

EMBARGOED UNTIL 11.00 A.M. MONDAY 3 MARCH 1997

**Institute For International Research
11th Annual Industrial Relations Conference**

**Obstacles To Employment And Productivity
Growth In
New Zealand's Labour Market**

**Roger Kerr
EXECUTIVE DIRECTOR
NEW ZEALAND BUSINESS ROUNDTABLE**

**Auckland
3 MARCH 1997**

OBSTACLES TO EMPLOYMENT AND PRODUCTIVITY GROWTH IN NEW ZEALAND'S LABOUR MARKET

There seems to be a natural life cycle to most soundly-based economic reforms:

- first a period of denial of the need for change and fierce opposition to reform proposals;
- secondly, the build-up of a political consensus that the old ways were not working and the implementation of a policy change;
- thirdly, a growing public acceptance of the reform as the benefits show up, to the point where it loses its controversial edge and fades from the political agenda.

This cycle has run its course with the abolition of import licensing, financial market deregulation, GST, liberalisation of shop trading hours, port reform, the Reserve Bank Act, corporatisation and the great majority of New Zealand's other recent economic reforms.

We seem to be in the third of these phases with the Employment Contracts Act 1991 (ECA). Two general elections after its implementation, one of them under new electoral rules, the ECA seems to be securely in place. Five years ago opponents of the ECA outnumbered supporters by nearly two to one; in recent polls more people have approved of it than disapproved. At the last general election, 60 percent of the electorate voted for parties which supported the ECA. This was reflected in the coalition agreement to retain the legislation, and indeed to address some of its weaknesses. In its negotiations with NZ First, Labour backed off its policy of repealing the ECA, and it will no longer be credible for Labour to revert to that stance. Moreover, unlike the situation under first-past-the-post, there seems little prospect under MMP of any coalition of parties committed to repeal of the ECA being able to form a government.

Developments and debate internationally have confirmed the correctness of New Zealand's decision to opt for a flexible, decentralised labour market. The

Howard government in Australia has abandoned the centralised Accord and it seems unlikely to be revived. Britain, the only OECD country besides New Zealand to implement major labour market reform in recent years, now has an unemployment rate of 6.5 percent whereas unemployment in much of continental Europe is around twice that level. The flexible US labour market has created a net 8 million jobs since 1991 whereas the European Union has lost 5 million. And the fast-growing Asian economies with the freest labour markets of all are continuing to maintain high growth and low unemployment.

We can now survey the record of nearly six years' experience since the ECA was enacted in May 1991 and compare it with the predictions of collapsing wages, anarchy and exploitation made by some at the time. Since the recession ended in mid-1991:

- output has grown by nearly 20 percent, and the economy is into its sixth successive year of economic growth;
- employment has grown by over 220,000 jobs (at an average annual growth rate of 4.5 percent in the last three years), and there have been more jobs created than there were unemployed in 1991;
- the number of people working full-time has increased by 159,000, some 72 percent of the new jobs;
- the unemployment rate has fallen from its peak of 10.9 percent (seasonally adjusted) in the September quarter of 1991 to 5.9 percent in the December quarter of 1996;
- long-term unemployment has fallen faster than the overall unemployment rate, and has dropped by over 40 percent in the last two years;
- the rate of employment growth has been higher for Maori and Pacific Islands people than for Europeans, and unemployment has declined for all ethnic groups and across the country.

Of course, not all of these improvements can be attributed to the ECA. Separating out the effects of the ECA from other influences is a difficult, if not impossible, task. The best attempt has been made by Tim Maloney of the

University of Auckland. His latest work suggests that around 16 percent of the growth in employment - itself a large number - may be directly due to the ECA and an indeterminate amount (at the limit 100 percent) may be due to its direct and indirect effects combined. However, Maloney's results are driven largely by the postulated employment creation effects of the fall in unionisation in different industries. While this effect is plausible (since we have long known that unions and collective bargaining in regulated labour markets are bad for employment), it captures only part of the job creation story.

In my view, the problem of estimating the employment effects of the ECA in a precise way with any analytical model is virtually intractable. One can get a better feel for them by looking at the comparative experiences of New Zealand and Australia in recent years. While economic growth in New Zealand and Australia has been similar since mid-1991, employment growth was 15.1 percent in New Zealand compared with around 8 percent in Australia. Unemployment has fallen in New Zealand to 5.9 percent of the labour force, but it has fallen from a similar peak in Australia to only around 8.5 percent. Moreover, virtually all Australian observers expect unemployment in Australia to remain stuck at about that level over the next few years because the Howard government has done too little to create a genuinely free labour market, whereas in New Zealand unemployment should continue falling.

Thus there is little doubt that the ECA has been a phenomenal job creation machine, whereas the previous regime was a machine for job destruction. Under the Labour government's unbalanced economic framework, employment actually fell (by 17,000 jobs) in New Zealand between 1984 and 1990. The ECA has also brought about enormous changes in enterprise culture, in particular far greater trust and cooperation in workplaces, less disputation and more job security. However, some critics have still not given up: the patently silly claims about the 'Richardson recession' and then 'jobless growth' have given way to debates about productivity and income trends. I am confident that events will show that the critics' views on these issues are equally mistaken.

On productivity, the argument is that productivity growth has been poor since 1991. A forthcoming Business Roundtable study by Geoff Hogbin will explore this claim in detail. No one should expect growth in average labour productivity to be sensational at a time when the economy has been absorbing thousands of unemployed workers, many of them with low skills. This point

notwithstanding, microeconomic data, such as firm-based surveys, point to significant productivity gains: the New Zealand Institute of Economic Research found that 75 percent of firms considered the net impact of the ECA on productivity had been positive. Moreover, the best general study to date, by Professor Viv Hall of Victoria University, shows no story of a slowdown even in average labour productivity. Far from being 'poor', labour productivity growth has held up at an average of 2.0 percent a year. More importantly, the post-ECA economic expansion shows much greater capital productivity growth (2.7 percent versus 0.0 percent) and considerably higher total factor productivity growth (2.3 percent versus 1.3 percent) compared to the previous expansion phases. With the labour market tightening, future growth in output will depend increasingly on productivity growth driven by investment in physical and human capital, continuing structural and technological change, and a sound structure of incentives in all markets.

In respect of income trends, the Treasury pointed out in its post-election briefing that some degree of wage disparity between high- and low-skilled jobs is needed to generate the dynamic processes required to make human capital a more significant driver of productivity growth, and over time to reduce poverty and income disparities. The post-ECA period has seen greater rewards for skill, and the number of industry trainees is at an all-time high. The ECA has also brought about a radically changed relationship between labour market insiders and outsiders, with the unemployed having greater opportunities to compete for jobs. The available data suggest that measures of poverty and inequality both increased with rising unemployment in the late 1980s and early 1990s, due to the Labour government's failure to tackle the problem of the rigid labour market. From 1992/93, the trends appear to have reversed, consistent with the view that economic and employment growth are the key drivers of reducing hardship.

Recent research also reported by the Treasury highlights the significant employment effects of the welfare system reforms of 1991. This research shows that the widening of the gap between income from employment and benefits increased labour force participation by two percentage points; increased total employment by 2.5 percentage points; reduced the unemployment rate (as defined in the Household Labour Force Survey) by 0.7 of a percentage point; and induced more young adults to participate in education and training.

Thus while some people were obviously worse off immediately after the benefit cuts, the longer-term results have clearly been positive for many. For most people the best way out of poverty is to get a job, even at a low entry level wage. Just over a quarter of people in the lowest 20 percent of the wage and salary distribution move to a higher income group within a year. Moreover, the data suggest that people on low wages and salaries tend to receive on average larger proportionate increases in remuneration than those higher up the earnings distribution.

Thus New Zealand's experience provides strong confirmation of the view that modern unemployment is largely attributable to regulations which impede the functioning of labour markets and poorly structured welfare systems. Europe, with both highly regulated labour markets and big welfare states, has endemic structural unemployment. The high-income Asian countries have maintained open and competitive labour markets and avoided large-scale state welfare, and have consequently enjoyed low unemployment, rapid economic growth and a relatively even distribution of income. Naturally, general economic growth also assists job creation, and is in turn fostered by sound labour market and welfare policies.

It has been a matter of great frustration that most New Zealand commentators have missed the importance of these policy reforms in alleviating New Zealand's unemployment problem. For 10 years the Business Roundtable has been arguing that unemployment in New Zealand is an economic and social scourge (there are still some lame brains who think employers benefit from 'a pool of unemployed'); that the levels reached in the 1980s were a disgrace; and that restoring full employment is a wholly feasible objective. For much of that time our arguments fell on deaf ears. Even Bill Birch, one of the architects of the ECA, could not see the unemployment rate falling below 7-8 percent. The Department of Labour has been consistently far too pessimistic with its unemployment forecasts, and the latest drop in the unemployment rate to 5.9 percent again came as a surprise to most commentators. Lately we have been arguing that full employment - which probably means a measured unemployment rate of perhaps 1-2 percent, because people are always joining or leaving the labour force or changing jobs - should be achievable by the year 2000. I suspect most people still do not take that proposition seriously. Journalists seldom bother to report our efforts to promote such goals; they like to concentrate on issues that excite reaction. Yet, as the head of the Treasury in

Australia has put it, unemployment is not inevitable - it is largely a matter of choice.

New Zealand will continue to make further inroads into unemployment only if it maintains sound economic, labour market and welfare policies, and improves them where possible. It will not do so if it gets diverted into palliatives such as so-called job-creation or work-for-the-dole schemes. Most of the existing Department of Labour schemes do nothing to increase total employment and, given today's much more favourable labour market, they should be scrapped. This is not to knock the thinking behind work-for-the-dole proposals: people should be strongly encouraged to move from welfare into work, and those receiving assistance from other taxpayers have a reciprocal obligation to become self-supporting wherever possible, whether they are on the dole or other benefits. It is simply that such thinking should be refocused back towards more fundamental labour market and welfare policy issues.

This conference is about industrial relations, so I shall elaborate only on policy issues in this area. The most important of these is the problem of the Employment Court, or more precisely the tangle created by the combination of the decisions taken in 1991 to enact statutory personal grievance procedures and to retain a specialist labour court.

These provisions of the ECA were a great mistake, as many of us argued at the time. The court has come to be known as the Unemployment Court, because it has manifestly kept New Zealand's rate of unemployment higher than it would otherwise have been. I would estimate conservatively that unemployment would be below 5 percent by now were it not for these deficiencies in the ECA and the attitude of the courts to its administration.

A study by Charles Baird published by the Business Roundtable and the Employers Federation last year documented some of the consequences of the Court's rulings in the area of dismissals. It concluded that on the basis of US experience the results could include:

- a loss of between 19,000 and 47,000 jobs;
- a 7 percent reduction in real wages paid to workers; and

- an 18 percent decrease in the mean income received by households in the lowest income quintile.

Whatever the precise magnitudes, there is no question that unjustifiable dismissal laws are a tax on employment and that they mostly hurt workers and the unemployed - not owners of capital who, at least in the long run, can redirect it elsewhere, including overseas.

The economic and legal issues that arise in this area have been elaborated in many Business Roundtable studies, and I will not rehearse them here. The essence of the story is that mandatory rules on job termination are a departure from the freedom of contract philosophy that lies behind the ECA and detract from its objective of creating an efficient labour market. Once upon a time legislators and the courts had it right in this area. As an oft-quoted decision by an American Supreme Court put it:

Men must be left without interference to buy and sell where they please and to discharge or retain employees at will for good cause or for no cause, or even for bad cause, without thereby being guilty of an unlawful act *per se*. It is a right which an employee may exercise in the same way, to the same extent, for the same cause or want of cause, as the employer.

Since that time the right of workers to quit at will (subject to any terms of a contract) has not been put in question - even though some decisions to quit clearly inconvenience or harm employers. Prior to the 1970s the same rules applied to employers, and until the ECA was introduced they did not apply to the large proportion of the workforce who were on individual contracts and were not union members. The ECA was a massive step backward in this regard, and Employment Court rulings have made the problem worse. The extension of the law to employees in the executive category, for example, is probably the greatest protection system for incompetent managers ever devised. Inevitably, consumers end up paying the costs.

Behind these developments is the same ideology that was rightly set aside in reforming most other features of New Zealand's labour law, namely that helpless employees must be protected from omnipotent employers. We all deal satisfactorily with banks, retailers and other firms with far greater resources than we have, without the aid of laws on minimum deposit rates and maximum retail prices, and without resorting to unions of savers or

consumers. This alone suggests that there must be a strong measure of myth in the doctrine of unequal bargaining power. If bargaining power was a systematically one-sided problem - as opposed to something which fluctuates with market conditions and which affects employers and employees alike - we would expect to see wages driven down towards zero in countries without minimum wages, employees without the power to quit at will, and the prices of goods sold by big firms tending towards infinity.

Of course, none of this happens, because it is not the difference in resources between buyer and seller that matters, but the alternatives available to each. Employers and workers are not in competition with each other: employers are in competition with other employers for workers and employees are in competition with other employees for jobs. In all markets, including the labour market, the best protections for savers, consumers and workers are freedom of entry and exit on both sides of the market, and openness to competition. Hong Kong has no minimum wage or unfair dismissal laws. Because these freedoms have helped it to maintain virtually full employment despite massive structural change, its workers are not easily exploited and they now enjoy average incomes 50 percent higher than those of New Zealand workers.

This is not to say that employers and employees have no inclination to behave opportunistically. Rather, the circumstances in which opportunistic behaviour is profitable are relatively rare. One reason is that it is normally profitable to strive to achieve and maintain a reputation as a good employer. Another is that contractual arrangements have evolved through market processes to safeguard against opportunistic behaviour on the part of both parties to an employment contract.

The legal scholar Richard Epstein has repeatedly emphasised the folly of judicial intrusion into routine affairs such as employment contracts:

It is one thing to set aside the occasional transaction that reflects only the momentary aberrations of particular parties who are overwhelmed by major personal and social dislocations. It is quite another to announce that a rule to which vast numbers of individuals adhere is so fundamentally corrupt that it does not deserve the minimum respect of the law. With employment contracts we are not dealing with the widow who sold her inheritance for a song to a man with a thin moustache. Instead we are dealing with the routine stuff of ordinary life; people who are competent enough to marry, vote, and pray are not unable to protect themselves in their day-to-day business transactions.

Beyond the issues that arise in standard contract law - such as fraud, misrepresentation, and duress - employment contracts do not leave gaps or implied terms that courts need to fill. Employment contracts are made every day; the costs of contracting are low; and people can evaluate realistically the risks and costs of contingencies such as dismissal. If it is optimal for workers to have a job security or just dismissal provision they will negotiate one voluntarily because the barriers to doing so are trivial. If not, they will choose to avoid the costs to them of lower wages or other less favourable terms in their contract which are the inevitable trade-off for greater job security. In short, mandatory unjustifiable dismissal provisions diminish the value of the compensation bundle for most employees.

Thus the problem that activist legislators or courts seek to address is an imaginary one, and their decisions harm the very parties they hope to benefit as a class. Activist judges often find meddling in other people's affairs a rather pleasant burden, but this tendency lends itself to abuses of power. The law has no economic rationale for a good faith or fair dealing intervention in labour relations. Economic competition does not create a perfect world, but on both the demand and supply sides of the market it provides incentives for civil and cooperative behaviour. Firms do not sack workers willy nilly; such practices are virtually unheard of as they are bad business and the costs of changing staff can be high. New Zealand employers have every incentive to keep and reward quality employees - after all, there are over 200,000 firms that can bid them away at any moment. The at-will contract is often the best mechanism for establishing terms of employment which avoid vulnerabilities, opportunism, one-sidedness and monopoly by either party in an employment relationship. If, subject to the terms of a contract, an employee can quit at any time, the firm has every reason to be responsive to the employee's concerns. If, subject to the terms of a contract, an employee can be dismissed at any time and for any reason, that employee has every reason to be productive. Productivity creates job security.

There are signs in the coalition agreement negotiated by National and NZ First that some of these realities have finally been recognised. The document refers to "judicial activism", and hints at the possible termination of the separate jurisdiction of the Employment Court. The briefing provided to the coalition parties by officials during the negotiations highlighted the problems of legalistic 'good faith' and 'fair' bargaining doctrines.

In its briefing to the incoming government, the Department of Labour raised the question of whether the problems experienced with decisions by the Employment Court and Court of Appeal were best addressed by legislative amendment or changes to institutional structures. The answer is that both are needed.

The National government drew back from abolishing the separate jurisdiction at the time the ECA was passed because some of its members regarded that move as a bridge too far at that stage. They took the view that after it became clear through experience that employment contracts were no different from other contracts, the task could more easily be handed over to the general courts. That step should now be taken. In addition, now that the government has sensibly dropped the idea of abolishing appeals to the Privy Council, access to that court for employment cases should also be reinstated on the grounds that this area of the law should be treated no differently from other commercial contracts.

If the courts could be trusted to administer employment contracts on the same basis as other contracts, there would probably be no need for an employment statute at all. Until that point is reached, parliament needs to make its intentions clear, and the most important change needed to the ECA is to put beyond doubt the ability to freely negotiate at-will contracts, including contracts requiring a simple period of notice before termination. At most, parties should have as a default option the right by negotiation to adopt statutory dismissal provisions or, less desirably, to opt out of them. Various other provisions of the ECA should also be simplified or discarded. As a minor example, no purpose other than bureaucratic and academic employment is now served by putting firms to the cost of reporting the details of thousands of employment contracts to the Department of Labour, and this requirement should be dropped.

Obstacles to job creation in other employment legislation should also be addressed if New Zealand wants to take seriously the objective of restoring full employment. An example is the current statutory minimum wage, which is a prime illustration of confused thinking on how to help people at the bottom end of the labour market.

The coalition parties have decided to increase the adult minimum wage to \$7 an hour and may increase it to \$7.50 next year. This new obstacle to the rights of low-skilled people to sell their own labour is an extraordinary decision. At \$7.50, the minimum wage would be above the level of the minimum wage in the United States, yet average incomes in New Zealand are only around two thirds of US levels. There is little argument among economists in the United States that its minimum wage laws typically cost jobs: the only debate is over the numbers lost.

Clearly the relative impact of the coalition government's decision will be far greater. It went against the advice of all its departmental advisers in making this decision - even the Department of Labour has now come round to warning of the negative effects of minimum wage laws. These fall most heavily on the young, the unskilled and less productive workers - the very people who should face the fewest obstacles to getting a foothold on the bottom rung of the earnings ladder. Labour and the Alliance are even more strongly attached to a policy which panders to populist instincts and the interests of their supporters in the union movement, but which offends any rational concept of equity.

Other employment legislation hinders job creation. The government plans to review the Holidays Act, where basically the principle of voluntary choice and freedom to contract should be allowed to prevail. The Human Rights Act discourages employment by raising the costs of hiring through restrictions on advertising and recruitment. Privacy and occupational health and safety laws have also increased employment costs and risks for firms. The gross inefficiencies of ACC, which accounts for the largest element in non-wage labour costs, are another major employment tax which affects jobs and wages. It is distressing that the Labour party still keeps coming up with ideas like maternity leave legislation which would increase non-wage labour costs and hurt the employment prospects of the very people its members tell us they care about, in this case women in the child-rearing age group. There is an equally long agenda in the welfare area which would include such things as time limits or two-tiered levels for unemployment and other benefits, and greater obligations on beneficiaries to seek and accept work.

However, there is a lot more that could be done to improve the operation of New Zealand's labour market, our employment prospects and economic growth. There is clear evidence that labour markets work if they are not constrained from doing so. Because unemployment is largely a matter of

policy choice, those who resist the removal of these constraints either do not understand how labour markets work or they must argue that unemployment should be accepted because the costs of eliminating it are too high. That is a hard argument to make.

In a recent lecture on why some nations are rich and some poor, the distinguished economist and public choice theorist Mancur Olsen said: "The best thing a society can do to increase its prosperity is to wise up." He was making the point that economic performance is mostly determined not by a country's natural endowments, the availability of technology or capital accumulation, but by the institutional arrangements it adopts and the structure of incentives they generate. Olsen added that those who prevail in the fight against special interests and quacks make an extraordinary contribution to the amelioration of poverty and the progress of humanity. When it comes to labour markets, and the entirely feasible goal of becoming a high employment, high productivity and high income economy, will New Zealand have the wit to "wise up"?