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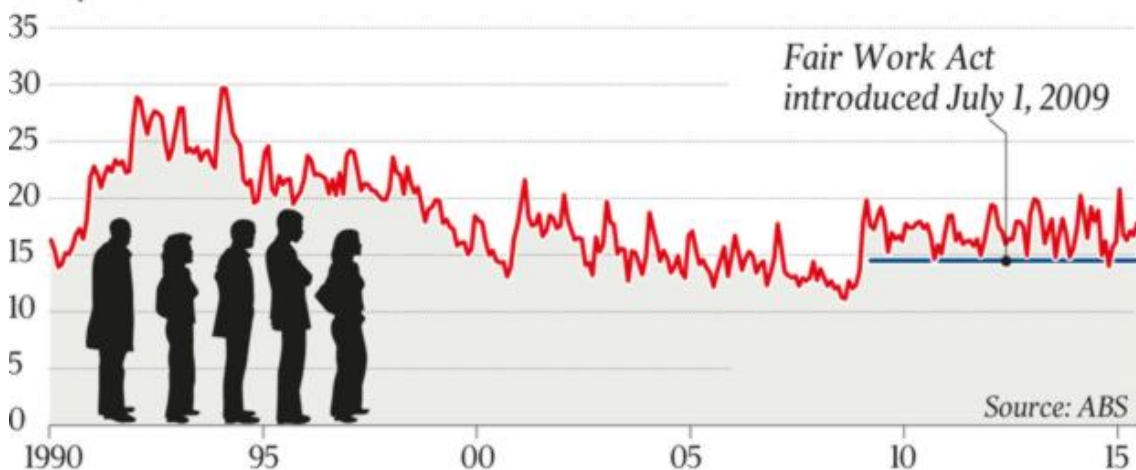
IR report: Productivity Commission falls short of the mark

HENRY ERGAS THE AUSTRALIAN AUGUST 09, 2015 1:02PM

**FAIR WORK FLOOR**

*Youth unemployment rate (15-19 years) – not attending full-time education, 1990-2015*

% of youth labour force



Source: TheAustralian

**The sole objective of the industrial relations system should be to facilitate the process by which employees and employers reach mutually advantageous agreements about the terms and conditions of employment.**

Whether our IR system achieves that objective while minimising compliance costs, avoiding unnecessary constraints on employees and employers, and promoting the integrity and accountability of collective organisations, should therefore have been the focus of the

Productivity Commission's workplace relations inquiry.

But that is not what the commission's 1000-page interim report does. Instead, starting from dubious premises, it reaches conclusions that are often inconsistent with the evidence it presents.

The commission's logic is simple. It opens with the claim that there is a serious imbalance between the bargaining power of employees on the one hand and employers on the other.

Left unaddressed, it says, that imbalance would result in an "inefficiently and inequitably low share of income for labour".

That makes an intrusive IR system necessary; and since it believes the Fair Work Act has performed tolerably well, it concludes only marginal changes are needed.

Unfortunately, each step in the commission's reasoning is incorrect.

To begin with, nowhere is the claimed inequality in bargaining power substantiated. Rather, a vast economic literature shows inequalities of bargaining power mainly arise when employees have little or no choice of employer, or to put it in economic terms, where the employer is a "monopsonist" or "oligopsonist" (that is, a sole or close to sole buyer) in the labour market.

But with the overwhelming majority of Australians living in large metropolitan areas — where labour mobility is high, any single employer accounts for a small share of jobs, and most employees' skills are reasonably transferable between employers — those situations are few and far between, at least in the private sector.

To say that is not to dispute the commission's argument that so long as employees face some cost, no matter how trivial, in changing jobs, even a market with many small employers would depart from the textbook ideal.

Yes, it would, just as would every market in the real world. But the report's technical analysis notes there is no evidence any such distortions are material; and in practice, trivial frictions are likely to cause trivial harms.

It is therefore irresponsible to claim, as the commission does, that those purely theoretical failings could justify the Fair Work Act's heavy-handed regulatory regime.

And the commission then compounds its error by failing to consider whether the Fair Work Act has actually made things better. Indeed, the report does the opposite: while citing the economic literature, it completely ignores the empirical test it sets out.

That test is precise and straightforward: if the Fair Work Act is correcting the purported market failure, employment must be higher than it would otherwise have been.

After all, just as monopolists restrict output to raise prices, so monopsonists restrict employment to lower wages; if an IR system addresses that distortion, employment has to rise.

But the report scrupulously avoids claiming that interventions such as penalty rates actually create jobs: and understandably so, as that claim would be laughable.

Nor does the report examine whether the Fair Work Act has actually increased labour's share of national income, as it claims it should; and that too is unsurprising as the Castalia study, which the Minerals Council of is releasing today, shows that in a world where capital is globally mobile, it neither has nor could. Instead, the commission's case in favour of the Fair Work Act consists of an observation and a contention.

The observation is that "economy-wide wage breakouts and associated stagnation — the horror of the 1970s — seem as dated as floppy disks". That is surely true; but attributing the change to the Fair Work Act is absurd.

Rather, the inflation of the 70s was a monetary phenomenon, which arose from the failure to adjust the exchange rate when the terms of trade boomed — with consequences compounded by the Whitlam government's recklessness, including its support for massive wage increases. And equally, the absence of any comparable "horror" in recent years is largely due to more sensible monetary policy settings. Startlingly, the report does not mention those broader factors, much less take them into account.

As for the contention, it is that "there is little robust evidence" of "detectable (adverse) effects" from the Fair Work Act.

Well, the PC should read its own reports, with last year's motor vehicle inquiry, to cite but one example, lambasting both the Fair Work Act's "restrictive workplace arrangements" and "the uncertainty about the processes for changing those arrangements" that helped destroy the industry's viability.

It should also consider the Castalia study, which shows how the monopoly privileges the Fair Work Act grants unions have distorted their behaviour, undermining their incentive to serve their members while encouraging backdoor deals that tax workers who have no say in how those unions are run. And it should look closely at the rise in youth unemployment that accompanied the Fair Work Act's entry into force and that has persisted despite sustained economic growth.

Yet the draft report does none of those things. But this is hardly the first time the PC's initial approach falls short.

And the crucial issue is not whether the commission always gets it right, but whether, having made mistakes, it has the intellectual honesty to tackle them.

That honesty was once the commission's hallmark. In fact, on one occasion a draft report issued by its predecessor, the Industries Assistance Commission, was so wide of the mark that it felt it had to issue another draft report before it could properly contemplate a final. Its willingness to do so merely strengthened its reputation, which is the most glittering asset today's commission has inherited. The challenge it now faces is to show the integrity and commitment to keep that asset intact.