEALAND

A RESPONSE TO *EMPLOYMENT: THE ISSUES*

**A REPORT OF THE PRIME MINISTERIAL TASK FORCE
ON EMPLOYMENT**

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NEW ZEALAND BUSINESS ROUNDTABLE

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1 BACKGROUND

Unemployment in New Zealand

Unemployment is unacceptably high in New Zealand. Although it is now falling sharply, on the latest figures 8.4 percent of the reported labour force is still without employment. Adding those who would return to the labour force if job prospects were brighter and workers who would prefer to work longer hours yields a degree of under-utilisation in the labour market which is both economically wasteful and socially damaging. Persistent unemployment, particularly where joblessness is concentrated among certain groups in society, may lead to the emergence of a permanent underclass in society and a situation where unemployment appears to be transmitted from generation to generation.

Nonetheless, *unemployment is essentially a political choice*, a point made by the Secretary of the Australian Treasury, Mr Ted Evans, in 1993. On the face of it, this proposition may seem difficult to accept. After all, in all developed economies around the world, unemployment is, to varying degrees, a problem. The reverse proposition is something along the following lines: "that unemployment is an international phenomenon of essentially unknown origin and unknown cure". This latter proposition is firmly rejected in this Report.

Unemployment is not an international phenomenon - witness the spectacular economic successes of the newly industrialising countries (NICs) of East Asia and of Japan. Unemployment is much lower in the United States than in EC Europe. *The causes of unemployment are well understood, with labour market inflexibilities and perverse welfare incentives being the main culprits.* And the solutions are clear-cut. The point is that the solutions involve difficult political choices and institutional changes, which in turn may imply losses for certain groups (most notably, the employed). *It is because the politics of unemployment are so difficult that the rate of joblessness remains unacceptably high in so many countries.*

The OECD (1994b, p.24) have put the point in the following way:

From quite understandable motivations to protect people from at least the worst vicissitudes of economic life, governments, unions and businesses have progressively introduced labour market and social policy measures and practices, which in achieving their intended ends, also have had the unintended but more and more important side effect of decreasing the economy's ability, and sometimes also society's will, to adapt.

The right approach to dealing with present-day unemployment is therefore not to attempt to slow the pace of change, but rather to strengthen the capacity to adjust to it.

1.2 The Issues Paper

The Report of the Prime Ministerial Task Force on Employment entitled *Employment: The Issues* was released in May 1994. The Terms of Reference for the Report were, briefly, to report on:

- Developments in the New Zealand economy and labour market since the 1950s, including:
 - demographic changes;

- changes in labour force participation, employment, unemployment, education and skill training experiences of different groups in the labour force;

- changes in employment levels and patterns by industry, occupation and region. the evolution of the economic and social policy environment and its consequences for employment and unemployment.

• The distribution and consequences of unemployment, including:

- the characteristics and location of the unemployed, discouraged and under-employed workers;

- the dynamics and distribution of long-term and recurrent unemployment;

- the factors affecting the choices and attitudes of labour market participants, including how people seek work;

- the effect on living standards of changing patterns of employment and unemployment.

• Trends in and analysis of labour markets of other OECD or relevant countries and their policy responses.

• Description and evaluation of New Zealand's current employment, skills training and other labour market related support programmes and policies.

• The medium-term outlook for the New Zealand labour market.

It should be noted that the Issues Paper is not the equivalent of a Green Paper, such as the one released in Australia in December 1993 entitled *Restoring Full Employment: A Discussion Paper* (Committee on Employment Opportunities 1993). The Issues Paper deliberately eschewed any detailed discussion of possible policy options, instead concentrating on the analysis of labour market and economic developments.

The process of developing and refining policy options to deal with unemployment has been left to the consultative processes embarked upon by the Prime Ministerial Task Force on Employment and to the release of the Options Paper later in the year.

1.3 The Options Paper

On the basis of the responses to the Issues Paper, the Task Force is directed to release an Options Paper which considers the following:

• The effectiveness and efficiency of the existing policy mix including:

- labour market related support programmes and services; and

- skill training programmes

in assisting the unemployed, particularly those who experience long-term and repeat spells of unemployment.

• Options for financing labour market and other labour market related support programmes for the unemployed.

• Other policy options, including youth minimum wage policy, to respond to the implications of labour market changes.

And in the light of these, present:

• Key policy options for:

- improving labour market and other labour market related support programmes, particularly those who experience long-term and repeat spells of unemployment; and;
- responding to other implications of labour market change.

In other words, the Options Paper is likely to be a relatively focused document canvassing policy options which, in the broad, are designed to improve the effectiveness and equity of the operation of the New Zealand labour market. Thus the role of labour market programmes in assisting the most disadvantaged in the labour market and the value of training programmes for the unemployed are examples of matters that are likely to be considered in the Options Paper. Other issues which doubtless have implications for unemployment—macroeconomic management, industry policy and supply-side reforms—would appear to be precluded as foci of the Task Force, although this is not to say some consideration could not be given to them.

1.4 The Objectives of this Report

This Report has a number of objectives, the main one of which is to provide a contribution by the New Zealand Business Roundtable to the analysis of topics canvassed in the Issues Paper and to make constructive suggestions for the Options Paper. A central aim of the sections that follow is to embed the discussion of the unemployment problem in New Zealand within the international analysis of the causes of unemployment and its solutions.

For instance, the OECD has recently released an important study *The Job Report* (OECD 1994a) which represents the result of two years intensive work within that organisation. The IMF has also recently taken some interest in unemployment (see *BRW* July 25 1994). Across the Tasman, the Australian government released a Green Paper on unemployment in December 1993, *Restoring Full Employment: A Discussion Paper* (Committee on Employment Opportunities 1993) and a White Paper in May 1994, *Working Nation* (Australia 1994).

The structure of this Report is straightforward, with ten sections in all, including this Background section. In Section 2, we canvass the main messages of the Issues Paper. In providing a critique of the Issues Paper, we note in particular the failure to address the key nexus between real labour costs and unemployment and the role of labour market flexibility in the translation of output growth into jobs.

In Section 3, we briefly outline the key features of unemployment in New Zealand, including the future outlook for the labour market. Following on from this, the notion of full employment in New Zealand is taken up, including its definition and the impediments to its achievement. One of the major themes of this Report - the importance of labour market flexibility - is considered in the fifth section. The vexed issue of the impact of income support arrangements on unemployment and its persistence is taken up in Section 6.

A number of specific policy options are considered in Sections 7 and 8, namely, the role of labour market programmes and reforming the employment service, respectively. A conclusion completes the Report.

2 THE ISSUES PAPER

2.1 What the Issues Paper says

The Issues Paper says that "The goal of the wider community must be a situation where everyone who wants to has the opportunity to undertake paid work" (New Zealand 1994, p.1). To achieve this goal, the Issues Paper outlines a number of areas that are important to improving employment opportunities and reducing unemployment. In turn, these are:

- an improved economic environment
- a skilled, adaptable workforce

- an increasingly international environment
- new technologies
- recent developments in employment
- assisting the disadvantaged in the labour market.

According to the Task Force, "no single measure will be sufficient to achieve our goal" (New Zealand 1994, p. 2).

The main messages of the Issues Paper can be summarised as follows. High rates of sustainable economic and employment growth are necessary but not sufficient to reduce unemployment. Sustainable growth is contingent on continuing improvements to New Zealand's international competitiveness, low inflation and quality investment feeding into better labour and capital productivity, *inter alia*. On the basis of growth alone, it is predicted that unemployment will fall in the range of 7 to 8 percent by 1999, in part because of the impact of growth on labour force participation.

Even with strong employment growth, some members of the labour force will be better placed to take advantage of the new opportunities than others. Hence the need for a "skilled, adaptable labour force" to enable its members to fill the newly created jobs, as well as shape the nature of jobs. The special needs of particular groups such as Maori should be taken into account in designing the nature of and delivery mechanisms in the education and training system.

New Zealand is an outward-looking economy, with approximately one-third of its production exported. It is necessary for New Zealand to maintain its openness, to diversify further its export base and to tap into the opportunities presented by the rapidly expanding economies of the Asian region. Tourism is a significant area in which employment opportunities can expand rapidly. The performance of the nontraded sector of the economy must underpin the competitiveness of the traded sector.

New technologies on balance can expand the demand for labour, especially via its impact on lowering the prices of products and services. However, a skilled, adaptable workforce is required to take maximum advantage of new technologies with minimal disruption and adjustment costs, as well as yield an equitable distribution of job opportunities.

Employment growth has a lagged and muted impact on long-term unemployment (LTU), defined as those who have been out of work for one year or more. Policies are required to allow the long-term unemployed to reposition themselves in the labour market to take advantage of new jobs. Such policies are not only equitable but efficient via their impact on the 'equilibrium rate of unemployment', defined as the lowest sustainable rate of unemployment. By making the long-term unemployed a more effective part of the workforce, the rate of unemployment at which wage pressures kick in can be reduced.

2.2 A Critique of the Issues Paper

The Issues Paper is a competent piece of work. It is logically structured, dealing first with a description of unemployment and the changing labour market. It canvasses the causes of unemployment before previewing the economy and employment growth trends. Some of the short- and medium-term policy strategies are discussed, including the need for a "skilled, adaptable labour force", "assisting people to work" and the role of income support.

There are clear examples of innovation in the Issues Paper which contrast favourably with the somewhat parallel Australian Green Paper (Committee on Employment Opportunities 1993). For instance, the discussion of flows in the labour market (New Zealand 1994, 45-46) is extremely valuable, particularly in stressing the magnitude of the flows in relation to stocks. For instance, it is pointed out (New Zealand 1994, p. 45):

[About] 100,000 people will move into employment over a three-month period, and about one-third of those unemployed at one time will not be unemployed three months later... . [Three-quarters] of a million different

individuals registered with the New Zealand Employment Service at some point during the four years to 30 June 1993.¹ Most of these people were unemployed only once and only for a short period, whilst a relatively small number of people were on the register for most of the time. In fact, ...[17.5 percent of the job seekers] accounted for half the total 'person-weeks' of registered unemployment during those four years.

Not only does the discussion on flows point to the important distributional nature of unemployment - that for most people it is a rare and transient state, but there is a concentration of prolonged joblessness among a small number - but also points to the essential futility of policies that seek to defend the stock of jobs, such as strong employment protection laws (see below in Section 5).

There is also some useful reference, albeit thin, to the problem of recurrent spells of unemployment (New Zealand 1994, p. 21). It is noted that, in the four years ending June 30 1993, there were 81,000 people (or some 40 percent of the unemployment pool at the end of the period) who had been on the register on at least four separate occasions, with an over-representation of males, those with low qualifications and Maori and Pacific Islanders. The issue of recurrent unemployment is one that deserves more attention.

Not surprisingly, there are elements of selective omission in the Issues Paper, some of which can be justified on space grounds, but others which doubtless were problematic for the Task Force to mention or emphasise. For instance, in the chapter entitled "Understanding Unemployment", the classification of unemployment into 'frictional, structural and cyclical' is curiously incomplete, with a fourth category, neo-classical unemployment (that is, unemployment induced by an increase in the wage rate [real labour costs]) not mentioned. There is also an unusual use of the term 'structural unemployment' as "unemployment which results from the changing structure of the economy - the changing structure of the economy and the skills and participation of the workforce" (New Zealand 1994, p. 43).

In point of fact, the term 'structural unemployment' is used to refer to unemployment that is "not reversed by subsequent economic upturn" (OECD 1994b, p. 18), which is a different point to the fact that unemployment can in part be explained by structural changes in the economy, albeit probably only in the short term. The statement in the Issues Paper that "structural unemployment is likely to be particularly important in countries such as New Zealand which have undergone rapid economic and financial liberalisation" (New Zealand 1994, p. 43) can be vigorously contested. *A number of countries that have not undergone such rapid economic and financial liberalisation as New Zealand have indeed experienced similar unemployment records (e.g. Australia) or inferior ones (e.g. Spain, Italy, Ireland).*

The weakness of the analysis of the components of unemployment is carried forward into the discussion of what is termed 'the equilibrium rate of unemployment'. The conceptual ambiguity of the term itself is admitted, but the Issues Paper goes on to state:

There is little empirical work regarding what percentage of unemployment represents the current equilibrium rate in New Zealand (with both methodological and data problems making such work highly speculative). However, evidence from overseas suggests that it may lie in the range 5 to 7 percent (New Zealand 1994, p.44).

There is little obvious understanding of the factors that affect the 'equilibrium rate of unemployment', particularly labour market flexibility and income support arrangements (see Sections 5 and 6 below), nor of the process of 'hysteresis' whereby the 'equilibrium rate of unemployment' tracks the actual rate of unemployment (see Layard, Nickell and Jackman 1991, and Chapman 1994). The statement in the Issues Paper that "cyclical unemployment is different from the factors that determine the equilibrium rate" (New Zealand 1994, p. 44) is simply not true. **[Justify?]**

There is also an unfortunate implication in this discussion that there is nothing that can be done about cyclical unemployment. This is not the case. Unstable macroeconomic policies in New Zealand in the past have accentuated cyclical movements in the economy, and more stable policies can reduce cyclical unemployment. Moreover, liberalisation of trade and product and financial markets can lead to greater diversification of the export base (this has been the case in New Zealand), which in turn can dampen the cyclical fluctuations experienced in the labour market.

Another area in which the argumentation in the Issues Paper is weak is the connection between education and training, on the one hand, and outcomes in the labour market. There is, for instance, some irony in the

description of the "marked improvement in the average educational attainment of New Zealanders" (New Zealand 1994, p. 3) over the past three decades juxtaposed with the description of the marked deterioration in unemployment over that period (especially Chapter 1, New Zealand 1994). There is a need to distinguish between the screening and ordering functions fulfilled by educational attainment and the productivity-enhancing impact of education and training.

Put another way, higher school retention rates and the attainment of formal post-school qualifications may simply be means of individuals improving their positions in the queues for jobs, particularly desirable ones. On the other hand, the substance of schooling and training may contribute to the job prospects of *all* participants in the education/training system. There is likely to be an element of truth in both positions; the Issues Paper, however, does not offer much direction on useful changes in the education/training system to assist the unemployment situation. The call for a "skilled, adaptable labour force" provides little useful information for policy makers (see *The Economist* 1994).

There are a number of other places in the Issues Paper where criticisms can be levelled. Most concern relatively minor issues. However, the downplaying of the role of wages, or more specifically real labour costs, in unemployment should be strongly queried.² The notion that employment growth is a necessary but not sufficient solution to unemployment - a central message of the Issues Paper - is also problematical. On the one hand, it is not analytically accurate; given adequate labour market flexibility, low levels of unemployment can be associated with varying rates of growth, including nil growth. On the other, it can potentially lead to a downgrading of the role of growth or, more perversely, the advocacy of specific measures to address unemployment which undermine growth.³ While it is true that employment growth can have a lagged and muted effect on long-term unemployment, on the Australian experience of the 1980s sustained and substantial increases in job numbers can lead to significant falls in LTU and the share of LTU in total unemployment (Sloan and Wooden 1994).

3 UNEMPLOYMENT IN NEW ZEALAND

3.1 Recent trends in unemployment in New Zealand

According to the most reliable figures on unemployment (the Household Labour Force Survey), unemployment in New Zealand stood at 142,000 (seasonally adjusted) in the June quarter of 1994 or 8.4 percent of the workforce. The number on the unemployment register was 185,000 at the end of June 1994, representing a drop of 13 percent on the previous year.⁴ On the HLFS basis, long-term unemployment fell by 21,000 or 17.1 percent in the year to June 1994 (Minister of Employment Press Release, 18 August 1994).

By any standards, an unemployment rate above 8 percent is unacceptably high, even though the trends are clearly favourable. Given the distinct possibility of strong employment growth inducing higher participation, particularly among groups whose participation has fallen recently (males, low skilled workers, older and youth workers, Maori and Pacific Islanders) (see Mersi 1994), unemployment is likely to remain unacceptably high for some time to come. Nonetheless, the central prediction of the Issues Paper that growth alone will lead to an unemployment rate in the range of 7 to 8 percent in 1999 would appear to be far too pessimistic provided present policies are maintained or improved. Both recent trends and the following simple analysis point strongly to such a conclusion.

Take the five year period 1994/95 to 1998/99 and assume average output growth of 4 percent per annum (which is a notch lower than the rates being recorded in 1993 and 1994).

Further, assume average productivity growth of 1.5 percent per annum, which is high by historical New Zealand standards but is consistent with post-reform trends (see Sloan 1992). On the basis of annual labour force growth of 1.5 percent (25,000 per year as assumed in the Issues Paper), the unemployment rate will fall by one percentage point per year. ***In other words, at the end of the five year period, unemployment could be as low as 4 percent if all the assumptions were to hold.***

If output growth is lower, if average productivity growth is higher or if labour force growth is higher, the improvement in unemployment would be less dramatic. Even so, a different combination of these variables that leads to a three-quarters of a percentage point decline in the rate of unemployment each year would produce an overall unemployment outcome of 5.25 percent in 1998/99, which is again lower than the prediction contained in the Issues Paper.

Given the endogenous nature of labour force growth (via changes in participation rates) and the difficulty in predicting movements in productivity, from a policy point of view the best means of achieving significant falls in unemployment is via the promotion of strong output growth and labour market flexibility. While not advocating active demand management by government (which is interestingly now eschewed by the OECD (1994b), emphasising instead the stabilisation or reduction of public debt levels), an environment conducive to high output growth can be nurtured by governments. Ingredients of this environment include: low inflation, low real interest rates, stable or falling public debt, flexible labour market arrangements, efficient and high quality infrastructure, and a plentiful and well-educated workforce. On many of these fronts, New Zealand has achieved a great deal.

On the most recent trends, there are a number of reasons to be optimistic. According to the National Bank of New Zealand National Business Outlook Survey of June 1994, 60 percent of the respondents expected unemployment to fall over the next twelve months. Over one-third of the firms surveyed expected to increase their employment levels over the next year, with only 4 percent expecting to decrease the number of jobs. Of all the respondents, the most optimistic were in Manufacturing industry, with 42 percent expecting to increase employment. The latest Household Labour Force Survey indicates job growth of 58,000 in the year to June 1994, the largest increase since the survey began.

Of course, as the saying goes "one swallow does not a Summer make". After all, the sluggish or negative output growth experienced in the decade up to 1992 and the pain of the adjustment of the economy towards a more outward and less protected orientation had produced marked rises in unemployment, concentrated among particular groups in the labour force and in particular regions. This deterioration is graphically depicted in Figure 1.1 of the Issues Paper (New Zealand 1994, p. 12) and is in marked contrast to the very negligible unemployment experienced in New Zealand up to 1977. By January 1992, the number of registered long-term unemployed had exceeded 100,000.

The point, however, is that the combination of economic indicators in New Zealand over the past year or so can truly be described as a 'beautiful set of numbers' (to borrow a favourite phrase of Australian politicians), which should provide the basis for sustained and strong output growth leading to significant declines in unemployment in the coming years.

3.2 International comparisons

Table 1.2 of the Issues Paper provides some international comparison of unemployment in a number of developed economies in 1991/92.⁵ On the gross measure of the unemployment rate, the position of New Zealand (10.3 percent) was a middle to upper ranking. Spain recorded a much higher figure of 18.1 percent and the figure in Canada was 11.2 percent. Much lower rates were recorded in Japan (2.2 percent), Germany (4.4 percent) and Sweden (4.8 percent). The figure recorded in the United States at that time was 7.3 percent. There has been a marked deterioration in the position of Spain and Sweden, where the unemployment rates currently stand at 24.6 percent and 8.5 percent respectively.

In terms of the long-term unemployed as a share of total unemployment, the OECD report (OECD 1994b) indicated that the figure for New Zealand in 1992 was 31.9 percent, which greatly exceeded the figures recorded in the United States (11.2 percent) and Canada (11.2 percent), but was exceeded by figures in a number of other countries—for instance, Belgium (61.2 percent), Ireland (60 percent) and Italy (67 percent). In 1991, the inflow rate into unemployment (as proxied by the number of unemployed for less than one month as a percentage of the population aged 15 to 64 minus the unemployed) stood at just over one percent in New Zealand in 1991, a figure exceeded in only three other developed economies, viz: the United States, Canada and Finland (see OECD 1994b).

Thus while the overall rate of unemployment recorded in New Zealand in the early 1990s placed the country in the middle to the upper end of the pack of the experience of developed economies, other evidence indicates

that the New Zealand labour market functions more effectively than in a number of developed economies, as evidenced by the share of LTU and the inflow rate into unemployment. These observations are, of course, no grounds for complacency.

Nor should they be interpreted to endorse the proposition that the causes of unemployment in New Zealand are essentially international (c.f. Burns 1993). The fact that unemployment and long-term unemployment are, to varying degrees, problems in many developed economies in no way precludes the possibility that the causes of unemployment are mainly domestic, and the solutions a matter for domestic policy choice. Certainly, policy flaws are shared by many countries, which is not altogether surprising given the similarities in political pressures on policy-makers across the democratic world. This is, however, a different point to saying that unemployment is an intractable international phenomenon.

4 FULL EMPLOYMENT FOR NEW ZEALAND

4.1 What is meant by full employment?

It was noted in Section 2 that the Issues Paper comes close to defining full employment as "a situation where everyone who wants to has the opportunity to undertake paid work" (New Zealand 1994, p.1). While this is a useful starting point, a number of qualifications should be made. For one thing, it is not a reasonable objective of policy to provide employment for everyone who wants a job immediately or within very close proximity to their residence, or at a wage rate that meets their expectations. In other words, full employment must involve reciprocal obligation, where jobseekers must show a preparedness to move, to retrain and/or to accept employment which may be seen as second-best.

Secondly, there are important issues of timing and sustainability. Coming from a relatively high base of unemployment, it is not possible for full employment to be reached overnight. Policies that lead to sustained gains in employment are preferable to policies which promote cycles of boom and bust. For this reason, the general idea of an 'equilibrium rate of unemployment' is valuable because it prompts analysts to consider the factors that determine the equilibrium rate and how these factors can be changed in order to reduce it (see Layard, Nickell and Jackman 1991).

The ultimate aim of policy should be to achieve a convergence of full employment, defined as a situation of all those wanting employment having a job (but subject to the caveats outlined above) and the equilibrium rate of unemployment. It is naive to predict that cyclical influences will disappear altogether. There are, however, important links between cyclical and structural unemployment. This point is made by the OECD - "[factors] that increase structural unemployment will often exacerbate the severity of cyclical unemployment ... while cyclical unemployment, if it persists, may well lead to an increase in structural unemployment" (OECD 1994b, p. 29). By the same token, policies that induce a reduction in structural unemployment (such as freeing up the labour market, limiting the duration of unemployment benefits) are likely to be associated with lower cyclical unemployment, by speeding up the labour market adjustments.

Overall, the main game is to reduce the structural component of unemployment through policies derived from careful analysis of the social and economic factors that underpin this element of unemployment. Some of these factors include: wage and price setting arrangements, employment protection laws, income support arrangements, labour mobility, education and training policies and a number of others. The factors that this Report focuses on - the factors that are deemed to be the most critical - fall into two broad categories, labour market flexibility and welfare.

4.2 The path to full employment

There is little doubt that what might be regarded as 'background factors' (although neo-Keynesians would take exception to this description) are important in promoting an environment conducive to high rates of output growth, which clearly facilitates better employment and unemployment outcomes. The key elements are sound monetary policy with a low and credible inflation target, prudent fiscal policy (lower government spending,

lower taxes, reductions in public debt) and supply-side reforms that enhance the competitiveness of the economy and add to its dynamic efficiency.

It is interesting to note that in the recently released document, *The Job Report*, by the OECD, active demand management as a policy to reduce unemployment is essentially eschewed. To quote from the longer OECD report (OECD 1994b, p. 27):

In the current economic circumstances, there are strict limits to what macroeconomic policy can realistically achieve, but nevertheless the broad lines are clear... .

[Macroeconomic] policy should create conditions for declines in interest rates. Where budget deficits put pressure on (market-determined) long-term interest rates, credible plans to reduce structural deficits can help. Cutting budget deficits might also enhance market confidence in governments' economic management and increase scope to cut officially-controlled (short-term) interest rates without a loss of credibility of monetary policy or disrupting foreign exchange markets. Lower interest rates would encourage the investment and growth that creates new jobs.

The report also mentions the importance of improving the flow of national saving, of price stability and of ensuring the quality of public spending and taxation regimes. It would be fair to say that none of these messages has been lost on New Zealand. To be sure, levels of public debt remain unacceptably high, although the move into fiscal surplus in the most recent budget is a step in the right direction. The main challenge is to maintain the resolve to wind back further the level of public debt. Rather than the government spend the unfortunately named 'growth dividend' (which is, after all, largely the mirror image of the cyclical deterioration in the budget position associated with the earlier recession), the appropriate action is to "achieve and maintain sound public finances" (OECD 1994b, p. 27) by using the additional funds to retire debt. As the OECD (1994b, p. 28) concludes, "[while] bad macroeconomic policy always results in bad economic performance, good macroeconomic policy does not, by itself, guarantee good overall economic performance. Propitious economic conditions offer only a starting point in dealing with unemployment".

Having established an environment conducive to growth, the translation of growth into new jobs becomes the critical issue. One of the most dramatic outcomes depicted in the OECD Report is the widely divergent patterns of employment growth over the past thirty years between North America, on the one hand, and EC Europe, on the other (see Chart 8, OECD 1994, p. 12). Between 1960 and 1993, the number of jobs in North America nearly doubled, whereas in EC Europe, employment growth over the entire period was less than 10 per cent (and until the late 1980s, mainly in the public sector). In fact, the employment-to-population ratio in EC Europe actually declined over the period. But these divergent records on employment growth were in the face of very similar overall rates of output growth.⁶ So what explains the divergent paths of employment growth? It is argued below that the critical factor is differences in labour market flexibility.

To summarize this section, good macroeconomic policy targetted on low inflation and reducing public debt is a necessary element of the environment that is conducive to the achievement of full employment over time. Anything short of good macroeconomic policy will, in all likelihood, scupper other policy attempts to lower unemployment. The next part of the story is to ensure that the microeconomic and social policy frameworks are such that private sector firms have strong incentives to hire workers and that the unemployed have strong incentives to take jobs, including jobs that may involve a change of residence, the acquiring of new skills or are less preferred. In other words, ***the critical factors are labour market flexibility and the incentives provided by welfare arrangements***, and it is to these issues that the next two sections are devoted.

Before we turn to these matters, from a policy point of view, there are two aspects of the path to full employment that should be canvassed here. The first is about policies *that prospectively will* deliver better outcomes on employment and unemployment and, without which, impediments to full employment will continue to exist. These have been broadly described above: a backdrop of sound macroeconomic policy, removal of supply-side blocks in the economy and particular attention to providing labour market flexibility and appropriate welfare incentives. The second aspect of the policy challenge, however, relates to the action necessary to deal with the *existing* stock of unemployment, particularly the long-term unemployed, whose state may well be due to past policy mistakes. There is no doubt that even first-best prospective policy will have a more favourable impact on new entrants to the labour force and the short-term unemployed, relative to the long-term unemployed.⁷ A case therefore exists for remedial policies to deal with the legacy of past mistakes, policies which are in addition to the first-best package that should produce strong output and employment growth. Hence

in Section 7 below we take up the role of labour market programmes in assisting the long-term unemployed.

5 THE ROLE OF LABOUR MARKET FLEXIBILITY

5.1 What is meant by labour market flexibility

The traditional image of the OECD is of an analytical unit with a strong preference for corporatist-style policy arrangements. While this flavour is apparent in the OECD report, *Labour Market Flexibility* released in 1986, the document is seminal in the sense that it conceded explicitly that labour market flexibility is an important ingredient of good economic policy. "*Dynamic economies bent on sustainable growth will have to be flexible. Labour market flexibility is one of the conditions for their success*" (OECD 1986, p.22, italics in original).

The general definition of labour market flexibility offered is "the ability of individuals in the economy, and notably in the labour market, to abandon established ways and adapt to new circumstances (OECD 1986, p.6). Six broad categories of labour market flexibility are outlined (OECD 1986, p.9, italics in original):

- *Labour costs*, including the general level of wages, wage differentials, and non-wage labour costs.
- *Conditions of employment*, including employment protection, and types of labour contract.
- *Work practices and work patterns*, including arrangements for working time and the environment and organisation of work.
- *Rules and regulations* relating to the labour market, including general rules, taxation, and regulations concerning small businesses.
- *Mobility*, including both external and internal mobility.
- *Education and training*.

Rimmer and Zappala (1988) extend the description of labour market flexibility by distinguishing between external and internal labour market flexibility, the latter dealing with the ability of firms to adjust to changing product market circumstances. They argue that internal labour market flexibility takes five main forms:

- *External numerical flexibility*, which refers to firms' ability to hire and fire workers.
- *Internal numerical flexibility*, which refers to the ability of a firm to deploy flexibly its workforce in quantity and time terms (e.g. number of working hours, timing of work).
- *Functional flexibility*, which refers to firms' ability to move workers between different tasks.
- *Wage flexibility*, which refers to the potential variability of wages and other labour costs to fluctuations in product demand, as well as the scope for performance-based pay (broadly defined).
- *Procedural flexibility*, which is about decision-making processes within the firm, including consultation arrangements.

It is not the intention of this Report to assess how New Zealand rates on each different measure of labour market flexibility. With the passing of the *Employment Contracts Act* (ECA) 1991, the overall degree of labour market flexibility that exists in the New Zealand economy has few parallels in other developed countries. In particular, if we consider the elements of internal labour market flexibility outlined by Rimmer and Zappala (1988), most New Zealand firms now have considerable scope to establish employment contracts with their workers that are

consistent with best meeting their competitive needs. Key aspects of the ECA that have greatly expanded labour market flexibility in New Zealand include: the abolition of blanket wage bargaining, the introduction of voluntary unionism, the elimination of requirements for union registration and for minimum union size, and the generally reduced power of the trade unions.

By most accounts, the labour market participants have settled down to the new environment created by the ECA. The key feature of arrangements is the dominance of individual contracts, overlaid with some collective single-employer contracts and a few collective multi-employer contracts. In the case of collective contracts, trade unions represent the vast majority of employees in negotiations. Since the passing of the ECA, real wages have increased, albeit very slowly (see Department of Labour 1994). Given sustained growth, they can be expected to rise as the labour market tightens.

It would appear, however, that there are aspects of an unfinished agenda in respect of labour market flexibility in New Zealand. Particular focus is placed here on employment protection, especially the actions of the Employment Court in relation to unfair dismissals, and on labour on-costs. These two matters are dealt with directly below.

Before turning to these issues, it is useful to review the findings of the OECD (1994b) in relation to the connection between unemployment and labour market flexibility. The Report emphasizes the importance of removing the barriers to hiring faced by private sector firms. Three elements are highlighted, viz: non-wage labour costs, wage differentials (including statutory minimum wages) and employment protection legislation. On the first, the Report concludes that "[there] is increasing agreement that part of the base for social security financing should shift away from taxes that add directly to labour costs" (OECD 1994b, p. 31). On the second issue, the Report notes the following (OECD 1994b, p. 32):

A widening of wage differentials could be expected to support faster employment growth... . [More] weight [should be given] to the market-clearing roles of wages, while pursuing equity objectives through other instruments... . [Statutory minimum wages] often end up damaging employment opportunities for unskilled labour. Sufficient differentiation in rates by age will prevent the minimum wage from becoming a barrier to hiring young people. Minimum wages can also be varied by region, especially in countries with significant regional differences in unemployment rates and living standards.

Finally, on employment protection legislation, the Report advocates a balance between "allowing greater freedom in decisions to hire and fire and ensuring sufficient employment security...[as well as] ensuring workers are protected against unfair dismissal" (OECD 1994b, p. 32).

5.2 Employment protection and unemployment

It is not necessary to review here the history and decisions of the Employment Court, and its predecessor, the Labour Court, in New Zealand. A recent study by the New Zealand Business Roundtable and New Zealand Employers Federation deals comprehensively with the key issues (NZBR/NZEF 1992). In the context of this Report on unemployment, it is useful to restate one of the main conclusions of that study:

Activism on the part of the judiciary to extend the reach of the law with respect to matters such as the implied terms of contracts, redundancy and dismissals risks harming the interests of both firms and employees. For example, if firms are uncertain as to the view a Court might take in the event that the decision to take on an employee does not work out, or if onerous and unrealistic procedural and substantive standards for termination are laid down, employers will be more reticent about creating jobs and will be forced to spend more resources in hiring staff and protecting themselves against the costs of dismissals. ***Barriers to the termination of satisfactory employment relationships are then likely to become barriers to new employment*** (NBBR/NZEF 1992, preface, italics added).

Anecdotal evidence since the release of the study is suggestive of a growing perception of decisions on unfair dismissal matters by the Employment Court weighted heavily in favour of existing employees. Those discriminated against are not just employers but also jobseekers whose prospects diminish if the costs and risks of employment rise. There is widespread media reporting and commentary on the Court's decisions. The point is that *perceptions* will drive actions by employers, even if those perceptions are based on only limited

information, The incentives of employers to hire will be reduced to a larger extent in the case of employees who are seen as 'riskier propositions'. Into this category will fall many of the long-term unemployed.

This outcome is in fact just one example of a recurrent theme of the OECD study *The Job Report* (1994a), namely that well-intended legislation can have harmful and long-lasting effects on the very groups it is meant to protect. Of course, on any particular issue, it is generally a matter of balance with, for example, workers legitimately expecting some form of legislative protection against harsh and unconscionable dismissal. In terms of the political economy of the ECA, to achieve the removal of most of the statutory limitations on bargaining and employment contracts, it may have been necessary at the time to go further and to include some explicit measures to redress what might otherwise have been seen as a politically unacceptable package.

Nonetheless, now that the success of the ECA is clear and its principles of freedom of contract are better understood, there is a case for minimising the transactions costs to both employers and workers of complying with legislation designed to protect workers against unfair dismissal. The government should also ensure that those interpreting the legislation do not overstep their mark relative to the legislation's original intention to make employment relations enforceable contractual matters with obligations on both sides.⁸ In this latter case, legislative amendments may be required to ensure that the actions and decisions of the Court are more closely aligned with the legislation's aims. A further option is to transfer the jurisdiction of the Employment Court into the general court system, the traditions of which are arguably more in harmony with the ECA philosophy that employment relations should be based on the principles of the law of contract.⁹

What is the international evidence on the relationship between employment protection laws and unemployment? A useful review of the literature is contained in the 1993 OECD *Employment Outlook*. A definition of employment security legislation is "the rules and regulations that protect an individual's employment within an enterprise - including those pertaining to dismissal" (OECD 1993, p. 95). While noting the variations between countries, "the precise reason for termination of a contract will generally call for a specific sequence of steps that must be followed by an employer" (OECD 1993, p. 96).

In terms of the theory, the effects of employment protection laws are multiple and contingent on a number of factors. In summary (OECD 1993, pp. 111-112):

High turnover costs reduce employers' demand for labour in the face of uncertainty about future demand and output. This may give rise to insider effects - incumbent workers might take advantage of high turnover costs to demand higher wages than would otherwise be possible, thus reducing the employment prospects for the unemployed. The adverse effect on employment, could, in principle, be offset by a lowering of wage demands by the unemployed. Even if they had much say in the wage determination process, the incentive to do so might be limited if unemployment benefits set unrealistically high reservation-wage floors, hence the persistence of high incidence of long-term unemployment... [To] account for persistence, it has to be assumed that employers are faced with continued uncertainty about future demand and output.

The evidence on the link between employment protection laws and unemployment is by no means certain, in part because of the difficulty of placing numerical values on employment protection laws. In broad terms, the countries with the most stringent employment protection laws are those with the highest rates of long-term unemployment, although there are considerable variations in unemployment outcomes in countries with similar laws. ***The empirical work of the OECD is suggestive of an adverse relationship between the strength of dismissal laws and persistent unemployment***, although there are clearly a number of other factors explaining long-term unemployment (OECD 1993).

A final point concerns is about the incidence of the costs of employment protection laws, in general, and compensation for unfair dismissal in particular. It is popularly held that it is companies that pay the compensation in unfair dismissal cases. As companies are resource-rich and individual workers are generally resource-poor, the outcomes of the relatively small number of cases are not unreasonable, so the argument goes. This popular view, however, is quite ill-founded, as any economics graduate could point out. Depending on the nature of the product markets faced by firms, the incidence of this 'tax' (the imposed firing costs) may be shifted to the consumers of the products (where firms are price-makers) via higher prices, or to workers in the form of lower wages (where firms are price-takers). In the first case, workers in general will lose out because they are forced to pay higher prices for products they purchase; in the second, the incidence of the 'tax' is simply shifted on to firm's workers. Where prices/wages only adjust partially, some loss of employment will occur over time.

5.3 Labour on-costs and unemployment

One of the key recommendations of the recent OECD report is the need to reduce non-wage labour costs "by shifting away from taxes on labour towards other taxes such as those on consumption" (OECD 1994b, p. 45). In point of fact, non-wage labour costs in New Zealand are among the lowest in the OECD, lower than in Australia, which latter are also relatively low. A recent survey of Business Council of Australia companies (the largest companies) with operations in New Zealand indicated that on-costs in Australia were more than double the level in New Zealand - 49 percent compared with 21 percent (quoted in *Industrial Relations & Management Letter*, August 1994). Even so, the Australian Green Paper on unemployment rejected the view that labour on-costs in Australia had a significant impact on aggregate levels of employment or unemployment (Committee on Employment Opportunities 1993, p. 56). It was stated, however:

[It] is clear that [non-wage labour costs] can have an adverse impact in certain circumstances and that there may be opportunities for policy improvements to obviate these problems. It appears that a review of the employment impact of non-wage labour costs is justified, with particular reference to the interaction of different forms of taxation, the effect of on-costs at the threshold points, and the administrative implications for small and medium sized enterprises (Committee on Employment Opportunities 1993, p. 56).

A number of points can be made in this context. The Committee on Employment Opportunities chose to use other OECD countries as the yardstick for the relative magnitude of non-wage labour costs. For both Australia and New Zealand, there is a compelling case to use the situations in the nearby dynamic Asian economies as the relevant yardstick. A second point, and one raised by the Committee on Employment Opportunities, relates to the actual incidence of non-wage labour costs (see above in 5.2 for the similar argument in relation to the incidence of firing costs). It was argued "that any reduction in on-costs would lead to an offsetting rise in indirect wage costs" (Committee on Employment Opportunities 1993, p. 55). Depending on the market circumstances of the producers, *inter alia*, the incidence of non-wage labour costs will vary in New Zealand (as elsewhere).

One of the most significant components of non-wage labour costs in New Zealand is the compulsory premiums paid by employers in respect of accident compensation. While it is not intended to revisit here the arguments for change to the accident compensation scheme (see New Zealand Business Roundtable 1987), the following conclusion in respect of incidence is worth noting:

Although the overall risk remuneration received by labour may not change, labour costs, employment and safety are likely to be affected by compulsory accident insurance unless compulsory payroll tax payments exactly replace other employee risk remuneration, and unless the benefits determined by the government exactly replace benefits that would otherwise be paid as a result of negotiations between employer and employee (New Zealand Business Roundtable 1987, p. 3).

Other non-wage labour costs have been imposed on New Zealand employers in recent years at a time when unemployment was growing. A partial list includes:

- Compliance costs under the Income Tax Act 1976 (including PAYE, Fringe Benefit Tax and Family Support).
- The Health and Safety in Employment Act 1992. This Act may impose excessive requirements on employers aimed at promoting the health and safety of their employees. (Certain obligations are also imposed on employees.)
- The Holidays Act 1981. The Act prescribes minimum rights and obligations relating to annual leave, public holidays and special leave for sickness, domestic or bereavement reasons.
- The Parental Leave and Employment Protection Act 1987 which provides unpaid leave as of right to employees who are expecting a child or, in certain circumstances, adopting a child, and to their parents.
- The Human Rights Commission Act 1977 and the Race Relations Act 1971. These Acts aim to prevent discrimination in hiring, firing, training or promotion on grounds of race, colour, gender, marital status, religious belief, age, and national or ethnic origin. They have been applied in a manner which excessively constrains

employers' ability to advertise for staff who are appropriate for particular vacancies and wastes jobseekers' time in applying for inappropriate jobs.

Lowering non-wage labour costs in New Zealand would not be sufficient to re-establish full employment; such action must be part of a package of measures. But both direct and compliance costs need to be taken into account when considering the impact of non-wage labour costs on employment and unemployment. There are additional, compelling reasons to investigate the nature and scope of accident compensation in New Zealand.

5.4 Minimum wage regulation and unemployment

The OECD Report urges the member countries to "reassess the role of statutory minimum wages as an instrument to achieve redistributive goals, and switch to more direct instruments" (OECD 1994b, p. 45). On the other hand, the Report notes (OECD 1994b, p. 45):

If it is judged desirable to maintain a legal minimum wage as part of an anti-poverty strategy, consider minimising its adverse employment effects, including by:

- Indexing it to prices, rather than average earnings;
- Ensuring sufficient differentiation in wage rates by age and region to prevent the minimum wage from harming employment prospects for young people or low-productivity regions.

What are the effects of minimum wages on employment and unemployment? The literature, both theoretical and empirical, is reviewed in ACIL (1994). The main conclusions that emerge from this literature are that minimum wages, if set at binding levels, adversely affect the employment prospects of the least productive in the labour force. There are empirical difficulties in testing the hypotheses about the impact of minimum wages on employment because there are no observations pertaining to firms that have closed (perhaps as a result of the higher minimum wage) or that never opened. We can never be sure of the counterfactual. Moreover, minimum wages do not only affect employment levels but also factors such as training, working conditions and levels of discrimination which are hard to measure empirically.

The OECD (1994b) is clear about the impact of minimum wages: "wages have significant consequences for employment and unemployment". Two further observations are made: the slant in demand towards skilled jobs in all developed economies over the past several decades and the divergent movements in the wage differentials between skilled and unskilled workers across countries:

In countries where wages are flexible...the employment and unemployment relations between low- and high-skilled workers changed little during the 1980s. On the other hand, in comparatively inflexible Europe, the relative employment and the relative unemployment situation of the unskilled has deteriorated (OECD 1994b, p. 18).

The message for New Zealand is clear: minimum wages are a harmful form of labour market regulation and are best avoided. If the minimum wage, both adult and youth, is to be retained, it should be sufficiently low to minimise adverse employment consequences which most harm those whom the minimum wage is supposed to benefit.

6 INCOME SUPPORT ARRANGEMENTS

6.1 The impact of income support arrangements on unemployment

By international standards, New Zealand operates a fairly modest income support arrangement for the unemployed. Using the replacement rate as an index (defined as the ratio of average income support while unemployed to average income while employed, both expressed in post-tax terms), for a single person in New Zealand the figure is approximately 27 percent, and for a person with a dependent spouse it is close to 40

percent (see Committee of Employment Opportunities 1993, p.175). Certainly in relation to the first year or two of unemployment, these replacement rates are low by the standards of other developed economies.

Another distinguishing feature of income support arrangements is the drawing of these benefits from general taxation and the absence of unemployment insurance (UI) arrangements, which are typical of most other developed economies save Australia. While the details of UI arrangements differ across the world, the schemes have a number of common features. The most important of these is the limited duration of earnings-related benefits payable to the unemployed, after which the unemployed generally have to rely on fairly meagre means-tested income support provided by the government. Thus while replacement rates are initially quite generous (as high as 90 percent in some countries), over time these replacement rates fall, often quite sharply.

There are therefore two issues: the impact of the level of replacement rates on unemployment and the impact of changes in replacement rates on unemployment. New Zealand has low but time-invariant replacement rates. Using United Kingdom data, Nickell (1979) estimated that the chances of re-employment among the unemployed were related to the replacement rate by a factor of -0.6: for a one percent increase in the replacement rate, the probability of re-employment declined by 0.6 percent. Other estimates, again using United Kingdom data, place a larger range around the estimates - from -0.12 to -1.0. Research also indicates that the impact of the replacement rate is not even across all workers, with different impacts on young versus old workers, and on short-term unemployed versus long-term unemployed. McKenna (1990, p. 62) concludes:

Most economists agree that an across-the-board reduction in benefits is unlikely to have a great impact on unemployment, although the rescheduling to reduce the disincentive effects among sensitive groups may reduce unemployment among those groups.

Turning to the issue of the duration of benefits and changes in replacement rates, the Australian Cass Report, *Income Support for the Unemployed in Australia: Towards a More Active System*, concluded as follows (Social Security Review 1988):

Countries with benefits of indefinite duration do seem to have more long-term unemployment than those countries which do not... . This is partly due to the increased work seeking effort in some countries by people approaching total loss of income... . There are also greater incentives under limited duration schemes for the long-term unemployed to qualify for other payments such as invalid or disability pensions.

The influential British economists, Layard, Nickell and Jackman (1991, pp. 472-473) summarise their position on income support arrangements as follows:

[Take] a tougher line on benefits...Benefits can be made less attractive by cutting their value, by reducing their duration, and by stiffening the work test. In our view, there are strong efficiency ... and equity arguments for having a reasonable value of benefits. But indefinite benefits are not in the interest of most able-bodied individuals, nor is it reasonable that they should be made available without a clear test of willingness to work.

These recommendations are mirrored in the policy suggestions contained in the OECD Report (1994b). *In brief, these are to restrict the time over which UI benefit entitlements apply; reduce replacement rates where they are high; and impose restrictive conditions on indefinite duration assistance to employable people*. Other suggestions include lowering the rate of withdrawal of benefits associated with the taking of part-time employment or a spouse taking work, and paying in-work income support to low-paid workers to remove the disincentive for the unemployed to take low-paid employment.

6.2 The Lessons for New Zealand

The lessons for New Zealand are fairly obvious. *Prima facie*, there is little to support the proposition that high replacement rates in New Zealand are a primary cause of unemployment or its persistence.¹⁰ This said, the replacement rates calculated using pay levels of the low-paid, rather than average earnings, underpin stronger disincentives for the unemployed to seek work than the average rates indicate. And since low-paid employment is the likely alternative for most of the unemployed, it is these recalculated replacement rates that are more relevant to assessing the impact of the welfare system on the incentive to work. Working on the basis of the lowest quartile of wages, replacement rates in 1987 were 56 percent for single people (64 percent for under 20

year olds), 80 percent for married people and 89 percent for married people with children (New Zealand Business Roundtable 1988).

The principal problems with income support arrangements in New Zealand, however, are their indefinite duration rather than the level of benefits *per se*; the high rates of withdrawal of benefits associated with part-time work; and inconsistently and sometimes weakly applied work testing procedures.

There are several options that might be considered to address the problems. The time may have come for New Zealand to consider introducing a form of unemployment insurance to align itself with the dominant practice in most developed economies (see New Zealand Business Roundtable 1988). In this way, the scope for establishing a change in the time path of benefits is greatly enhanced and thereby the incentives for the unemployed to return to work are significantly sharpened, even in less preferred jobs. Some preliminary suggestions on a UI scheme for New Zealand are as follows:

- Run the scheme as a hypothecated income tax on employees, with offsetting reductions in income tax if deemed desirable.¹¹
- Do not seek contributions from employers lest these add to non-wage labour costs and adversely affect employment.¹²
- Make the scheme prospective, so the existing unemployed are not confronted with a new set of incentives for which they are unprepared.
- Pay the unemployed in relation to previous earnings for a period of time (say between 6 and 12 months) after which time benefits would be significantly reduced.

With the passing of the ECA, the case for UI in New Zealand is greatly strengthened, as the unemployed are no longer locked out of the labour market by virtue of binding wage and other regulations as was previously the case (c.f. New Zealand Business Roundtable 1988). With much greater freedom to negotiate contracts on terms that suit both parties, the unemployed in New Zealand now have much greater scope to secure employment. The lower benefits that will apply after a period of time will have the effect of lowering the reservation wage of jobseekers, thereby increasing the probability of their accepting employment. This short-circuiting should have the benefits of reducing skill atrophy associated with lack of work experience and minimising the demoralising effects of long-term unemployment.

On the issue of the withdrawal rates of benefits, high effective 'tax' rates for low income workers are potentially damaging not only to the unemployed themselves but in adding to the general unemployment problem. The general suggestion of the Issues Paper to reduce significantly the rate of benefit abatement at income levels greater than \$50 (a figure which would not appear to have changed since 1988 at least) or \$60 for those with children is sensible and should be pursued. In view of the fact that many new jobs in the New Zealand labour market will be part-time, it is inappropriate to confront the unemployed with disincentives to take these jobs.¹³

The strict application of the work test is another important aspect of reform which is also made easier with the passing of the ECA. But to operate a credible work test which jobseekers expect to be firmly and fairly administered, there must be a set of appropriate sanctions which are actually applied. The current situation is absurd, since the sanction is too harsh (a 26-week stand-down of benefits) and is therefore very rarely applied. The suggestions coming out the Australian White Paper (Australia 1994) are helpful: phased stand-down periods according to duration of benefit receipt and for first versus second and subsequent breaches of the work test.

In the event of the government opting to implement targeted labour market programmes for the long-term unemployed (see Section 7 below), another aspect of the work test could be the insistence that the unemployed either accept employment or a place in a training or employment programme. This is part of the notion of a 'reciprocal obligation' - the government guarantees to provide income support for the unemployed, but in return the unemployed must be prepared to accept employment, even if it is perceived as inferior, or be involved in an employment or training programme. Some consideration may be given to a requirement for the unemployed to relocate out of depressed regions. The converse can be immediately justified: denying benefits to those who move to depressed regions, at least for a considerable period of time. ¹⁴

7 THE ROLE OF LABOUR MARKET PROGRAMMES

7.1 What are labour market programmes (LMPS)

The OECD Report (1994b) argues the case for a two-pronged strategy to reduce unemployment: increase the incentives for private sector employers to hire workers and improve the employability of people. In short, it is about jobs and people. On people policies, the Report (1994b, p. 34) sets out a number of measures:

A progressive shift of resources is needed from passive income support to active measures. Active labour market policies improve access to the labour market and jobs; develop job-related skills; and promote more efficient labour markets. Active policies can strengthen the links between aggregate demand, job creation and the supply of qualified labour.

There are, however, grounds to be less optimistic about the role of labour market programmes in providing a solution to unemployment. But before discussing this issue, it is necessary to define labour market programmes (LMPs). LMPs fall into three broad categories, viz:

- Wage subsidy schemes (WSS) to private sector employers
- Public sector job creation schemes (PSJCS)
- Training programmes.

These are further outlined in Sloan (1993), and while in practice there is some overlap, it is useful to think of LMPs falling predominantly into one of these three broad categories. There are also very many variations within the categories, particularly in relation to the level and duration of funding. For example, WSS schemes can set high or low ratios of subsidies to labour costs incurred by employers; subsidies can last for six months, twelve months, etc. The cost per placement varies according to the broad type of LMP, as well as within LMP categories. In general, PSJCS are much more expensive per placement than WSS.

An important descriptor of LMPs is their degree of targeting. Virtually all LMPs operate under certain eligibility conditions for participants. Duration of unemployment is a common criterion, but some schemes are also limited to certain age groups or even ethnic groups. The case for narrow targeting of WSS is that, in its absence, employers will 'cream' the best of those who meet the eligibility criteria, leaving the most disadvantaged without placements. The principal disadvantage of narrow targeting is that the participants are potentially stigmatised if the criteria connote significant disadvantage to employers and the scheme develops something of a 'bad name'. Schemes run through the Youth Clubs in the United Kingdom are cases in point (see Sloan and Wooden 1987).

7.2 The impact of labour market programmes

The impact of LMPs on unemployment cannot, even in a short-term sense, be equated with the number of placements made under LMPs. This is because LMP expenditure gives rise to a number of effects which negate or reduce their impact on unemployment. Using WSS as an illustration, these downside effects fall under three headings:

- *Deadweight losses*, wherein firms take on the actual (subsidised) workers that they would have done in any event.
- *Substitution effects*, wherein firms take on subsidised workers in place of nonsubsidised workers.
- *Displacement effects*, wherein firms receiving wage subsidies achieve a competitive edge over other firms, resulting in the latter laying off workers.¹⁵

While there are a number of estimates of the net effect of WSS expenditure after taking into account these three effects, a figure of 20 percent is not unexceptional (see Sloan 1993 and Committee on Employment Opportunities 1993). That is, for every 100 WSS placements, only 20 can be regarded as additional, with substitution effects accounting for the bulk of the 'lost' 80 placements. *The importance of this result is that even the short-term effectiveness of LMP expenditure is likely to be low, apart from question marks over the longer-run benefits of the programmes on the employability of the participants. At the very least, expectations of the potential gains of large-scale government spending on LMPs need to be heavily qualified.*

Of course, it can be argued that the 'churning effect' of LMPs (that is, the substitution of non-subsidised workers by subsidised workers) does not eliminate their value (Chapman 1994). Not only is such an outcome seen as equitable, the point is made that there may also be some efficiency gains. If LMPs can make the unemployed a more effective part of the labour supply, so the argument goes, the power of the insiders in the labour market can be reduced and, as a consequence, the rate of unemployment at which wage pressures kick in (non-accelerating wage inflation rate of unemployment (NAIRU)) will be reduced.

Whether the implicit view of the functioning of labour markets has much relevance to New Zealand is open to some debate, however. For one thing, it may be that the 'power' of the insiders essentially derives from their imbedded specific skills and tenure, 'power' which will not be eroded by the unemployed participating in LMPs, especially PSJCS and training programmes. Secondly, in a relatively flexible labour market such as New Zealand, it is not clear why the unemployed would not simply offer themselves to employers at the 'market clearing rate', barring strong disincentives arising from welfare arrangements. In other words, LMPs are not necessary for the unemployed to become an effective part of the labour force.

The OECD (1993) has reviewed the effectiveness of LMPs using both macro- and micro-level studies as the basis for their conclusions. The conclusions drawn underline the ambiguity of the overall results.

The macroeconomic analysis lends some support to the view that active programmes strengthen the relationship between job creation and output growth. In addition, there is some evidence that higher expenditures on active programmes may facilitate wage moderation, thereby stimulating labour demand. However, these latter studies are not very robust and other studies come to the opposite conclusion. Likewise, microeconomic studies of impact evaluations, though confined to a few countries, suggest that a number of programmes have had a significant impact on improving employment prospects and earnings of the programme participants. Again, though, the results are mixed, and there are several examples of programmes which seem to have had little impact (OECD 1993, pp. 67 - 68).

7.3 Some highly targeted spending on the long-term unemployed

The argument about the role of LMPs may boil down to the particular disadvantages faced by the long-term unemployed whose skills have atrophied, whose motivation has been scuttled and whose qualification and skill levels are often relatively low. By virtue of the scarring effect of lengthy unemployment, and income support which meets the adequacy test but fails to provide sharp incentives for the long-term unemployed to take employment, the provision of programme assistance may be the only means of enforcing a 'reciprocal obligation' on the long-term unemployed. In other words, there may therefore be a case for highly targeted LMP spending on the long-term unemployed. As the OECD (1993, p. 68) notes: "positive outcomes have been attributed to programmes with relatively precise targeting, perhaps because these programmes on average tend to be associated with more careful assessment of individual needs".

While arguing the case for narrowly targeted LMPs to apply to the most disadvantaged in the labour market (with appropriate criteria such as duration of unemployment and possibly ethnic status and region), the improving labour market conditions in New Zealand should mean that overall spending on LMPs can be expected to fall over the next few years. That is, there should be tight re-positioning of spending on LMPs, with cuts in programmes on expenditures with broad eligibility criteria.

Of the types of LMPs available to assist the long-term unemployed, which is likely to be most effective? On the evidence to hand, WSS are the preferred type. Where the labour market disadvantage of the LTU, in part, arises from statistical discrimination on the part of employers using unemployment duration as a proxy of productivity, subsidies can effectively defray the screening costs that employers are otherwise unwilling to meet. And as a

consequence, WSS participants may be retained by employers after the subsidy period ends (Stretton 1984).¹⁶ In addition, the costs per placement are lower than in PSJCS.

In a regulated wage environment such as Australia's, there are clear bases from which to apply subsidies. WSS participants can be remunerated at standard award wages, and the subsidies granted to employers are then specified as a proportion of the award wages or as flat amounts. The New Zealand situation is more complex since there is now no fixed notion of a mandated, going wage for a job. Decisions are therefore required as to the apportioning of costs between participants and the government. It may be appropriate, for instance, to consider an arrangement whereby participants are paid at a rate equivalent to the 'dole' plus some small emolument. Employers could then be subsidised either proportionately or by fixed amounts. Decisions are also required as to the duration of subsidies - longer and smaller ones are probably preferable to shorter and larger ones. Up-front payments to employers, as well as financial rewards for employers retaining employees, may also have some place (Australia 1994).

On training programmes, there has been little systematic work that allows strong conclusions to be drawn. Short training courses, particularly those conducted outside mainstream accreditation arrangements and outside the context of employment, are generally ineffective in enhancing the employment prospects of the participants (see Committee on Employment Opportunities 1993). More promising are targeted training programmes designed to remedy specific deficiencies of the participants (language and literacy problems, for instance) or programmes providing job search guidance and assistance. Participation in these programmes may sometimes be sensible prior to participation in WSS.

8 REFORMING THE EMPLOYMENT SERVICE

8.1 The role of a public employment service

In most developed economies, considerable public resources are devoted to the running of a public employment service (PES). New Zealand is no exception in this regard, operating the network known as the New Zealand Employment Service (NZES). A PES typically performs three functions: "job information and brokerage, administration of income support and the admission of participants to active programmes" (OECD 1993, p. 54). But as the OECD (1993, p. 54) notes: "[each] of these can often be performed by other bodies than the PES agency".

A perennial conflict in PES operations across the world is between agencies operating as effective job brokers, matching workers and jobs, and servicing the labour market as a whole (or at least significant chunks of it) versus agencies concentrating on those in the labour market with special needs/disadvantages. This conflict has been apparent in relation to the NZES, with emphasis over the past several years on the agency acting as a general broker in the labour market, particularly in sub-professional segments, rather than homing in on the needs of special groups.

Obviously, the case is not wholly one way or the other - it is a matter of striking the right balance. Serving the special needs of the unemployed cannot be totally divorced from the requirement for the agency to maintain credible links with employers and to assist in the matching of workers, many of whom will, it is hoped, come from the 'disadvantaged' pool, with jobs.

The OECD's (1993, p. 56) conclusion in respect of PES effects is as follows:

[Evaluations] of various kinds have reported positive effects from individual counselling targeted on persons with difficulties in finding jobs; these effects tend to be greater if individual service needs can be identified relatively soon after the beginning of unemployment.

There is a strong case for early intervention in cases, especially where the characteristics of the unemployed indicate a high probability of prolonged joblessness (see Chapman and Smith 1992). *One of the most alarming observations about the operations of NZES is the fact that the unemployed appear to have very little contact*

with the service over long periods of time (The Issues Paper 1994, p. 94). This arrangement needs urgent reform to provide for regular and ongoing contact with the unemployed in a focused and particularised way. Continuity of contact between a service officer and the unemployed is also desirable.

Overall, the propositions put are as follows:

- refocus the NZES on the 'long end' of the unemployment queue while continuing to act as job placement agency consistent with the focus;
- intervene early and actively in cases which predispose to prolonged joblessness;
- ensure that the unemployed retain contact with NZES (or alternative agency) on a regular basis, desirably with continuity of client-officer contact.

A further issue is whether the NZES, or part of its operation should be opened to competition.

8.2 Opening the NZES to competition

Considering the role of PES, there are in fact few reasons why all (or indeed any) of its functions should be provided in the public sector. Put another way, the case for public provision of employment services on grounds of market failure is fairly weak. For instance, the role of an employment service in matching jobs and workers can be undertaken quite effectively (arguably more effectively) by private sector companies and organisations. Typically, such private broking arrangements flourish at the professional end of the labour market. Where the market is most likely to fail is at the 'long end' of the unemployment queue although, judging by Australian experience, even in this segment of the market, community-based agencies sometimes operate quite successfully.

The other point is that the dynamics of monopoly public provision tend ultimately to be inimical to providing good and preferred service to the clients. Organisations take on 'lives of their own' and policies which favour the organisations are often promoted over policies which might favour the clients. This is not to deny the very good intentions of those who work in public agencies, including the NZES. However, by providing clients with some choice (for example, in relation to assessment, counselling and placement in programmes) between agencies, the performance of all agencies is likely to be lifted. The opening up of the public employment service in Australia to competition was one of the better suggestions coming out of the White Paper (Australia 1994), and one whose details might bear some analysis in relation to the lessons for New Zealand.

9 CONCLUSION

This Report is bravely entitled "Towards Full Employment in New Zealand". I say 'bravely', because many believe that full employment is a phenomenon of the past and is unlikely to be achieved again, now or into the future. This proposition is firmly rejected in this Report. At the same time, full employment is not simply about all those wanting employment having jobs. There must also be strong expectations on the part of jobseekers to move, to retrain, and if necessary to accept seemingly inferior jobs in the first instance.

It is pointless to deny the practical and political difficulties of creating an environment that is conducive to the restoration of full employment. But, as Ted Evans, Secretary of the Australian Treasury has stated, unemployment is essentially a matter of political choice, a political choice made by many but not all countries. Unemployment is not an international phenomenon in the sense that we do not understand its causes or its solutions. We do. It is a case of governments opting for policies that placate the median voter but that do much damage to the prospects of the least productive and most disadvantaged in the labour market.

The Issues Paper is a very useful focus for a debate about unemployment in New Zealand. It is a competent piece of work and deals soundly with many of the relevant issues. There are a number of places in the document

where criticism can be levelled, particularly its downplaying of the role of labour costs in generating unemployment. Its use of the term 'structural unemployment' is highly questionable. The proposition that unemployment increased in New Zealand in large measure because of various supply-side reforms is refuted by equivalent or greater increases in unemployment in countries that did not embark on such reforms. The alternative question is: to what level would unemployment have risen in New Zealand had the reforms not been instituted? Nonetheless, much of the analysis in the Issues Paper is uncontroversial, and many of the (implicit) suggestions are quite sensible.

As far as the prospects for lower unemployment in New Zealand are concerned, it is concluded here that considerable gains are likely to be made over the next several years. The prediction of the Issues Paper that unemployment in New Zealand will stand at between 7 and 8 percent in 1999 is seen as implausibly high. In fact, calculations based on a set of realistic assumptions point to a rate of unemployment which would be as low as 4 per cent by 1998/99. In other words, economic growth and the improved flexibility of the labour market will make very considerable inroads into the unemployment problem in New Zealand.

There is some truth in the proposition that growth is a necessary but not sufficient condition to solving unemployment. This author would nonetheless place great weight on the value of high and sustained growth in output and employment. There are three key aspects of the required policy strategy: ensuring that output growth is translated into employment growth; establishing a convergence between full employment and the 'equilibrium' rate of unemployment; and providing targeted assistance to the most disadvantaged in the labour market, disadvantage that is in part caused by past policy mistakes.

On the first, the critical factor determining the translation of output growth into jobs growth is the degree of labour market flexibility, measured along a number of dimensions. With the passing of the *Employment Contracts Act*, New Zealand has experienced a dramatic improvement in its overall extent of labour market flexibility. There is, however, one major unfinished agenda item and that relates to the high (perceived) costs of firing arising from the unfair dismissal decisions of the Employment Court. The overseas evidence is very clear: strong employment protection laws are associated with high rates of unemployment, particularly long-term unemployment. The suggestion made here is that the work of the Employment Court be transferred to the normal court system and the principles of contract law, which underpin the approach of the ECA, be more strongly invoked in respect of dismissal matters. The other impediment to greater labour market flexibility relates to minimum wages and their potential harm to the employment prospects of the lowest paid and least productive members of the workforce.

Unemployment is not simply a story about labour market flexibility; it is also a story about welfare. High replacement rates reduce the incentive of the unemployed to take work, especially low-paid work. High rates of benefit abatement associated with part-time employment reduce the incentive of the unemployed to take part-time jobs, which now account for a significant (and probably growing) fraction of the job market. Income support of indefinite duration induces persistent unemployment and weakly applied work tests are likewise associated with persistent unemployment. The policy implications are to maintain income support at adequate but not generous level; to ease the abatement of benefits associated with part-time work; to consider prospectively a form of unemployment insurance characterised by a sharp fall in benefit levels after a fixed period of time; and to enforce more stringently the work test on the unemployed.

Even with first-best prospective policies, there is a case for remedial action to assist the pool of long-term unemployed. At the same time, the potential benefits of labour market programmes designed to assist the long-term unemployed should not be overstated. Not only is the net job creation of these schemes typically a small fraction of the total number of placements (and disadvantage the short-term unemployed and new entrants), the longer-run impact on the employment prospects of the participants is dubious. Nonetheless, within the class of labour market programmes, the preferred option is wage subsidy schemes tightly targeted on the long-term unemployed. With the improving unemployment situation in New Zealand, it can be expected that over the next few years, overall expenditure on labour market programmes will fall.

The role of the public employment service was briefly canvassed. A number of suggestions are made, including refocussing NZES on the 'long-end' of the unemployment queue and opening the service up to competition from private sector agencies.

This Report has covered a broad canvass. Its principal objective has been to imbed the key issues related to unemployment in New Zealand within the international discussion of these same issues. But the coverage has

not been exhaustive. In particular, and with the exception of some passing reference to training programmes within the discussion of labour market programmes, there is no mention of the role education and training might play in reducing unemployment. In defence of this exclusion, education and training policies should appropriately have a medium-term focus, to lift standards and increase participation. The short-run effect of these policies on unemployment will, in all likelihood, be quite weak. It is also important to distinguish between the genuinely productivity-enhancing effects of education and training as opposed to their screening and ordering functions in the labour market. Some very serious thinking needs to go into the appropriate direction of education and training policies in New Zealand and the substance of the programmes. *Prima facie*, it is not clear that New Zealand is 'getting it right', but detailed analysis is left to another place.

Overall, this Report is optimistic about the outlook for unemployment in New Zealand. There is no doubt that the reforms have caused pain. And the pain has not been evenly distributed. But by removing many of the supply-side roadblocks in the economy, that would otherwise limit the speed at which the economy could grow sustainably, and by recasting the New Zealand economy to be an outward-looking and competitive one, the prospects for the unemployed in New Zealand are generally bright.

FOOTNOTES

1 The total number of registered unemployed in June 1993 was approximately 200,000.

2 This includes the Issues Paper's rather weak rejection of the argument about minimum wage laws and unemployment - "most studies find that, at the levels which they are typically set, minimum wages have only a small impact on unemployment" (p.50). What the Paper fails to mention is that most studies find an adverse impact of minimum wage laws on those with the lowest productivity in the labour market, the group which is typically over-represented in the unemployment pool (ACIL Economics and Policy Pty Ltd 1994).

3 An example is large-scale, unfunded, non-targeted labour market programmes which do little to improve the employment prospects of the participants but the expenditure thereon produces negative general equilibrium effects on the economy, in turn feeding through into the labour market.

4 The figures from registered unemployment are not comparable from data derived from the Household Labour Force Survey.

5 Note that one-off comparisons of this variety can be misleading given differences in the timing of the business cycle across the world.

6 Logically, labour and total factor growth rates were much higher in EC Europe than in North America over the period.

7 Some of the reasons for the poorer employment prospects of the long-term unemployed include skill atrophy, loss of motivation and the use of unemployment duration as a screen by employers.

8 Another example of the need for vigilance on the part of legislators arises from the Court's recent decision that a partial lock-out by an employer, undertaken during a bargaining period, was not permissible under the terms of the Act. This decision has potentially far-reaching implications in introducing an inappropriate bias into contract negotiations.

9 It is interesting to note that the recent attempt by the Australian government to strengthen employment protection laws was met with loud howls of protest, the result of which was a significant watering down of the provisions. Compensation is now strictly limited and higher paid workers are effectively barred from industrial remedies for alleged unfair dismissal. Another important aspect of the change was the exemption of labour market programme participants from the employment protection provisions.

10 The disincentive effects are most adverse for married individuals with a dependent spouse and children, with an average replacement rate of over 70 percent in 1987 (see New Zealand Business Roundtable 1988).

11 Private insurance companies could also be involved, running in competition with public insurance.

12 The other possibility is that employer contributions would be shifted on to workers in the form of lower wages. In this case, it is preferable to fund the unemployment insurance through employee contributions only.

13 The relatively low proportion of the unemployed earning more than the 'free zone' income suggests that the unemployed are very responsive to the prospect of high effective marginal tax rates.

14 This rule currently applies in Australia.

15 A further effect can be added to this list, namely the 'general equilibrium' effect which results from the fact that LMP expenditure must be funded, with potential effects on a range of variables including interest rates.

16 The productivity of the participants is also likely to rise during their period of subsidised employment.

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