

**UNEMPLOYMENT INCOME SUPPORT
IN NEW ZEALAND**

OPTIONS FOR POLICY REFORM

**NEW ZEALAND BUSINESS ROUNDTABLE
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EXECUTIVE SUMMARY

UNEMPLOYMENT AS A LABOUR MARKET PROBLEM

* Unemployment in New Zealand was low during most of the post-war period. Social policy concentrated on the adequacy of benefit for the few who were unemployed.

- The emergence of persistent, structural unemployment has focused attention on unemployment benefit as a major policy concern.

* Labour market and income support reforms are linked. Over the medium term, the rate of unemployment will depend largely on the efficiency with which the labour market works.

- If minimum or award wages are set at levels that prevent many adults from finding work and the structure of wages does not respond adequately to changes in labour market conditions, there is little alternative but to provide unemployed workers with income support on a long term basis;

- Reforms to labour market institutions and other policies that affect incentives to work and acquire skills are capable of eliminating involuntary unemployment for those of working age. The problem of income support should then be confined largely to the 'frictional' unemployment of workers transferring between jobs.

CRITERIA FOR THE DESIGN OF UNEMPLOYMENT INCOME SUPPORT POLICIES

* Unemployment benefit provides unemployment insurance but may also be regarded as a mechanism for income redistribution.

- In addition, individuals and their employers make provision for unemployment by private saving or through redundancy payments or superannuation schemes.

* Considered as a means of income distribution, unemployment benefit may provide both income support (a minimum income in unemployment) and income maintenance (an income in unemployment that is commensurate with income when employed).

- For efficiency and distributional reasons, government policy should be confined to ensuring the provision of a minimum income in unemployment.

* Income support policies are necessarily a compromise between the objectives of adequacy, economic efficiency and simplicity.

- In general, tightly targeted social programmes are to be preferred to more general social policy interventions.

* The evidence suggests that the disincentive effects of unemployment benefit are important, especially for young people.

- The effects can be reduced through careful attention to 'stand-down' periods and work testing, and through the introduction of experience rating;

- There is a need to move towards a system of income support for young people with fewer distortionary effects on the choice between continuing education or entering the labour force;

- Other benefits (such as domestic purposes benefit) also have work disincentive effects.

ASSESSMENT OF THE NEW ZEALAND SITUATION

* The New Zealand unemployment benefit system meets the adequacy criterion extremely well:

- Basic benefits are high (in relation to earnings) both by past New Zealand standards and by comparison with Australia and other countries.

- There is an extensive system of supplements for those with special needs.

* The question for New Zealand policy makers is whether these gains in adequacy have been achieved at too high a cost in terms of disincentives for work and educational participation, and high effective marginal tax rates.

* New Zealand has instituted an extensive system of benefits to ensure that low income working families have incomes that are higher than those of the unemployed.

- As a result of these income tested arrangements, many New Zealand families face high effective marginal tax rates, thus contributing to an environment where enterprise and initiative are not adequately rewarded.

POLICY APPROACHES

* The following strategies concerning unemployment benefit should be examined carefully:

- Introduction of a lower rate of benefit for persons aged 16 and 17 years (alternatively, raise the age of eligibility to 18 years in which case family support would be payable to low income families of unemployed children);

- Pay benefits to persons aged 16 and 17 years subject to a parental as well as a personal incomes test;

- Introduce longer stand-down periods for those leaving secondary or tertiary education;

- Allow benefits to fall in relation to earnings over the next few years (but make increased use of special benefits to address areas of hardship);

- Tighten income tests;

- Review the operation of the work test.

The first two of these options have been taken up as part of the Government's youth support scheme.

* Income support for low income people in employment should be reviewed with respect to both the amount of assistance provided and the range of income over which it is withdrawn.

* Consideration should be given to financing unemployment benefit by explicit premiums rather than through taxes.

- This would permit the introduction of experience rating for employers and employees;

- An opting out scheme for those with adequate private cover (from employers or insurance providers) could also be considered.

* Self-provision for unemployment can be encouraged through a general climate of monetary stability and low marginal tax rates.

- There is a good case for reviewing government regulation of the insurance industry to identify and remove any impediments to the provision of a diversified and innovative range of products.

* Job subsidy and job creation schemes are not sensible approaches to dealing with unemployment. While training schemes may have a place in dealing with unemployment, attention should be focused on more fundamental problems.

- The acquisition of work skills by the young can best be facilitated by remedying the defects of secondary education and by improving the functioning of the labour market.

1 INTRODUCTION

Since taking office, the present New Zealand Government has followed policies which have had the stated aim of creating a more efficient economy and a fairer society. It is currently engaged in a wide-ranging examination of the success of a number of social policies in meeting their fundamental objectives. A Royal Commission on Social Policy has recently reported and reviews of the administration of several social programmes have been undertaken.

This present paper is intended to be a contribution to the re-examination of social policy in New Zealand. Because of the potential for conflict between the equity and efficiency objectives of government, policies to assist the unemployed are a difficult area. As is argued in detail in the next section, a level of income support that is considered desirable on income maintenance or adequacy grounds may well have adverse effects on the incentives to work and to engage in training. The major argument of this paper, however, is that it is possible to achieve a more precise balance between the government's equity and efficiency objectives by closer targeting of the assistance provided through unemployment benefit to those most in need of it, and by more careful attention than in the past to offsetting the potential for adverse incentive effects. The paper also makes suggestions as to how these strategies might be implemented.

The focus is on unemployment benefit but a number of other programmes are considered. Because of the concern to ensure that persons in employment have incomes that are at least as high as they would receive if unemployed, programmes to assist low income persons in employment are closely linked to unemployment benefit. Many of the arguments advanced in this paper apply to the other benefits that are payable to persons of working age. Education and training programmes, moreover, have often been seen as preferable alternatives to receiving unemployment benefit.

The structure of the paper is as follows. The objectives and implications of policy for the unemployed are discussed in Section 2. The New Zealand system of income support for the unemployed is summarised in Section 3 and compared with the similar (but less generous) system that exists in Australia. Directions for reform of unemployment benefit are suggested in Section 4. Finally, the relationship between unemployment benefit and related programmes, such as education, training and job creation, is discussed in Section 5.

2 SOME FUNDAMENTAL ISSUES

THE WIDER CONTEXT

During the first thirty years following the end of World War II, unemployment benefit arrangements were a relatively unimportant part of the New Zealand social welfare system. As recently as 1977 fewer than 4,000 New Zealanders were receiving unemployment benefits. During this period it was natural that policy should focus on providing an adequate benefit to the few that were unfortunate enough to be unemployed. Following the report of the Royal Commission on Social Security in 1972, a basic level for benefits in general was set for married couples at 80 per cent of the after-tax wage of a builder's labourer. This level of income has since been maintained in real terms through increases in benefits in line with changes in the Consumers' Price Index. Because New Zealand's poor economic performance and the growth in government spending has led to a decline in post-tax wages in real terms, the result has been that benefits have risen in relation to earnings since the mid-1970s. Additions to the basic benefit are paid to those with children, high housing costs or other special needs; lower basic rates of benefit are paid to single persons and to unemployed persons without children.

The number of registered unemployed has climbed since 1977 to reach its present level of around 120,000 (August 1988). As unemployment has increased so has the average duration of spells of unemployment. Moreover, unemployment has increasingly become concentrated among disadvantaged groups such as Maori and the young.

Thus while the overall unemployment rate (according to the labour force survey) was 5.0 percent in March 1988 and that for Europeans was 4.0 percent, the Maori unemployment rate was 13.4 percent. And while the unemployment rate for persons aged 30 to 34 was 4.1 percent, that for 15 to 19 year olds was 12.9 percent.

The performance of the labour market in New Zealand has deteriorated. New Zealand is now a medium unemployment country and on current trends may become a high unemployment country over the next 12-18 months. Moreover, the distribution of unemployment among groups in the labour market has worsened, and the problem has become persistent and structural in nature, not merely cyclical. Emigration may also have acted as a safety-valve to some extent. Although a number of countries have experienced a similar deterioration, others have succeeded in maintaining a relatively good labour market performance despite adverse economic conditions. Japan and Switzerland, for example, have generally maintained rates of unemployment of below 3 percent.

Unemployment rates in the United States, and more recently in the United Kingdom, have been steadily declining.

Although a low level of unemployment is desirable on social grounds it is not, of itself, a sign of economic good health: this depends on how low unemployment is achieved. A command economy may well achieve low unemployment at the cost of low productivity of labour.¹ Sweden's relatively low unemployment rate has been achieved partly at the expense of extensive public sector job creation and a very high tax burden. It may be that the low levels of unemployment in New Zealand prior to the 1980s were a reflection both of the slow rate of structural change in the economy as a result of direct controls, tariffs and a large monopoly state enterprise sector, and of actual and suppressed inflation. Under present labour market institutional arrangements, the correction of these imbalances within the economy is likely to involve a level of unemployment that is high by past New Zealand standards. The fact that real wage increases have run ahead of the modest growth in productivity, adjusted for changes in the terms of trade, has been important in the increase in unemployment. The consequence of this set of economic and labour market policies has been a low-wage, low-productivity economy which has not been capable of achieving its full employment goals.

Over the medium term, the rate of unemployment will depend largely on the efficiency with which the labour market works. If the labour market is functioning well, pay will be closely related to differences in individuals' productivity and hours of work. In these circumstances not only will effort and the acquisition of skills be rewarded but jobs at appropriate entry level wages will be available to those (such as school leavers and persons from disadvantaged groups) who are acquiring labour market skills. With experience, an individual's pay rate will rise. Given labour market flexibility, and stability in macroeconomic policy, it should be possible for most of those who want work to find it in normal circumstances. In an economy undergoing rapid structural change, a higher level of frictional unemployment is to be expected as people move from one job to another.

The solution to unemployment, therefore, is to be found largely in measures to improve the functioning of the labour market and not in palliatives such as employment schemes. If the labour market is working well, developments in product markets will translate readily into increased job opportunities. In rigid labour markets there is the danger of jobless growth – a phenomenon that has recently been evident in some European countries – or of no growth at all. A well-functioning labour market will offer a plentiful supply of training opportunities which are paid for in part by acceptance of wages during training that are lower than would otherwise be the case. While

¹ The extent of disguised unemployment in the Soviet Union and China is being revealed with the recent economic reforms in those countries.

entrants to employment may initially receive relatively low wages, they will have every incentive and opportunity to learn new skills and hence improve their level of pay. In these circumstances most unemployment should be frictional in nature and of relatively short duration. The essential feature of income support schemes for the unemployed would be to provide assistance during what should typically be fairly brief spells of unemployment.

The reform of the labour market has been discussed in a number of New Zealand Business Roundtable publications. It should be noted here that labour market and income support reforms are linked. If minimum or award wages are prescribed by law or emerge from the wage fixing system at levels that prevent a sizeable section of the adult population from attracting employment, there is little alternative but to provide unemployed workers with income support on a long-term basis. European and Australasian societies with inflexible labour markets tend also to have generous unemployment compensation schemes.²

THE OBJECTIVES OF UNEMPLOYMENT BENEFIT

There are two ways of considering unemployment benefit. On the one hand, unemployment insurance is a marketable commodity or service that people would wish to buy and sell provided they were not prevented from doing so by government actions. On the other, unemployment benefit may also be regarded as a mechanism for governmental income redistribution.

(i) Insurance

This section investigates the extent to which incomes in periods of unemployment can be provided privately through the market.

A number of suggestions have been made recently that actuarially fair private insurance could play a significant role in providing unemployment compensation (e.g. Beenstock and Brasse, 1986). If these schemes were implemented, individuals would purchase a policy that would guarantee them an income for each week that they were unemployed during a specified time period.

A useful starting point in assessing these proposals is to inquire why a private market in unemployment insurance does not exist at present in New Zealand. First of all, relatively generous

² The unemployment compensation schemes that exist in various countries are documented, for example, in the 1987 edition of the *OECD Economic Outlook*. Aaron (1984) in his discussion of Australian social security policy noted that, in contrast to the United States, there was no limit to the length of time during which unemployment benefit could be received and suggested that this was a reason why the average duration of unemployment might be longer in Australia. Unfortunately he did not also discuss differences in labour market institutions between the two countries.

government benefits are provided; this, by itself, limits the scope for private insurance. But important groups, including two income families, are effectively excluded from unemployment benefits through the benefits income test. Why are these groups unable to purchase unemployment insurance on terms that are attractive to them?

A number of reasons can be suggested why unemployment insurance is a difficult risk for private insurers. Insurance works essentially through the pooling of risks. This works well when the risks are essentially independent (as for life insurance). But, because of swings in economic activity, when one group of workers is experiencing high unemployment the same is likely to be true of some other groups. The tendency for countries to experience roughly simultaneous swings in economic activity limits the scope for pooling risks offshore. Moreover, and perhaps most importantly, the problems of adverse selection and moral hazard are likely to be particularly acute for unemployment insurance because of the ability of both employees and employers to affect outcomes.³ It may be that unemployment insurance is so costly to provide that individuals do not find it an attractive proposition.⁴

Before the introduction of government unemployment compensation schemes in the early twentieth century, trade unions and friendly societies in the United Kingdom, Australia and New Zealand offered insurance against unemployment, sickness and funeral expenses. Beenstock and Brasse (1986) have studied the British schemes and report that they were not operated according to sound actuarial principles. No attempt was made to match an individual's contribution with his or her risk of unemployment. Benefits were often set at levels that were too generous in relation to the contributions; the rules of the fund were altered when funds appeared inadequate to meet current

³ 'Adverse selection' refers to the tendency for insurance policies to be attractive to the worst risks. (The problem arises because perfect discrimination between risks is likely to be unrealistically costly for insurance companies.) Those with least risk of unemployment will, at any given price, prefer to carry their own risk rather than to purchase insurance. This, in turn, may lead to further price increases. 'Moral hazard' refers to the possibility that the decision to purchase insurance may subsequently influence individuals' behaviour. Those who have purchased unemployment insurance may choose to indulge in more frequent, or longer, spells of unemployment than would otherwise have been the case. Insurance companies have open to them a number of strategies to reduce, but not eliminate, these factors. They would have to take these facts of life into account in deciding on the terms on which they are prepared to offer unemployment insurance. The problems of private insurance apply equally to government schemes - but governments can enforce participation. (Governments can, of course, also require individuals who would not otherwise have done so to participate in privately operated schemes, perhaps at some minimum level of coverage.)

⁴ Beenstock and Brasse (1986) provide estimates of what actuarially fair private insurance could cost in the United Kingdom. Regrettably, they have not been able to take adverse selection and moral hazard explicitly into account in estimating the premiums that would apply. Their estimates make it clear that unemployment insurance could be an expensive proposition for some groups. For example, a married man aged 30 with no children and in the construction industry would pay 65.5 cents each month in premiums to purchase an income of \$1 a month indefinitely if unemployed. The cost of an income of \$400 a month would therefore be \$262 a month. By contrast, an otherwise similar person in insurance and banking would pay 9 cents to purchase an income of \$1 in unemployment.

and future liabilities. Coverage of the labour force never achieved high levels. On the eve of the introduction of social insurance in the United Kingdom in 1911, some 2.5 million out of a working population of 20 million belonged to trade unions that operated unemployment insurance schemes. Beenstock and Brasse make the interesting comment that:

"From the collective viewpoint of the unions, unemployment benefit provided the legal means with which to enforce the collectively agreed rates of pay for the members' skills. To maintain any member on out-of-work benefit was not only to tide him and his family over the distress of being unemployed but to ensure that he did not accept employment under stress of starvation on such terms as to harm the interests of the union as a whole (p.14)".

Through the operation of unemployment insurance schemes, the consequences of wage bargaining for unemployment were recognised by trade unions and accepted by them, a discipline that is absent in the current wage bargaining environment.

There are a number of methods other than unemployment insurance through which persons can make provision against the possibility of unemployment. Individuals may save for themselves or they may make payments to superannuation funds that pay benefits on termination of employment. Benefits paid by employers on termination of employment may also be thought of as a form of self-provision similar in some ways to unemployment insurance - employees receive payments on termination that are financed by the acceptance of lower wages than would be the case without such payments. It may be that employers (or trade unions) are in a better position than insurance funds to offer unemployment insurance. They may be better able to deal with adverse selection and moral hazard problems because they have more information about individual employees and a greater range of sanctions. Mortgage insurance policies, however, include features that are analogous to unemployment insurance. The scope for self-provision for unemployment therefore appears to be considerable although some individuals would not be able or willing to self-insure (for example because they considered the risk of unemployment to be negligible). Society may therefore wish to require minimum arrangements for self-insurance to be made or, on distributional grounds, to ensure the provision of a minimum income in unemployment. Self-provision for unemployment is discussed further in Section 4.

Many North American and European governments operate social insurance schemes. The term 'social insurance' is a misnomer since contributions are seldom, if ever, closely related to the risk of unemployment, (although, as discussed later, there is an element of experience rating). Moreover, benefits are normally paid on a 'pay as you go' basis rather than being financed from accumulated

contributions. The schemes, which are often financed through an earmarked tax and pay benefits that are related to earnings, are best analysed according to the criteria for income redistribution that are next considered.

(ii) Redistribution

In OECD documents and similar publications, social security schemes are said to serve two ends - income support (the provision of a minimum income in unemployment or retirement) and income maintenance (the provision of income in unemployment or retirement that is commensurate with income when employed). Flat rate unemployment benefit schemes of the New Zealand type provide income support and also a degree of income maintenance for low income workers. Social insurance schemes following the North American or European pattern that pay earnings-related benefits are less successful in providing income support (since they provide a small benefit for those with low earnings when in employment) but result in a higher degree of income maintenance for middle to upper income earners.

It can be argued that income maintenance is not an appropriate objective for government redistribution policy, which should be confined to ensuring the provision of a minimum income in unemployment. First, there appears to be considerable scope for individuals to supplement this minimum through self-provision; it is clearly desirable that individuals should, to the maximum extent, take responsibility for their own welfare. Secondly, in view of the accumulating evidence as to the seriousness of the disincentive effects of high marginal tax rates, it is undesirable for governments to undertake tasks that individuals are perfectly capable of performing for themselves should they so wish.⁵ Finally, the payment of substantial government benefits to individuals enjoying high incomes when in employment would not appear to be desirable on distributional grounds. It is interesting to note here that the United Kingdom has recently withdrawn the second, earnings-related, tier of its unemployment benefits scheme. This change was made to reduce the number of persons for whom income if unemployed is high in relation to their wages.

Philosophers and political theorists such as Nozick have argued that compulsory redistribution involving use of the powers of the state is morally objectionable. In the light of experience over the post-war period, it is possible to sympathise with a desire to reduce the intrusion of the state into activities that individuals can undertake for themselves. The provision of a minimum income in unemployment, however, would appear to be an inescapable function of government. From the

⁵ The payment of substantial government benefits gives rise to the same moral hazard problems as were outlined for private insurance in footnote 3.

passage of the Elizabethan poor law at the start of the seventeenth century, governments in English-speaking countries have intervened to ensure the provision of minimum incomes for persons without work.

It has frequently been argued that the state should provide assistance to all persons with low incomes and not just to those who fall into specific categories, such as the aged and the unemployed. Friedman's well-known proposal for a negative income tax is based on this view. But not all persons with low incomes are necessarily needy; students or low income workers receiving substantial assistance from their families or those self-employed in businesses in an unusually bad year, may, for example, have low incomes. A more precise direction of assistance to the needy is possible if benefits are paid subject to a categorical test of need in addition to an assessment of income and wealth. This reduces the cost of providing a minimum income to those in need of it.

The objectives of taxation policy are commonly said to include efficiency, equity and simplicity. The objectives of income support policy (a form of negative taxation) are similar. In particular, it is frequently suggested that income support schemes should be assessed in terms of the following criteria:

- * adequacy - the provision of an acceptable minimum income;
- * incentives - the avoidance of excessive adverse effects on the incentives of recipients to work, save, or engage in education or training;
- * cost - to minimise the cost to the taxpayer (and hence permit reductions in marginal tax rates);
- * simplicity - ideally income support schemes should be easy to administer and use, and should avoid stigmatising the recipients.

An inescapable difficulty with income support policy is that simultaneous achievement of all four objectives is impossible. Suppose that society decides on a level of benefits that would be adequate and, to avoid means testing, also decides that this level should be paid to everyone in the defined category, irrespective of income. The cost to the taxpayer would be likely to give rise to concern and

the result, particularly in times when incomes in general are not increasing rapidly, would be the payment over time of less generous universal benefits of this type.⁶

Alternatively, the cost of paying a given level of benefits may be limited through income testing, but this may discourage the unemployed from supplementing their benefits through part time work. Moreover, the more generous the basic level of benefit (whether income tested or not), the greater is the incentive for the individual to become or remain unemployed rather than take full time work, and the greater the cost to the taxpayer is likely to be. For any level of benefits, the incentive to become or remain unemployed can be reduced by more careful attention to such features of the system as work testing, waiting or stand-down periods, and the detection of abuse. But these increase the costs of complying with the system both for beneficiaries and the administration.

Income support policies must therefore be a compromise between desirable, but competing, objectives. But there are grounds for arguing that certain compromises are to be preferred to others. In particular, closely targeted income support schemes are likely to provide a more precise balance between equity and efficiency objectives than more universal schemes. Targeting involves two main aspects: the use of additional payments directed towards beneficiaries with particular needs (such as the presence of dependent children or high housing costs) and income or assets testing. The gains from income testing, in terms of a more precise direction of assistance to the most needy and reduced marginal tax rates, in general more than outweigh the costs in terms of the disincentive to take part time work for those subject to the benefits income test. This is particularly the case if care is taken to ensure that the decisions of not too many people are influenced by the high effective tax rates generated by income testing. Assistance should therefore be withdrawn at a rapid rate in an area of the income distribution that is not dense. Relatively few working families with children, for example, have incomes much below 75 percent of average earnings. Provided that tax rates in general can be kept low, the 'short high fence' may, for a given level of benefits, minimise the

⁶ The history of the universal Australian family allowance programme illustrates this well. This programme was introduced with considerable fanfare in 1976 and absorbed the tax rebates that were previously provided for persons supporting dependent children. Family allowances have since been increased by 50 per cent (in 1982) over a period when prices have more than doubled. A family income supplement scheme has been introduced for low income working families and, from October 1987, family allowances have been paid subject to an income test. A more extensive family allowance supplement scheme for low income families with children was introduced in Australia at the start of 1988; this absorbed the older family income supplement scheme and the allowances previously provided for the children of pensioners and beneficiaries. The universal New Zealand family benefit is small in relation to the assistance provided to low income families.

obstacles for the currently unemployed in seeking full time employment.⁷ The problem would be greatly eased if marginal tax rates can be lowered through some combination of reducing government expenditure, flattening the income tax rate scale and shifting the tax mix towards indirect taxation.

The New Zealand unemployment benefits scheme is analysed in terms of these criteria in Section 3.

THE SIDE EFFECTS OF UNEMPLOYMENT BENEFIT

Unemployment benefit may have adverse effects on the incentives to work and to acquire education and training.

(i) Work Incentives

Both from the point of view of the individual and that of the economy, it is important that tax and social security systems should, as far as possible, not distort the choice between paid work and non-market activities, including leisure. If individuals who otherwise could work choose because of the existence of social security benefits not to do so, the level of output and hence income in the economy will be lower than would otherwise be the case. Studies in many countries have shown that a close association exists between unemployment and poverty. Moreover, employment even in low paying occupations improves both subsequent employability (for example by teaching the basic requirements – such as punctuality and reliability – of holding a job) and self-esteem.

Unemployment benefit provides an income to those who are not currently working but who are looking for work. A benefit of this type is almost bound to give rise to disincentive effects.⁸ To say this is not to imply that New Zealanders are lazy nor that they are necessarily making fraudulent

⁷ For further discussion of the points raised in this paragraph see Blinder and Rosen (1985) and Cox (1986). In general, as compared with a universal scheme providing a given level of benefit, income testing permits lower marginal tax rates in general but results in higher effective marginal tax rates over the range of income where assistance is withdrawn. The economic efficiency loss resulting from each scheme depends on the income distribution, the numbers of persons in each income range and the relevant labour supply elasticities (or, equivalently, the utility function from which these are derived). The simulations reported in Bascand and Porter (1986) are of interest in that they suggest that the conclusions reported in the text are likely to hold true for wide ranges of income support schemes and alternative elasticity assumptions. Moreover, Feldstein (1987) argues that the means testing of age pensions is desirable on efficiency grounds to the extent that it confines pensions to those, such as low income groups, who would not have saved in any event. For persons of working age, an analogous argument is that means testing may be desirable if it confines benefits to those who would not have worked much in any case or whose labour is not especially productive. And there are factors other than high effective marginal tax rates that may discourage low income earners from increasing their hours of work (e.g. travel costs, child care costs). Note, however, that targeted schemes are likely to be more expensive to comply with and administer than universal schemes.

⁸ Note that, for social security benefits, both the income and the substitution effects are unfavourable to work effort. The income effect arises from the provision of the benefit; the substitution effect arises from the fact that the benefit has to be financed and hence that marginal tax rates are higher than would otherwise be the case.

claims for social welfare payments. Persons who are genuinely looking for work may, by the existence of unemployment benefit, be induced to search longer than would otherwise be the case. While some period of job search may be desirable in terms of achieving a better match between workers and jobs, periods of job search can clearly be longer than is useful.

If workers who become unemployed have the alternative of receiving unemployment benefits, then the level of such benefits, in effect, sets a floor to wages. Persons are unlikely to provide labour to the market unless they receive a margin above unemployment benefit to compensate them for the trouble and expense of working. Employers may therefore argue that they find it hard to fill vacancies in low paying occupations because potential employees prefer to continue to receive unemployment benefit.

However, in the New Zealand context the most relevant constraint on job creation may not be the level of benefit but the minimum wage and system of awards that prescribe the amounts below which employees cannot legally be paid. The level of unemployment benefit may be one factor that influences the setting of these minima but it is not the only nor necessarily the most important one. In fact the ratio of benefits to award wages seems to have increased markedly in New Zealand in recent years.

In Australia there has also been variation in recent years in the ratio of benefits to earnings. Unemployment benefit rates increased rapidly under the Whitlam government but fell during the first Fraser years. From 1982/83 unemployment benefit rates have tended to increase again. It is of considerable interest to inquire how important changes in benefit have been in explaining the growth in Australian unemployment in recent years. To do this one has to allow for other possible influences on unemployment, including the level of demand in the economy, changes in wages in relation to productivity and increases in the level of taxation (which also reduces the returns from working as opposed to not working). In a statistical exercise of this type it was found that changes in the level of unemployment benefit had a significant, but not major, effect in explaining the growth in Australian unemployment (Cox, 1986). However, unemployment among young people may be more seriously affected by the level of benefit.

In the United States and the United Kingdom, a large number of studies have been undertaken, using both time series and cross sectional data, to assess the magnitude of the disincentive effects of unemployment benefit. Two main propositions have been addressed in these studies. The first proposition is that the higher the benefit-wage replacement ratio, (the ratio of income out of work to income in work), the longer will be spells of unemployment and the higher will be measured unemployment. Almost all of the studies find that this relationship is an important one. For

example, Nickell (1979) is able to reject the hypothesis that unemployment duration is not affected by the replacement ratio and finds an elasticity of duration with respect to the replacement ratio of 0.6.⁹ A review of the United States literature by Danziger, Haveman and Plotnick (1981) concluded that "despite the problems, a positive relation between unemployment insurance and duration of unemployment appears robust." But in a re-analysis of some of this evidence Atkinson et al. (1984) concluded that the evidence about the relationship between unemployment benefit and unemployment duration in Britain is far from robust. "With some combinations of assumptions," they argue, "it is possible to reproduce the earlier finding of an elasticity of around 0.6; with other - quite reasonable - formulations the estimated elasticity is not significantly different from zero." Thus, although it is probable that a more generous level of benefits would increase the average duration of unemployment, the size of this effect is still subject to debate.

The second question, which has been studied in the United States, is whether the structure of unemployment insurance increases unemployment, particularly through incomplete experience rating which subsidises industries and workers with a pattern of intermittent employment. This argument, which has considerable relevance to the proposals - discussed later - to introduce experience rating into the New Zealand unemployment insurance system, has been advanced by Feldstein (1978) and recently by Topel (1983, 1984). Hammermesh (1979) argues that unemployment insurance has a favourable effect on employment: for example, married women enter employment in order to build up entitlements under this programme.

One of the most difficult questions concerning unemployment benefit policy is whether a limit should be placed on the length of time for which benefits are received. There is evidence (e.g. Aaron, (1984)) that the average length of spells of unemployment is shorter in those countries that impose limits than in those which do not. But the evidence also suggests that the probability of an individual finding a job decreases with the length of his or her unemployment (see e.g. Nickell, 1979). If a limit were imposed on the duration of benefit receipt, it may be that, rather than finding jobs, many who leave unemployment would leave the labour market (and perhaps rely on another benefit). Countries that place a limit on the duration of receipt of unemployment benefit usually provide a back-up form of income support for those whose entitlements have been exhausted (although this back-up scheme may be administered at the local level and be subject to strict eligibility criteria). Moreover, the adverse distributional consequences from imposing a limit on benefit receipt could be considerable, particularly if labour market inflexibility prevents all who want to work from finding jobs. On balance, unemployment benefit should probably continue to be of

⁹ An elasticity of 0.6 implies that, for a 10 percent increase in the replacement ratio, the average duration of unemployment will rise by 6 percent.

unlimited duration, at least until the current malfunctioning of the labour market has been addressed through a strategy of deregulation.

Governments can take a number of actions to offset, to some extent, the disincentive effects of unemployment benefit. As noted, benefits are paid subject to a work test and to waiting periods that may be extended for persons who left their jobs voluntarily.¹⁰ (There has been a tendency over recent years to make both the waiting periods and the operation of the work test less stringent.) Recent Australian experience would suggest that the review of beneficiaries to ensure their continuing eligibility is also important.

The premiums that are charged to employers and employees in the social insurance scheme that operates in the United States depend on their respective unemployment experience. Experience rating, as well as being actuarially fairer than the present New Zealand system, improves the incentive aspects of the scheme in a number of ways. Employees know that the greater the number of spells and length of unemployment that they experience, the higher will be the premiums they would pay on regaining employment. Employers would have a greater incentive to classify separations accurately into resignations and redundancies since their experience rating would depend only on the latter.¹¹ This would reinforce other aspects of the system (such as waiting periods) that are intended to discourage voluntary unemployment. The possibility of introducing experience rating into the New Zealand unemployment benefit system is discussed further in Section 4.

The Government has introduced a number of measures to ensure that low income working families with children have incomes at least equal to the maximum unemployment benefit rate. Assistance for children and for high accommodation costs is paid to such families at levels similar to that for unemployment beneficiaries. A guaranteed minimum family income of \$300 a week for a one child family is also payable; an additional amount of \$22 a week is added for each extra child.

¹⁰ In New Zealand and Australia the work test for unemployment benefit requires registration with the state employment service. There is no reason why the work test for benefit should not be administered entirely by the social welfare department which would require evidence of job search activity before paying benefits. Such a system was in fact operated in Australia for a number of years. This change would leave the state employment agency with its placement activities. There would then appear to be a good case for transferring the placement function to the private sector.

¹¹ It has been suggested that employers might limit their liability under experience rating by making working conditions so difficult that employees had little choice but to resign rather than be made redundant. It is possible that such cases may occur. But, in general, poorer working conditions would reduce morale among employees and hence productivity; this course of action would not be costless to the employer.

To keep costs within reason, this assistance is gradually phased out as income increases. The result is that most New Zealand families with children face effective tax rates of 48 percent and some face higher rates.¹² This should be added to the list of incentive problems resulting from unemployment benefits.

Finally, it should be noted that the other benefits payable to persons of working age give rise to incentive problems similar to the ones posed by unemployment benefits. This is particularly the case for domestic purposes benefit.

(ii) Incentives for Education and Training

In general, unemployment benefits make labour force participation more attractive as compared with non-participation than would otherwise be the case. If a person enters the labour force and is unable to find work, unemployment benefit is available. Unemployment benefit therefore increases the expected return from working and reduces the risk from entering the labour force, and is likely to make labour force participation higher than would otherwise be the case.¹³

These arguments are of particular relevance for young people. In deciding whether to continue in education, a young person weighs the long term benefits of education in terms of higher earnings against the short term costs – reduced earnings or government benefits (if employment is not found). At present the only support available for young people in the post-compulsory years of secondary education in New Zealand is through tertiary assistance grants, family support (and, where relevant, the guaranteed minimum family income) and family benefit. By contrast, unemployment benefit at a higher rate of around \$100 a week is available regardless of labour force experience to 16 and 17 year olds should they enter the labour force and fail to obtain work. As the importance of upgrading the skills and adaptability of the New Zealand labour force to enable successful competition in world markets increasingly becomes realised, it is likely that greater emphasis will be placed on increasing participation in the post-compulsory years of education.

The Government announced, in May 1988, the introduction over a three year period of a new system of income support for young people over fifteen who are at secondary school, polytechnic or

¹² Beneficiaries face effective marginal tax rates of 15 or 30 per cent in the early stage of part time earnings. Around 12 percent of families with children are beneficiaries and most of them are domestic purposes beneficiaries.

¹³ Of course, labour force non-participation is also subsidised in certain cases through payment of other benefits such as domestic purposes benefit.

university, on an Access training course or unemployed. Under this scheme assistance will be provided on a consistent, age-related basis and will be directed towards young people in greatest need. Assistance will be provided to secondary students from low income families to encourage them to remain in education. The maximum rate of assistance under this new scheme will, for students without dependants, be below the present levels of unemployment benefit.

Persons who complete their secondary education are less likely to become unemployed subsequently than those who leave school early. It is therefore important that disincentives should be minimised that might prevent increasing numbers of New Zealanders from achieving the levels of literacy and numeracy now associated with secondary school completion. It should be noted, however, that the relatively high level of youth wages is likely to be a more important factor than unemployment benefit in discouraging people from continuing their education since the majority of the age group is in employment. This highlights the importance of avoiding any artificial influences on youth rates, such as bringing them within the scope of the statutory minimum wage legislation. Some suggestions about the rates of unemployment benefits for young people are advanced in Section 4.

Participants in training schemes in New Zealand receive incentive allowances in addition to unemployment benefit. In a well-functioning labour market, it should be possible for employees (through acceptance of wages lower than would otherwise be the case) and employers to finance training without a need for an explicit government subsidy. The requirement for government subsidies to training is, to a considerable extent, a symptom of labour market inflexibility.

Unemployment benefits may also discourage labour mobility. Persons may prefer to remain unemployed in their own region and receive benefits rather than move to another where jobs are available. (Since housing costs, in particular, are likely to be higher in expanding regions than in declining ones, the improvement in real standard of living as a result of moving may, by comparison with unemployment benefit income, be quite small in many cases.)

3 THE NEW ZEALAND UNEMPLOYMENT BENEFIT SYSTEM

New Zealand pays income tested, flat rate (i.e. not earnings-related) unemployment benefits, the size of which depend on family composition but not earnings. Benefits are financed through general taxation, not through specific contributions. In this section, the New Zealand benefits system is assessed in terms of the objectives that were outlined earlier of adequacy, incentives, cost and simplicity.

Comparisons are also made between the New Zealand unemployment benefit system and the similar system that exists in Australia. Australia also has a flat rate system in which the benefit paid is related to family circumstances and not past earnings. By comparison with the earnings-related unemployment insurance systems that exist in most European and North American countries, flat rate benefit systems tend to be generous to employees with low earnings (and especially to those with family responsibilities) but less generous at higher income levels. Social assistance may also be payable in addition to unemployment insurance but the Australian unemployment benefit is higher than that payable under the social assistance schemes of other countries. By comparison with most other countries, Australia's unemployment benefit system places a high priority on redistribution and a lower priority on the avoidance of adverse incentive effects. It is shown below that the New Zealand system accentuates these effects to an even greater degree.

ADEQUACY

One of the most difficult issues in social policy is the determination of the size of the minimum income that the state should provide. Whether by official decision or customary use, poverty lines have been developed for a number of countries. But the level of income at which these poverty lines are established is essentially arbitrary (SWPS, 1981). As the Australian Royal Commission on the basic wage demonstrated in 1919, it is easy to establish on adequacy grounds alone a level of benefit that far exceeds the capacity of the taxpayer to finance it. The level of income support payments must, as noted earlier, be a compromise between the objectives of adequacy, incentives, cost and simplicity.

The historical record is for unemployment benefits to be established at a level somewhat below the earnings of persons in low paying employment. This is the famous principle of 'less eligibility' that was enshrined, for example, in the nineteenth century British poor law.

In New Zealand the usual method has been to assess the adequacy of benefits by relating them to a measure of earnings or award wages. The 1972 Royal Commission saw this link as fulfilling the objectives of "belonging and participating" in the life of the community. In other words, the Royal Commission adopted a relative approach to poverty. But unemployment beneficiaries were granted rates of benefit that were below those applying to longer term beneficiaries.

Although the benefit standard was established in terms of wages it has not been updated according to movements in wages. Instead, benefits have been increased in line with consumer price changes; this is consistent with an absolute approach to poverty. Real wages increased in New Zealand up to around 1975 but have since declined (although at the same time the 'social wage' delivered through government expenditure has increased). This general trend has, of course, been symptomatic of a poorly performing economy and is rare amongst OECD countries. The result has been a tendency for benefits to move upwards in relation to earnings, although this has to some limited extent been offset by the taxation of benefits and the provision of supplements to the incomes of low to middle income families. This is illustrated in Table 1. By contrast, most Australian benefits in relation to earnings are below the peak reached in the mid 1970s (although they are substantially higher than the levels of the early 1970s).

It is of considerable interest to compare the levels of benefit provided by the Australian and New Zealand systems and to compare them with the level of earnings in each country. This is done in Table 2. Benefits in New Zealand are taxed but the Australian system of tax thresholds ensures that beneficiaries with no private income do not pay tax. The most relevant comparisons are therefore between net benefits and net earnings in New Zealand and between gross benefits and net earnings in Australia. The New Zealand figures include family support where relevant. Family benefit has been credited to all families with children for New Zealand and its equivalent, family allowances, to families with children for Australia.

TABLE 1

BENEFITS AS A PERCENTAGE OF AFTER TAX AVERAGE EARNINGS IN NEW ZEALAND

YEAR	SINGLE	MARRIED	MARRIED (Plus 2 Children)
1971	34.04	60.08	65.61
1975	40.37	65.06	70.83
1980	42.35 (36.21)*	69.04 (60.30)*	67.94
1985	46.56 (41.26)*	77.60 (63.83)*	80.26 (73.89)**
1987	45.53 (40.28)*	75.89 (60.66)*	70.00 (78.65)***
1988	45.49 (40.24)*	75.81 (60.60)*	69.93 (80.16)***

Source: Department of Social Welfare

Notes: (a) Until 1979 no benefits were taxable. From 1979 to 1986 only the unemployment benefit paid to those without children was taxed. Since October 1986 all benefits have been taxed. The benefit rates used are those which are applicable in January each year (1987 and 1988 rates are for April).

(b) Earnings are average ordinary time weekly wages - all persons, all sectors.

* Figures in brackets give net unemployment benefit rates which, since 1979, have been lower than other benefit rates for beneficiaries without children.

** Figure in brackets is after allowing for the family care supplement payable to low and moderate income families.

***Figure in brackets is after allowing for family support which is payable to low and moderate income families. The figure not in brackets gives the ratio of net benefit before family support to the net average ordinary time weekly wage.

TABLE 2

BENEFITS IN RELATION TO NET EARNINGS IN AUSTRALIA AND NEW ZEALAND

	AUSTRALIA	NEW ZEALAND
	\$A (per week)	\$NZ (per week)
	1988	1988
Single, Under 18	50.00 (0.140)	108.63 (0.326)
Single, 18 to 20	91.20 (0.255)	108.63 (0.326)*
Single, 21 and over	112.10 (0.314)	134.02 (0.402)*
Single plus 1 child	154.05 (0.409)	250.94 (0.720)
Married Couple	200.10 (0.538)	201.80 (0.606)
Married Couple plus 2 children	244.10 (0.628)	296.88 (0.800)
Average ordinary time earnings (persons)	466	436.97
Net of tax -		
- Single Persons	357	333.02
- Single plus 1 child	377	348.36
- Married Couple	372	333.02
- Married Couple plus 2 children	389	370.36

Note: Figures in brackets give the ratio of benefits to net earnings. Family allowance/family benefit and family support are included where relevant.

* Adult rate is paid from age 20 in New Zealand.

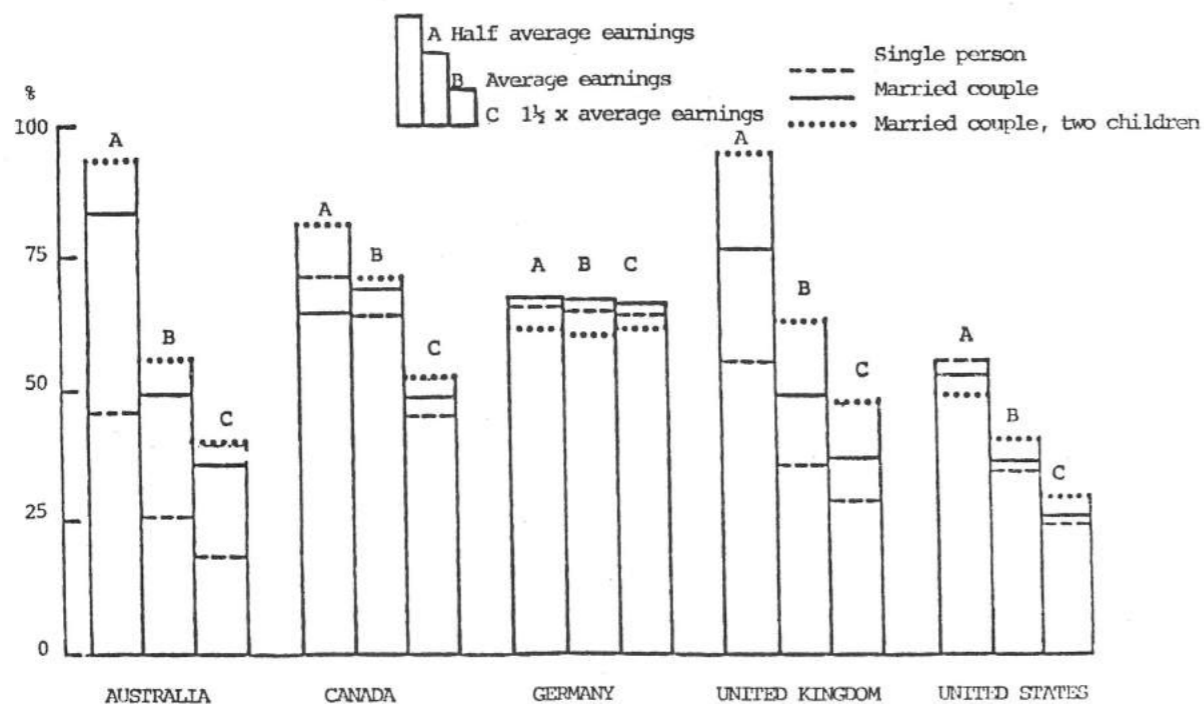
In summary, Table 2 shows that benefits in New Zealand are generally higher in relation to average earnings than they are in Australia. This is particularly the case for single and married people with children, and for single people under the age of 18 years.

In addition to the basic rates of benefit outlined above, supplements are paid to beneficiaries with particular needs. An income tested accommodation benefit of up to \$40 a week (single) and \$58 a week (married) is paid to beneficiaries with high housing costs. (By contrast the corresponding payment in the Australian unemployment benefit system, rent assistance, has a maximum of A\$15 a week.) In exceptional circumstances, unemployed people may be granted special benefit. Many also receive subsidised housing through the Housing Corporation of New Zealand. These substantial subsidies are withdrawn as income increases; this acts as a disincentive to earn extra income over wide ranges of private income.

As noted earlier, the New Zealand, Australian and United Kingdom systems of flat rate benefits are generous to low income employees and particularly those with family responsibilities. The following diagram which has been prepared by the OECD shows that unemployment benefit replaces a higher percentage of income in Australia and the United Kingdom than it does in Canada, Germany and the United States where unemployment benefits are related to past earnings. It can be concluded that the New Zealand system of unemployment benefit is, by international standards, generous to low income families.

INCOME REPLACEMENT RATIOS BY FAMILY SIZE AND PREVIOUS EARNINGS

First Year of Unemployment



Source: Secretariat calculations

As compared with other countries and its own past standards, the New Zealand system of unemployment benefits therefore appears to meet the adequacy criterion exceedingly well.¹⁴ A relevant question for New Zealand policy makers, however, is whether these gains in adequacy have been achieved at too high a cost in terms of disincentives for work and educational participation, and the addition to tax burdens.

INCENTIVES

The discussion in Section 2 suggests that two aspects of incentive effects require particular consideration:

- * The replacement ratio - the ratio of income in unemployment to the income the person could expect in full time work; and
- * The effective tax rates that beneficiaries and low income earners face if they decide to increase their work effort.

The replacement ratio can be considered to be a measure either of benefit adequacy or of disincentive effects inherent in a system of benefits. The simplest concept of a replacement ratio is the ratio of benefits to a measure of average earnings. This has already been shown in Table 1. Although such a measure is a useful indicator of changes through time in the general level of benefit, it may be a misleading guide to the seriousness of disincentive effects. This is because persons who become or who are likely to become unemployed may be drawn disproportionately from the low income population.

A somewhat more sophisticated concept of a replacement ratio has been adopted in Table 3 which presents average replacement ratios for a number of occupational groups. The earnings measure has been refined by calculating wages on a full-time equivalent basis (thus reducing the variation due to differences in hours of work) and by subtracting the tax that would be payable for an additional week of earnings. Family benefit and family support are added where relevant to both benefits and wages. It is assumed that beneficiaries do not work.

¹⁴ The Australian literature on equivalence scales suggests that the amount of income a family needs to achieve a given standard of living depends importantly on the number of children and adults, labour force participation and housing costs (see SWPS, 1981). The New Zealand social welfare system would appear to make generous allowance for most of these factors.

TABLE 3

AVERAGE REPLACEMENT RATIOS FOR OCCUPATIONAL GROUPS
(AS AT NOVEMBER 1987)

OCCUPATIONAL GROUP	SINGLE (over 20)	MARRIED	MARRIED (plus two children)
Administration/Management	.282	.359	.551
Agricultural	.567	.624	.838
Clerical	.434	.566	.768
Production etc.	.424	.508	.754
Professional/technical	.349	.430	.593
Sales	.567	.478	.683
Service	.505	.547	.695
All occupations	.425	.483	.703

Source: 1985-86 HEIS data, updated to 1987-88 values

The replacement ratios calculated here are similar to, but generally slightly lower than, those shown in Table 1. The highest replacement ratios occur for agricultural workers (although the value of 'in kind' income for this group would have been ignored). It is worth noting that 79 percent of beneficiaries come from the production occupation group (compared with 32.5 percent of wage earners) and that, of those, 70 percent are unskilled.

It is argued with some validity that it is more relevant to compare benefits with, say, the lowest quartile of wages (the level of wages exceeded by 75 percent of employed persons) rather than with average earnings, as such a measure is more likely to be representative of the income a presently unemployed person could expect were he or she to gain employment. The effect of making this comparison is to increase replacement ratios: benefits for single people are 56 percent of the lowest quartile of earnings (64 percent for those under 20), while for married people the figures are 79.8 and 88.8 percent, respectively, for those with and without children.¹⁵

¹⁵ In its April 1988 Report, the Royal Commission on Social Policy has undertaken a similar exercise. It compares benefit ratios with the median of minimum award wages and also the wage which marks the boundary of the lowest quartile of minimum award rates. Because earnings are in excess of award wages it discovers higher replacement ratios than those quoted above. For a person earning the lowest quartile award wage, the replacement ratios are 60 percent (for a single person over 20), 91 percent (for a married person over 20 without dependants) and 95 percent (for a married person with two dependants). The Royal Commission comments that the impact of replacement ratios on actual behaviour has not been tested. It added, however, that only unemployment beneficiaries with dependants have (because of targeted family assistance measures) replacement ratios high enough to be considered a potential disincentive, and that these are only 18 percent of all beneficiaries. But this is assertion rather than evidence. In certain circumstances an income out of work of 60 percent of wages could be attractive (e.g. if a person places high value on leisure or has income that he or she does not report to the Department of Social Welfare). Even so, as noted later, the high effective marginal tax

Ultimately, however, the lowest quartile of earnings is just as arbitrary a benchmark as average earnings. Ideally one would like to consider replacement ratios on an individual basis. For persons now in employment, the distribution of benefits in relation to earnings provides a measure of the incentive to become unemployed (the entry replacement ratio). For those who are now unemployed, the relevant concept (the exit replacement ratio) is the ratio of benefits to the earnings they could expect to get were they to become employed. The previous earnings of unemployed persons may give some indication as to the size of exit replacement ratios but this is likely to be an overstatement to some extent, since prospective earnings may decline with the length of unemployment.

Entry replacement ratios have been studied in New Zealand on an individual basis. It has been estimated that, based on the wages that they are earning at the moment, 4 percent of New Zealand wage and salary earners face replacement ratios of more than 70 percent while 21 percent face replacement ratios of over 50 percent. Not surprisingly, young single people and families with children are the groups most likely to have high replacement ratios. On the face of it, these ratios do not appear to be unduly alarming – four fifths of New Zealanders can expect to be more than twice as well off in work as out of it. It should be noted, however, that all these estimates of replacement ratios ignore the costs of working (travel, clothes, child care etc) and the value that individuals place on leisure. They may therefore underestimate the seriousness of the problem. Moreover, in the final analysis it is not the structure of incentives that people face which is important but how behaviour changes in response to those incentives. It may be the case that people react strongly to generally weak financial incentives.

It is worth enquiring why, in the light of the generous New Zealand benefits system, replacement ratios are not higher. As noted, an important reason for this is the extensive system of income support for low income persons in employment. These arrangements tend to reduce replacement ratios but result in high effective tax rates over wide ranges of the income distribution.

The Department of Social Welfare reports that beneficiaries with private incomes of less than \$50 a week (\$60 a week where there are dependant children) face effective tax rates of 30 percent; those above these limits but with private incomes of less than \$80 a week face effective tax rates of 60 percent; and for those with incomes above \$80 a week the combined tax rate is 100 percent.¹⁶ (For

rates resulting from the income schemes for low income working families may be as serious a disincentive problem as high replacement ratios.

¹⁶ These effective rates are based on the assumption that the private income of beneficiaries is ultimately taxed at the 30 percent rate at which tax is withheld from this income in the first instance. In fact some such income is taxed at 15 percent and these beneficiaries will receive a tax refund at the end of the year. The guaranteed minimum family income is payable if the part-rate beneficiary works 30 hours a week or more.

approximately one third of unemployment beneficiaries who also receive accommodation benefit, the figures are 55 percent, 85 percent and 100 percent respectively.) It could be argued, however, that the problem of high effective tax rates in the benefit system is more apparent than real since few beneficiaries report incomes in the abatement range to the Department of Social Welfare. One reason for this situation may be that the income test itself has discouraged work or the reporting of it. If so, a tightening of the present (relatively generous) benefits income test parameters may cause little further loss of economic well-being among beneficiaries.

More serious, perhaps, are the high effective rates for low income working people. The guaranteed minimum family income implies tax rates of 100 percent for persons in full time employment and with incomes below the minimum level. At present only around 4,000 people qualify. But the phasing-out of the family support payment implies tax rates of at least 48 percent over wide ranges of private income (see Table 4). This rate will be even higher where accommodation benefit is also phased out or where rents from the Housing Corporation of New Zealand increase with income. These high rates are likely to contribute to a climate of lack of enterprise and initiative in New Zealand. About 200,000 families will receive Family Support for the 1988/89 year. By contrast, as at March 1988, the universal family benefit was paid to 436,066 families.

TABLE 4

FAMILY SUPPORT : APRIL 1988 LEVELS

	1	2	3
Number of children	1	2	3
Maximum rate (\$ a week)*	36	52	68
Income limit for Maximum Assistance (\$ a week)	288	288	288
Assistance phases out at (\$ a week)	488	577	666
" " " (from 1/4/89)	508	566	619

* Family benefit is also payable

Because of the concern to ensure that persons in work have incomes similar to the unemployed, the assistance schemes for low income earners have been closely linked to unemployment benefit. If it were possible to reduce unemployment benefit rates, for example, then it might be possible to reduce the guaranteed minimum family income. A more rapid abatement of unemployment benefit would make it possible to reduce the level of income at which the family support scheme itself begins to reduce.

COST

Expenditure on the provision of unemployment benefits in New Zealand is shown for recent years in Table 5. This shows a dramatic increase since the mid-1970s as the numbers of unemployed have grown. The upward trend was interrupted briefly in 1984-85 as the reduction in real unit labour costs during the 1982-84 wage freeze led to a subsequent reduction in unemployment. The rise in unemployed following the sharp wage increases of the 1985/86 wage round is reflected in the figure for 1986, and there has subsequently been a further substantial increase in unemployment benefit expenditure. The numbers of unemployed are expected to continue rising through 1988 and 1989.

Expenditure on benefits in New Zealand is dominated by National Superannuation, which accounted for 67 percent of the total in the year to March 1986. Unemployment benefit expenditure was the third largest item (after domestic purposes benefit). It is expected to be the second largest item in 1988/89. This increasing fiscal burden underlines the importance of improving labour market performance to lower the unemployment rate, and to achieve any available economies in unemployment benefit policy.

TABLE 5

EXPENDITURE ON UNEMPLOYMENT BENEFIT IN NEW ZEALAND

Year Ended 31 March	Expenditure (\$m)
1960	.4
1965	.2
1970	1.5
1975	5.2
1976	8.5
1977	13.4
1980	66.1
1981	118.8
1982	156.4
1983	195.2
1984	315.8
1985	274.7
1986	290.5
1987	459.7
1988	672.7
1989(est.)	1009.1

SIMPLICITY

The Government goes to considerable lengths to ensure that its unemployment benefit and family support systems are convenient for the recipients, despite their seeming complexity. The Department of Social Welfare places a good deal of importance on publicity and information. It presents unemployment benefits as being "a helping hand and not a hand out". Family support entitlement is assessed by the Inland Revenue Department and may be reflected in reduced income tax deductions by employers. This payment mechanism is convenient for recipients (but less so for employers and the tax administration). Although this activity is admirable from many points of view, since it encourages low income people to claim the benefits to which they are entitled, it should be recognised that the result is likely to be higher levels of social welfare spending (and hence tax rates) than otherwise would be the case. Changed attitudes towards receipt of social welfare benefits have generally been a factor in the growth of social welfare spending over the past twenty years.

The administration expenses of the Department of Social Welfare for the unemployment benefit are about 2 percent of its total expenditure. It has been suggested that the level of abuse of benefit in New Zealand is low. The Australian experience shows, however, that there are returns to more vigorous administration. For example, regional review teams, located in areas where there are significant job vacancies and which focus on recipients' efforts to find work, "have proved very successful in helping alert people on benefit to job vacancies in their local area." New Zealand has also begun to take steps to improve administration, but much remains to be done.

4 POLICY APPROACHES

This section of the paper reviews possible reforms of the New Zealand benefit system to achieve a more precise balance between equity and efficiency objectives. The first stage involves the redesign of the minimum protection that is offered by the state to the unemployed and low income families. In the second stage, this is combined with a shift in the financing of unemployment benefit from general revenue to premiums that involve an element of experience rating. Finally, the scope for increasing private provision for unemployment is assessed.

THE STATE SCHEMES

(i) Young people

As noted earlier, unemployment benefits for young people, particularly 16 and 17 year olds, are high in relation to the incomes that they can expect from employment (and the benefits they would receive in similar circumstances in Australia where a number of measures were announced in May 1987 to make the system more stringent). It is suggested that the following strategies should be carefully examined:

- * Introduce a three rate benefit scheme for unemployed single persons without children by paying a lower rate of benefit for 16 and 17 year olds. This would reflect the low earnings that this group are likely to receive during their early years in employment when they are acquiring skills and labour force experience. It is not unreasonable to expect parents to provide some support for their unemployed children (as they would have to do were they to continue their education).
- * Pay unemployment benefits to persons aged 16 and 17 years subject to a parental, as well as a personal, income test. There is no reason why the taxpayer should finance the payment of benefit to the unemployed child of a millionaire. As in Australia, this measure could be presented as the "abolition" of the dole for those aged under 18.
- * An alternative approach would be to raise the minimum age for eligibility of unemployment benefit to 18. Family support and family benefit would then be payable in respect of unemployed persons under 18 years (as it would be were they to continue their education). There may be a need for additional support through special benefit in cases of particular hardship (e.g. the homeless).

- * Introduce longer waiting periods for benefit for those leaving secondary and tertiary education. (In Australia these may now be as long as thirteen weeks.) Family support and family benefit would be available during the waiting period. The intention of this proposal is to lessen any effect that the availability of unemployment benefit may have on decisions to enter the labour force rather than to continue in education. It can be argued that the payment of unemployment benefit to persons who have never worked is inappropriate.

The first two of the options listed above have been taken up as part of the Government's youth support scheme.

(ii) All unemployment beneficiaries

It was suggested earlier that the New Zealand system pays unemployment benefits that are high in relation to earnings both by past New Zealand standards and by overseas standards. Moreover, there appears to be scope for making the New Zealand benefit system more closely targeted. This section presents a number of options for addressing these problems.

- * Allow benefits to fall in relation to earnings.

The Government's programme of economic reforms is aimed at enabling the resumption of growth in all incomes, including wages, over the next few years. If successful, a continuation of the present policy of increasing benefit rates in line with consumer prices will result in a reduction of the ratio of benefits to earnings. If faster adjustment is required, consideration could be given to freezing certain rates for some time. As noted, there is a case for an actual reduction in the benefits paid to young people.

It has to be accepted that the reduction in benefits in relation to earnings will result in an increase in the number of persons experiencing financial hardship and provision would need to be made for meeting their needs. One possibility would be to make increased use of special benefit, which is presently available for those whose incomes are insufficient to meet their essential commitments.

A cap could be placed on unemployment benefits to ensure that they do not exceed (say) 70 percent of previous earnings. This would move the New Zealand unemployment benefit system to a basis closer to that of Canada, Germany and the United States. To

obtain substantial savings, however, the cap would have to be placed at a level of 60 percent of previous earnings or less.

- * Tighten income tests.

At present unemployment benefits do not start to abate until private income exceeds \$50 a week (\$60 a week for couples with children). An abatement rate of 30 percent applies above these limits but below \$80 a week; above \$80 a rate of 70 percent applies. By combining part-time work with benefit it is quite possible for a person to receive more than the guaranteed minimum family income for those in full-time work. But it is far from clear that this income test results in useful amounts of part-time work by beneficiaries since few unemployed individuals declare significant earnings.

One way of reducing the seriousness of these problems would be to abate benefits more rapidly. For example, the cut-out point for benefits for couples with children could be reduced from its present level of \$377 a week to \$326 by lowering the free area to \$20 a week and by abating benefits thereafter by 70 percent of private income. A similar change could be made for single beneficiaries. Such a change would not result in major savings in its own right but would reduce pressures to make the system of income support for those in full-time employment more generous.

Consideration could also be given to introducing an assets test along Australian lines.

- * Review the administration of unemployment benefits, including the operation of the work test.

It has often been remarked that social programmes, as they are actually put into place, may differ considerably from the intentions of their designers. This suggests that considerable attention needs to be paid to the administration of programmes and, in particular, to the design of systems to ensure that those responsible for delivery face an incentive structure that encourages them to achieve programme objectives. In times when unemployment is increasing rapidly there is an understandable temptation to emphasise the paying of benefits to applicants and to place less importance on reviewing the continuing eligibility of recipients for benefits. Australian experience suggests, however, that the introduction of a more stringent system of reviews can have a significant effect on overall numbers. Beyond this, attention needs to be paid to the 'quality control' aspects of the benefit system. For example, regional managers of the

Department of Social Welfare could (with appropriate performance incentives, if necessary) be made responsible for the results achieved by their offices.

(iii) Assistance to low income persons in full-time employment

A major problem in New Zealand is the wide range of incomes over which assistance to low income families is withdrawn. The measures relating to unemployment benefit outlined above would reduce pressure to make the income support system for those in employment still more generous. In addition, consideration should be given to increasing the rate at which this assistance is withdrawn. If, for example, the abatement rate on family support was increased from 18 percent to 50 percent, the abatement range would be reduced from the present \$288 a week to \$488 a week (1 child) to the much shorter \$288 to \$360. Effective tax rates would be raised to 80 percent over the abatement range which would be shorter (and would affect fewer individuals) than at present. For the reasons outlined earlier (see footnote 7), such a change is likely to have favourable incentive effects particularly in the context of overall reductions in marginal tax rates. If the amount of assistance given to low income families could be frozen in value or reduced, this would lead to further gains in economic efficiency. Assistance to persons in employment should be paid subject to a test of assets as well as income.

At present accommodation benefit is withdrawn over the same range of income as family support. Under the new scheme which is now being phased in, the benefit is abated at a rate of 25 percent for income in excess of \$273 a week. For families paying accommodation costs of \$100 a week, the upper limit for receipt of benefit is \$403 a week. The payment of accommodation benefit to working families is a relatively recent development and it is suggested that it and the subsidies inherent in the system of providing low income housing through the Housing Corporation of New Zealand should be critically reviewed. The provision of in-kind transfers of this type is, for a number of reasons, widely considered to be a poor form of social intervention. Because assistance is tenure-specific, those who are fortunate enough to obtain Housing Corporation accommodation may receive subsidies (in the form of rents below market levels) far in excess of those available to similar low income people who rent in the private market. Moreover, the subsidies provided through the Housing Corporation are not well targeted in that they are not withdrawn entirely as income increases.

FINANCING THE STATE SYSTEM THROUGH PREMIUMS

A more ambitious step would be to replace the present system of financing benefits from general revenue by contributions levied explicitly on employers and employees. This would permit the introduction of experience rating, as presently occurs in the United States.

A system of premiums combined with experience rating would offer a number of advantages. When making hiring and redundancy decisions, employers would have to consider the effect of redundancies on the premiums that they would have to pay in future, while employees would have to consider the effect of redundancy (or a longer spell of unemployment) on future premiums. To the extent that experience rating can be implemented on an actuarially fair basis, individuals (such as seasonal workers) and industries (such as construction) with a pattern of intermittent employment would no longer be subsidised. This would both be fairer and would encourage a better allocation of resources. Topel (1984) argues that the United States system of experience rating is incomplete and that an important reduction in unemployment may be achieved by adjusting methods of financing unemployment insurance without changing the level of benefits available to workers. Moreover since, under experience rating, the temporary lay-off of workers (e.g. for seasonal reasons) would no longer be subsidised through the social security system, employees might experience an improvement in job security.

It would no longer be appropriate to limit the payment of benefits by income or assets tests if, rather than receiving tax financed benefits, individuals purchased unemployment insurance from the government. Coverage would therefore be extended to groups (such as most two income families) who are presently excluded from benefit. Through premiums, individuals would be purchasing unemployment insurance on an actuarially fair basis, although government subsidies might - for distributional reasons - continue to be directed towards the long-term unemployed.

The premiums that would be charged under experience rating would depend on the level of benefit offered and the risks (for each group) of becoming and remaining unemployed. These premiums would not enter into effective marginal tax rates unless the benefits offered varied with income. Replacement of taxes with premiums would therefore reduce marginal tax rates overall. Experience rating would discourage the employment of workers who are likely to become unemployed but would reduce the costs of employing persons with stable employment records. But, since some groups with relatively high incomes tend also to have unstable employment patterns, it is not certain whether the introduction of experience rating would adversely affect average rate progression in the tax and benefit system combined.

Having said this, there are likely to be some low income persons with poor unemployment records who would be disadvantaged by the introduction of experience rating. (The earlier discussion suggested that the unemployed are drawn disproportionately from the lower paid.) Concern about the situation of these groups suggests that it is unlikely, in practice, that unemployment compensation would be based fully on insurance principles. For example, as in the United States, there might be maximum unemployment insurance premia. The insurance based component of unemployment insurance might be supplemented by a social assistance scheme, similar to the present one, for the long term unemployed. These alternative proposals would sacrifice some of the efficiency gains available from experience rating to achieve a distributionally more satisfactory outcome. But, even so, the efficiency gains from introducing experience rating could still be considerable.

SELF-PROVISION FOR UNEMPLOYMENT

It was suggested earlier that the role of the state was to provide a minimum level of protection in unemployment. Anything more than that should be the responsibility of individuals themselves.

There are a number of ways in which individuals can and do provide for the possibility of their unemployment. The term 'social insurance' which is used to refer to the benefit systems of some overseas countries suggests that it is natural to look to unemployment insurance as being an alternative to the state scheme. But, because of the information advantages that they enjoy, it may be that unemployment insurance is more efficiently provided by employers than by insurance companies.

Employers may better be able to address the problems of adverse selection and moral hazard that were discussed in Section 2. Employees may rationally choose to take some part of their remuneration in the form of redundancy packages, to be paid for by accepting wages that are lower than would otherwise be the case. Private savings can also be used to provide income in unemployment.

The essential point is that, while moral hazard and adverse selection problems exist, markets may be able to develop strategies to address them. (This is further illustrated by the provision in the past of unemployment insurance by trade unions and friendly societies.) Thus the existence of adverse selection and moral hazard problems does not in itself constitute a case for government intervention over and above ensuring the provision of a minimum income in unemployment. It is necessary to investigate further the mix of public and private provision that will best promote society's efficiency and equity objectives.

A major question is how private provision for unemployment relates to the minimum required by the government. In general, two models are possible:

- * The supplement model, in which individuals who are not satisfied with the level of benefit provided by the government are able to purchase additions in the market. Alternatively they could supplement a compulsory level of self-provision mandated by the government.
- * The opting-out model, in which individuals with unemployment protection that meets standards set by the state are not required to pay premiums or specific social security taxes. (However, these individuals may be permitted to re-enter the government scheme if their benefits from private sources become exhausted, or there may be a residual tax – financed scheme for the long term unemployed.)

In a sense a version of the first model is already available in New Zealand. Individuals who are concerned about the risk of unemployment can and do save against this possibility. The re-examination of the minimum protection offered by the state that was suggested earlier in this section would increase the scope for self-provision. Beyond this, self-provision can best be encouraged through a general climate of monetary stability and low marginal tax rates. So long as these payments are appropriately taxed, there is no reason to limit the amounts that superannuation funds and employers pay in the event of redundancy.¹⁷

Some writers have argued that insurance against unemployment is better provided through the insurance industry than by employers. This point is a debateable one, but ultimately it is a question that would be best decided through individual choices in markets and a trial and error process. The interesting suggestion has been made that it may be less costly for the insurance industry to provide income replacement insurance (in which the risk of income loss through unemployment is aggregated with that arising from sickness, accident, etc) than unemployment insurance as such. In New Zealand the provision of income replacement insurance of this type is made difficult by the availability of relatively generous income tested social welfare benefits and by the existence of a state accident compensation scheme which pays benefits that are related to earnings. There is a

¹⁷ It might be argued that superannuation should be used only to finance retirement incomes. But individuals may well experience greater hardship during periods of unemployment than after retirement and it seems perverse to deny them access to their savings. Moreover, the trend in New Zealand and Australia is to reduce the tax advantages of saving through superannuation funds. Governments therefore have less need to be concerned about the uses to which individuals put these funds than used to be the case.

good case for reviewing this scheme, and also government regulation of the insurance industry which may prevent it from offering a diversified and innovative range of products.

The opting-out model offers the prospect of additional gains through competition in the supply of the minimum unemployment benefit that is required by the state. Because, for distributional reasons, the government is likely to provide a minimum income in unemployment, the danger of 'free riding' is a real one. In the absence of restrictions individuals may choose to pay premiums neither to the government scheme nor to private insurers, secure in the knowledge that income support from the government would be forthcoming should they need it. To avoid these dangers the state itself would have to decide the circumstances in which people could opt out of its unemployment insurance scheme. In doing so, bureaucrats may adopt an unnecessarily cautious and restrictive attitude. More serious, perhaps, is the danger of political interference in the premiums charged by insurance companies and in the redundancy provisions offered by superannuation funds and employers. It is a matter for further consideration whether, in practice, the opting-out model would be an advance over the simpler supplements model.

The feasibility of the opting-out approach, and its strengths and weaknesses, are illustrated by the health insurance arrangements that applied in Australia during the first years of the Fraser government. (As with unemployment insurance, moral hazard and adverse selection policies have to be addressed in the provision of health insurance.) Under the Fraser scheme individuals who belonged to approved health funds were not required to pay the identified Medibank levy. This scheme was, without doubt, a successful alternative to a government monopoly in health care financing. But the development of innovative approaches to health insurance was impeded by the restriction of approval to traditional health funds of the community-rated type.

Since health funds were already offering health insurance before the opting-out system was introduced in 1976, it could be argued that this example differs importantly from the example of unemployment insurance in New Zealand. Although it is likely that industry would develop innovative approaches to unemployment insurance were opting-out permitted, this could certainly take some time. But while competition may, for a time, be relatively limited it is unlikely to cause harm. There is, therefore, no reason to prohibit opting-out.

5. RELATED PROGRAMMES

There is a natural reluctance to pay benefits to the unemployed - persons who are capable of working and who are, in fact, looking for work - and to receive nothing in return. This has led to suggestions that unemployed people should be required to "work for the dole", that subsidised employment in the private or public sectors should be available for the long term unemployed, or that continued receipt of unemployment benefit (particularly by the young) should be conditional on participation in training courses. (Workfare schemes are best thought of as schemes in which continued receipt of unemployment benefits depends on participation in subsidised employment.)

There is nothing wrong with the idea that people should be expected to do some work in return for receiving unemployment benefit. The problem arises in finding the work. In the nature of things the tasks in the community that are most worth doing are already being undertaken through private employment, mainstream government programmes or voluntary effort. There is thus a very real danger that subsidised employees will largely displace from employment those who were previously undertaking those jobs.¹⁸ Public sector job creation schemes may also be seen as providing unnecessary jobs. Employment subsidy schemes have been a typical response to rising unemployment. But, as their unsatisfactory nature has become apparent, their introduction has been followed by their abolition. This cycle has been followed a number of times since the early 1970s and in New Zealand the Government has sensibly moved to phase out the majority of these schemes.

Training schemes may be a more promising approach. No one can doubt that the young (and older) unemployed should be able to acquire the skills that will enable them to compete in the labour market. In the United States, training programmes were a cornerstone of the war on poverty. There was, in the 1970s, considerable pessimism about the performance of education and training programmes in alleviating poverty. More recent assessments suggest, however, that training programmes can be effective provided that they are carefully directed to those most likely to benefit. Training programmes may be particularly advantageous where they eliminate disadvantages that previously prevented a person from attracting an employer. Such programmes

¹⁸ In his recent book *Would Workfare Work?* John Burton argues that, in the United Kingdom context, "the main avenue for workforce job creation should be within the explicit public sector including local authorities, public agencies, nationalised industries, education, health care and the Departments of State (as well as housing and Restart programmes operated by the MSC)." The adverse consequences for the efficiency of the public sector of taking unnecessary labour need to be recognised. This is particularly the case for state-owned enterprises which should be run on commercial lines.

A major argument of this paper is that a degree of frictional unemployment is characteristic of a growing economy and that a punitive approach to the unemployed is not warranted. If the various suggestions advanced in this paper (e.g. for experience rating) were implemented, individuals would be "paying for" their benefits to a much greater extent than at present. Government subsidies will be directed to those most in need of them. In these circumstances public disquiet about the operation of unemployment benefit should be much reduced.

may be of particular benefit to the long term unemployed who may be unskilled or left by structural change with inappropriate skills. Bassi and Ashenfelter (1986) conclude that the United States "employment and training programmes have neither been an overwhelming success nor a complete failure in terms of their ability to increase the long-term earnings of disadvantaged workers and that women and the economically disadvantaged have benefited most from these programmes". But there are a number of considerations that suggest that the role training schemes can play in coping with unemployment is likely to be a secondary one.

To the extent that training schemes are providing a remedial education for those who do not have a sufficient grasp of the content of the school curriculum, the best solution is to remedy whatever defects may exist in secondary schooling. The need to provide government subsidies to training is also a symptom of a poorly functioning labour market. In a more flexible labour market employers and employees would more readily be able to agree on wages and other conditions of employment that would make the provision of training mutually profitable. From this perspective training does not create jobs; jobs create training. Finally, participation in government sponsored training should be subject to the same criteria as other investment activities. Those who take part in such activities (assuming a constraint as to total supply) should be those for whom the benefits exceed the cost by the greatest margin. It is not clear that these are always the unemployed nor that a specific share of places should be reserved for them. (Such rationing problems could, however, be overcome by the use of forms of charging to regulate supply and demand, and this may well be an appropriate approach at the post-compulsory level.)

Thus while training courses may have a place in dealing with unemployment, they should not be allowed to divert attention from the more fundamental problems that require attention. In the New Zealand context, the single most important problem is the system of labour relations and the constraints that it imposes on individual contracting, collective representation and the options for wage bargaining.

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