# STATEMENT 4: AUSTRALIA'S LABOUR FORCE UTILISATION

This statement examines Australia's labour force utilisation in international and historical context, and the role of recent Government policy in influencing labour market decisions. The statement also examines characteristics of casual employment and the relationship between flexible labour markets and employment security. Finally, a forward look is taken at the likely long-term trend in labour utilisation.

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# STATEMENT 4: AUSTRALIA'S LABOUR FORCE UTILISATION

This statement examines the progress that Australia has made on labour force utilisation, and considers the impact of the future demographic challenge. Labour force utilisation is one of two key policy priorities identified in the *Intergenerational Report 2007*, released in April 2007, for addressing the inevitable slowing of economic growth arising from demographic change. The other key priority is productivity growth.

The ongoing rise in employment is one of Australia's important economic and social success stories. The participation rate reached an all-time high in September 2006, at just over 65 per cent. Coupled with this, unemployment is currently at a 30-year low.

This statement begins with a profile of Australia's path of economic growth, contrasting this with other OECD countries in order to provide international context for Australia's position on the spectrum of labour market arrangements and outcomes.

The statement then turns to Australian labour market performance in an historical context. The growth in employment, decline in unemployment and the change in the composition of the labour force over the past decade and a half are remarkable. These have been important contributors to Australia's impressive record of economic growth. The labour market outcomes have been brought about through a mixture of policy and non-policy factors: broad policies associated with macroeconomic stabilisation and creating the conditions for sustained growth; specific policies designed to provide incentives for greater participation in the labour force; and changing demographics, boosting the availability of people in working-age cohorts.

The statement then examines the growth of casual labour and scrutinises the perceived trade-off between flexible labour markets and job security. Finally, policy priorities for maintaining full employment in the face of global change are considered. While there remains further scope to improve labour market outcomes, progress becomes more difficult as Australia approaches global best practice. Moreover, at the limit, labour utilisation is bounded by the number of hours people want to work. As the Intergenerational Report projects, the proportion of the population made up of the working-age cohort is likely to dwindle primarily because of the retirement of the baby boomers.

The challenge for policy is to obtain the best labour force outcomes as the age structure of the population changes, while at the same time improving the productivity performance.

# LABOUR FORCE UTILISATION IN INTERNATIONAL AND HISTORICAL CONTEXT

In this section, Australia's labour market performance is discussed in international and historical context. Trends in labour utilisation are examined by considering developments in participation rates, demographics, unemployment, hours worked and labour mobility.

# Labour utilisation and productivity in international context

GDP per capita is a standard measure of the performance of an economy over time and across countries. GDP per capita can be expressed as hours worked per capita multiplied by GDP per hour worked. The former is a measure of labour utilisation and the latter is the standard measure of labour productivity.



#### Chart 1: Path of economic growth — Australia

Source: Groningen Growth and Development Centre, Total Economy Database, January 2007.

The horizontal axis in Chart 1 shows labour utilisation measured as weekly hours worked per capita. It depends on demography (that is, the age structure of the population), labour force participation, unemployment, and average hours worked. The vertical axis shows labour productivity measured as GDP per hour worked. Growth in GDP per capita over time is shown by the north-east trend in the chart.

In 1960, the average Australian worked 15 hours a week and an average hour of work generated \$22.90 of GDP, measured in 2005 dollars. Multiplying these two figures together, we find that, expressed in 2005 dollars, real GDP per capita was \$343.50 a week. In 2006, the average Australian worked 17.1 hours a week and an average hour of work generated \$56.77 of GDP. Hence, in 2006, real GDP per capita was (multiplying the two numbers together) \$970.77 a week.

Subsequent to the last recession, average annual growth in GDP per capita has been a little under 2.5 per cent. Economic growth has been achieved by growth in both labour utilisation and productivity. The large shifts to the right following 1983 and 1993 are a consequence of falling unemployment associated with recovery from recession.

Chart 2 plots the same relationship, but across countries rather than over time. The curved lines running through Australia and the US represent combinations of labour utilisation and productivity that correspond with the same level of GDP per capita. For instance, Netherlands has around the same GDP per capita as Australia but achieves this with lower labour utilisation and higher productivity. Alternatively, a country could have similar GDP per capita but with a combination of higher utilisation and lower productivity. Countries above the line running through Australia have a higher level of GDP per capita.



Chart 2: Labour utilisation and productivity in OECD countries, 2006

Source: Groningen Growth and Development Centre, Total Economy Database, January 2007.

Labour utilisation and productivity make different contributions to generating GDP per capita, as can be seen by comparing Australia, the US and France. Australia and the US have very similar labour utilisation. The key difference between the two is the level of labour productivity, which is around 20 per cent higher in the US than in Australia. In contrast with Australia, France has significantly lower labour utilisation with labour productivity roughly similar to the US, leading to lower overall GDP per capita. There are several factors contributing to lower labour utilization in France and other European countries. Blanchard (2004) argues that European countries have used the increase in productivity over time to increase leisure rather than income, but others argue that labour utilisation outcomes are associated more with labour market and social policy settings.

Chart 3 shows that labour utilisation has been steadily declining in France since the 1960s. A succession of regulations since the 1980s together with demographic change have gradually reduced average weekly hours worked (OECD 2005). In 1998, the government mandated a reduction in the working week from 38 hours to 35 hours for large firms by 2000 and for smaller firms by 2002. Employment protection legislation in France has tended to inhibit not only the firing but also the hiring of workers.

In France, gains in real GDP per capita have been achieved by trend productivity growth more than off-setting the trend decline in labour utilisation, illustrated by a north-westerly progression in Chart 3. In contrast, in the United States, which is characterised by a considerably more flexible labour market, both productivity and labour utilisation have trended up over time, resulting in a north-easterly progression in Chart 3.



Source: Groningen Growth and Development Centre, Total Economy Database, January 2007.

Bourles and Cette (2006, 2005) find that some European countries have higher labour productivity because they have lower levels of employment and lower productivity workers are less likely to participate in the labour force. McGuckin and Van Ark (2005) find a negative relationship between labour utilisation and productivity, but only in the short run. This result suggests that new labour force entrants have lower productivity but catch up with the rest of the labour force after a period of skills development.

These comparisons highlight an important distinction between labour utilisation and labour productivity as drivers of income level. A given level of income can be reached by either higher labour utilisation or higher productivity (or a combination of both). However, labour utilisation is bounded by the number of hours people want to work. By contrast, productivity growth is not bounded (although the current productivity level is bounded by the technology frontier).

### Decomposition of labour utilisation

In Australia, labour utilisation has increased over time, with average weekly hours per capita increasing from around 15.5 hours in the 1960s to around 17 hours in 2006. Changes in labour utilisation can be decomposed into changes in: labour force participation; population; unemployment; and hours worked by employed people. While growth in total population tends to be steady and has little impact on the swings in labour utilisation, the age distribution of the population has a large impact on labour utilisation.

All other things being equal, an increase in labour utilisation would result from an increase in the participation rate, an increase in the working age proportion of the population (15 to 64 year olds), an increase in average hours worked or a decrease in unemployment.

#### Participation

Chart 4 shows that the participation rate, the ratio of the labour force to the population aged 15 years and over, increased gradually from around 61 per cent in the late 1970s to 64.8 per cent in March 2007. An all time high was reached in September 2006.



Source: ABS cat. no. 6202.0.

Behind this development has been an increase in female labour force participation which has more than offset a decline in male participation (Chart 5). The female participation rate has increased from around 44 per cent in the late 1970s to

57.5 per cent in March 2007, lifting total participation over the same period. Similarly, participation rates for students also increased over this period.



Strong employment growth since 2004 has encouraged more people to enter and remain in the workforce. In particular, the participation rate of males appears to have ceased its long-term decline and has recently increased slightly.

Australia's participation rate exceeded the OECD average of 60.2 per cent in 2005 but was below the rates of nine other countries, including Canada, Denmark, Norway, Switzerland, Sweden and the US.

Abhayaratna and Lattimore (2006) identified the key cohorts in which Australia's participation is relatively low. For prime aged males (25 to 54 years), Australia ranked 25th among 30 OECD countries in 2005, more than 5 percentage points below the top ranking countries. For child-bearing aged females (25 to 44 years), Australia ranked 23rd, well behind the rates of New Zealand, the US, the UK and Canada. For people nearing retirement (55 to 64 years), Australia ranked 13th, behind the rates of New Zealand, the US, the UK and Canada. If Australia closed the participation gap with the highest ranking comparable OECD country in 2005 for each of these labour market segments, there would have been around an additional 600,000 people participating in the labour force.

Several countries with higher participation rates than Australia have much higher participation amongst older workers. For example, participation rates in 2005 amongst 55 to 64 year olds were 86 per cent in Iceland, 73 per cent in Sweden, 71 per cent in New Zealand, 69 per cent in Norway, 68 per cent in Switzerland, and 67 per cent in Japan. The same rate for Australia was around 55 per cent.

Nonetheless, participation amongst older workers in Australia has risen significantly over recent years. Kennedy and Da Costa (2006) find that the increase in the participation of women aged 55 to 64 years since the early 1990s is evenly spread between part-time and full-time participation. For men, full-time participation fell between the late 1970s and mid-1990s before rising sharply in 2000. Part-time participation has been on a steady upward trend over this whole period. Over time, different generations of men have not had markedly different participation rates in older years except the most recent generation, but more recent generations of women have had higher participation. This suggests that the upward trend in female participation will continue for some time yet. It is too early to tell whether the recent increase in older male participation will be sustained.

Kennedy and Da Costa also suggest that tightening eligibility for the Disability Support Pension, the mature age tax offset and the recent changes to superannuation might be part of the explanation for higher participation of older workers. Moreover, increasing educational attainment of younger generations may contribute over time to higher participation rates. There may be family reasons — increased participation by women might be causing higher participation by men, if partners choose to retire at the same time. Attitudes about hiring older worker could be changing. Older workers may be reducing their hours and working part time as a transition to retirement rather than giving up work altogether. It may also be a behavioural response to increasing life expectancy and concerns about retirement income adequacy. Finally, the cyclically strong labour market could be causing fewer separations of older workers and so reducing 'unplanned' retirement.

The *Intergenerational Report 2007* projects that Australia's overall participation rate will fall from around 65 per cent to around 57 per cent by 2046-47 due to the ageing of the population. Notwithstanding that the participation rate of people of traditional working age (15 to 64 year olds) is expected to rise from 76.2 per cent in 2006-07 to 78.1 per cent over the same period the participation rates of older cohorts are also expected to rise, but not to the levels of younger cohorts. With increasing shares of the population in older cohorts, the overall participation rate will fall. These trends highlight the important role played by demography on participation.

## Demography

One way of illustrating the importance of demography on labour utilisation is to examine the dependency ratio: the number of dependants — the young aged 0 to 14 and those aged 65 and older — divided by the number of working age population. A decline in the dependency ratio lifts labour utilisation in two ways. First, it means the proportion of working aged people in the population increases. Second, the albeit smaller effect, is that fewer dependants need fewer unpaid carers to look after them. As Chart 6 shows, the dependency ratio declines steadily from the 1960s as the sharp decline in young dependants more than offset the gradual rise in the proportion of older persons until we reach a demographic 'sweet spot' in around 2010. After this

time the rise in older persons dominates and demography begins to detract from labour utilisation.



In Australia, as with many developed countries, population ageing will reduce labour utilisation over the next 40 years. The *Intergenerational Report 2007* projects that in the period to 2047 the number of 0 to 14 year olds in Australia will rise slightly, those of traditional working age (15 to 64 years) will rise by about 20 per cent, older people (65 to 84 years) will more than double and the very old (85 years and over) will more than quadruple. The dependency ratio (both young and old as a proportion of working age people) will rise from around 50 per cent in 2007 to nearly 70 per cent in 2047. On current participation rates by age cohort, this implies a significant reduction in the availability of labour.

Australia is by no means alone in facing a rising dependency ratio — in fact, Australia's demographic challenge in this respect is much less serious than in some other countries. The dependency ratio averaged 65 per cent in the OECD area in 2005 and ranged between about 55 per cent in Korea, the Czech and Slovak Republics and above 80 per cent in Mexico and Turkey. The dependency ratio is expected to rise sharply in most OECD countries, except Mexico and Turkey where it is expected to decline. By 2050, the dependency ratio is expected to exceed 100 per cent in Italy, Japan and Spain.

The rise in the dependency ratio comes about despite a fall in the proportion of young people. The youth-dependency ratio fell from around 60 per cent in 1980 to around 40 per cent on average in the OECD area in 2005. In most OECD countries, the youth dependency ratio is projected to continue to decline but only modestly to average 37 per cent in 2050. On the other hand, the elderly-dependency ratio across the OECD

has risen from around 20 per cent in 1980 to around 24 per cent in 2005. By 2050, this ratio is projected to more than double in the OECD area to 52 per cent. Some countries will face much sharper increases. By 2050, the old-age-dependency ratio will exceed 70 per cent in Italy, Spain and Japan (OECD 2006c).

The impact of demography can also be shown by disaggregating the increase in utilisation into demographic and non-demographic factors. The solid line in Chart 7 shows that labour utilisation has increased by around 1.2 hours per week since the late 1970s. The bars represent contributions to the change. The demographic effect has increasingly contributed to higher labour utilisation as working age cohorts have increased relative to the total population. From the turn of this decade, the demographic effects are projected to be negative (for both males and females). The non-demographic effects include the impact of business cycles on unemployment and average hours, plus changing participation rates and hours worked within age cohorts. Non-demographic effects have mostly added to labour utilisation only in recent years.





Note: Contributions to the change in labour utilisation are calculated using a rolling annually re-weighted shift-share approach. Source: Australian Bureau of Statistics and Treasury calculations.

The underlying trends are quite different for males and females. For males, the non-demographic effects have been negative, more than offsetting the demographic effects, resulting in average weekly hours worked per male falling by around an hour per week (Chart 8).





For females, both demographic and non-demographic effects have contributed to increased average hours worked, with non-demographic effects having a larger influence than demographic effects. Average weekly hours per female have increased by over 3 hours per week (Chart 9).



Chart 9: Contributions to the increase in labour utilisation (females)

Source: Australian Bureau of Statistics and Treasury calculations.

# Average hours

While labour utilisation overall has increased, average weekly hours worked per employed person have fallen by over two hours since the late 1970s (Chart 10).



Chart 10: Average weekly hours of those in work

The main source of the decline is an increase in the proportion of part-time workers (Chart 11). On average, part-time employees work around 16 hours per week compared with around 40 hours for full-time employees.



#### Chart 11: Part-time share of total employment

Increased part-time work should be regarded as a positive development if it reflects individuals' preferences for labour and leisure. Casual employment is taken up in a latter part of the statement.

While average hours worked per employee have been falling as the share of part-time employment rises, it has been suggested that Australians in full-time employment have been working longer average hours than any other OECD country. However, at around 40 hours per week, average full-time hours are currently around the same level they were three decades ago. In addition, recent work by the Australian Bureau of Statistics (Baker and von Sanden 2006) suggests that there has been a consistent overestimate in the hours measures used to rank Australia against other OECD countries. Once this has been accounted for there is no evidence to suggest that Australians working full-time are working more, or indeed fewer, hours per week than workers in other OECD countries.

#### Unemployment

Increased participation alone will not lift labour utilisation unless those new participants are employed. The unemployment rate has fallen to a 30-year low (Chart 12). Following the oil shock in the early 1970s, the unemployment rate rose sharply from around 2 per cent to around 6 per cent between 1974 and 1978. This reversed a steady trend towards increasing labour utilisation underway since the 1960s. Following the recessions in the early 1980s and early 1990s, unemployment again rose sharply with the result that over 10 per cent of the labour force were without a job. Strong employment growth since the early to mid-1990s has resulted in a steady fall in the unemployment rate.



Australia's unemployment rate is below the OECD average, and lower than major economies such as the UK and Canada and similar to that in the US. Moreover, Australia's unemployment rate has fallen substantially more than the OECD average over the last decade and a half (Chart 13). On the OECD's standardised unemployment rate measure, the most recent peak in both the OECD average and Australian unemployment rates was in 1993, when the OECD average was 7.8 per cent and the Australian rate was 10.6 per cent. The gap between unemployment rates was virtually closed by the end of the last decade. In more recent years, Australia's unemployment rate is a full percentage point or more lower than the OECD average unemployment rate.



Chart 13: Difference between Australian and OECD unemployment rates

Reduction in the unemployment rate is likely to be assisted by a mobile labour force. This aspect is taken up in Box 1.

Source: OECD Main Economic Indicators database.

#### Box 1: Labour mobility

A flexible, mobile labour force plays an important role in maintaining macroeconomic stability by preventing wage pressures in one region or occupation spilling into more generalised wage pressures and inflation at the national level. Labour mobility also facilitates economic growth by enabling the reallocation of labour to its most productive use, including in order to exploit new opportunities and technologies as they arise.

In an economy operating at close to full employment, relative wage adjustments become even more important in attracting workers from other industries or regions. Under a rigid, centralised wage fixing system, wage dispersion would be low and firms in more productive sectors of the economy would find it more difficult to attract workers from less productive sectors. As wage setting becomes more decentralised and responsive to sectoral and regional conditions, the dispersion of wages is higher resulting in higher labour mobility, a lower dispersion of unemployment and improved national productivity.

Chart A shows the range of annual growth in average weekly earnings in the six States. The increasing volatility of this indicator suggests that wage flexibility across the States has been increasing. As discussed in Budget Statement 3 increased wage dispersion provides a clearer signal about changes in labour demand in industries and regions, and is one factor that will increase labour mobility and reduce regional unemployment disparity.



#### Chart A: Range of state wages growth

## **FACTORS AFFECTING LABOUR UTILISATION DECISIONS**

The focus of this section is on the role of recent government policy in influencing labour utilisation decisions. These policies have implications for both the supply and demand for labour.

Ultimately, the decision to participate in the labour market is based on an individual's preferences for work and leisure. Paid work provides individuals with substantial benefits, including a means to satisfy their material needs and those of their families, the opportunity to develop personally, live independently and interact socially. Factors that influence a decision to participate in the labour market include family situation, educational attainment, age, tax and welfare payment implications.

## Macroeconomic performance

Australia has experienced more than a decade and a half of continuous economic growth. GDP growth since the turn of the millennium has averaged above 3 per cent per annum, among only a handful of OECD countries achieving such rapid growth.

During this 15 year period, Australia has experienced a number of external and internal shocks – the Asian financial and economic crises, two major droughts, the global slowdown of 2001, the uncertainty after the 9/11 attacks, SARS, a housing boom, natural disasters, significant increases in oil prices and the commodities boom. Any of these shocks could have triggered an economic slow-down and/or higher inflation in years past, but there have been notable improvements in resilience compared with earlier times. Australia not only continued to experience stable economic growth but thrived, surpassing the per capita income levels of the average of OECD countries. Australia has reached record employment levels and attained the lowest unemployment figures for 30 years, with low inflation.

Australia has maintained a strong economic record in the face of these shocks because the economy is more flexible and better able to adapt quickly to change. The OECD (2006a) has recently commented that wide-ranging macroeconomic and microeconomic reforms, particularly to promote competition, were instrumental in engendering greater flexibility in the Australian economy. These reforms are broad and deep, and have been implemented progressively over many years.

Key macroeconomic reforms of recent years include the adoption of a fiscal policy strategy with the primary objective of budget balance over the economic cycle and formalising the independence of the central bank to pursue a medium term inflation target. Together, these policies act to maintain economic stability, encourage private investment, entrench low public debt and ensure that, over time, the current account continues to reflect private saving and investment decisions. The fiscal pressures associated with demographic change are addressed in the fiscal strategy through a supplementary objective of improving the Government's net worth. This has led to the creation of the Future Fund.

Microeconomic reforms have also played a significant role in helping to maintain the stability and flexibility of the economy. Microeconomic reforms include: liberalising Australia's foreign trade and investment; liberalising financial markets and workplace relations regimes; major tax and transfer payments reform that broadened the base and lowered tax rates for both corporations and individuals; reforms of the indirect tax system; targeted incentives to work and save; corporate law reform; and a broad ranging National Competition Policy agenda. By 2003, Australia's economy wide product market regulations were judged to be the least restrictive in the OECD.

Notwithstanding the above, the reform task is far from complete. Substantial issues around national markets remain difficult to progress because of federalism constraints. Areas of 'new scarcity' require economic solutions — notably water and greenhouse. There is also a need for attitudinal change in policy making, away from promotion of resource utilisation — job creation — to resource allocation and resource creation; that is, supply side improvement.

#### The taxation and income support system

Australians' decisions on whether to work and how long to work are influenced by the tax system and the provision of income support. The tax and income support systems should minimise distortions between reward and effort, while providing assistance for those in need. The challenge is to avoid undue disincentives to work.

Over a number of years, the Government has lowered the marginal income tax rates and increased the thresholds at which the rates start to apply. For example, compared with their income tax liability prior to the introduction of *The New Tax System*, and including changes in the 2007-08 Budget, on 1 July 2008 a person on \$25,000 will have had a tax reduction of around 54 per cent, a person on \$65,000 will have had a tax reduction of around 33 per cent and a person on \$100,000 will have had a tax reduction of around 29 per cent. This has improved incentives to lift workforce participation.

In particular, the increases announced in the 2006-07 and 2007-08 Budgets in the 30 per cent tax threshold from \$21,601 to \$30,001 and the substantial increases in the Low Income Tax Offset will have increased incentives for workforce participation, particularly for secondary income earners who are more responsive to changes in tax.

The earlier reductions in the top two tax rates to 40 per cent and 45 per cent and increases in the top two tax thresholds, with further increases in these thresholds from 1 July 2008 announced in the 2007-08 Budget, are seeing increased returns to individuals from supplying more labour and enhanced international competitiveness of Australia's personal income tax system. Maintaining this competitiveness is important for sustaining workforce participation and productivity in Australia. The overall rates and thresholds of Australia's tax system now compare favourably with other similar countries.

Australia has a highly targeted welfare system. The Family Tax Benefit system recognises that households with children face greater costs than those without. Family Tax Benefit Part A is directed towards those families with lower incomes. The necessary implication of targeting benefits is that as family income increases benefits are withdrawn. The alternatives are either not to provide these benefits (thereby leaving beneficiaries worse off) or creating a universal entitlement system with the higher spending, higher taxing and greater churning that such a system would entail.

While Australia's tax and targeted welfare systems necessarily create higher effective marginal tax rates, the Government seeks to identify and act where it can to reduce these and minimise their impacts. Over recent years, effective marginal tax rates have decreased significantly for families. For example, before 2000-01, families faced a 50 percentage point increase in their effective marginal tax rates from the withdrawal of family payments above the base amount. *The New Tax System* of 2000-01 reduced this withdrawal to 30 percentage points. In 2004-05 the withdrawal rate was reduced further to 20 percentage points.

The Government's Simplified Superannuation reforms provide greater incentives for labour force participation by older workers by introducing greater flexibility in how superannuation savings can be drawn down in retirement. The reforms will encourage people to maintain their connection with the workforce.

From 1 July 2007, superannuation benefits paid from a taxed fund will be tax free for people aged 60 and over. This will increase retirement incomes, particularly for individuals who make additional superannuation contributions. Further, people aged 60 and over may pay less tax on other income as superannuation amounts paid from a taxed fund will not be included as assessable income. This will increase the incentive for individuals to undertake work whilst also drawing down their superannuation. The halving of the assets test taper rate for the age pension will also provide greater incentives for individuals to work.

The reforms will also increase incentives for the self-employed to participate in the labour force and save for their retirement as they will be eligible for a full deduction for their superannuation contributions (up to \$50,000 a year), and for the Government's co-contribution for personal contributions.

These reforms follow significant changes in 2004, when the Government announced a number of measures to broaden access to superannuation and improve the flexibility of the superannuation system. Changes included simplifying the work rules for those over 65, and the introduction of the 'transition to retirement' measure to allow individuals to draw down on their superannuation while still working.

# Family and individual circumstances

The ability to balance family responsibilities with work is a key issue for many Australians. Access to affordable, high quality child care is a key factor in participation

decisions, particularly for women of child-rearing age, who are relatively under-represented in the labour force.

The accessibility of child care in Australia has improved. Since 1 July 2006, there has no longer been a limit on the number of outside school hours care and family day care places. These places are now treated the same way as long day care places, which were already uncapped. This allows existing and new child care providers to expand child care places to meet demand. Overall, child care places have increased from around 300,000 in 1996 to around 600,000 places currently, and by 2009 there are likely to be over 700,000 child care places.

The cost of child care directly affects female labour force participation. The international empirical literature bears out this inverse relationship, although the range of responses varies widely. In Australia, the results are similar, yet tend toward the lower end of the range found in the international literature (Doiron and Kalb 2005; Rammohan and Whelan 2005; Kalb and Lee 2007). Evidence also shows the impact of child care costs on labour force participation varies across different subgroups within the female labour force. For example, Kalb and Lee (2007) show that a given change in child care costs has a greater impact on the participation of sole parents, mothers of preschool age children, and low income parents.

The affordability of child care has been improved through the Child Care Benefit and the Child Care Tax Rebate. Child Care Benefit is a subsidy which varies according to parents' income, the number of children in care and the type of care. The Child Care Tax Rebate is a non-refundable tax rebate on 30 per cent of out-of-pocket child care expenses; that is, fees incurred for approved care less Child Care Benefit.

In the 2005-06 Budget the Government announced a comprehensive package of reforms to the welfare payments system. The Welfare to Work reforms involve rebalancing the welfare system to increase the workforce participation of those working age Australians with the capacity to work, while maintaining a strong safety net for those who need it. The reforms focus on improving the labour force outcomes of people with disabilities, parents, mature age people and the long term unemployed through a combination of new eligibility rules for income support payments, more places in employment services, changes to participation requirements, a new compliance framework and an Employer Demand strategy.

The major component of the Welfare to Work package includes measures designed to encourage parents and people with disabilities to re-enter the workforce. In addition, the participation obligations for mature age people on Newstart Allowance are now more consistent with those for younger recipients and assistance for the long-term unemployed has been expanded.

The new participation requirements are also supported by improved employment services that include a new Employment Preparation service in Job Network for parents, carers, and mature age people returning to the workforce.

The income test for a number of allowance payments was also made more generous through a reduction in the maximum taper rate from 70 cents to 60 cents in the dollar. This initiative reduces effective marginal tax rates, thus improving the rewards from part-time work.

To assist employers to employ people with disabilities and parents who require flexible working arrangements an Employer Demand strategy has also been introduced. This strategy provides funding of up to \$100,000, for up to 12 months, for innovative recruitment, employment and retention projects that are specifically aimed at the Welfare to Work target groups.

#### Labour market regulation

There have been significant reforms to the Australian labour market and workplace relations system in recent years. Simplifying workplace agreement procedures and allowing wages and conditions to be better linked to productivity improvements provides greater incentives for work and the creation of new jobs and assists many families with marginal labour force attachment to participate in paid work.

The *Workplace Relations Act* 1996 increased scope for direct bargaining between employers and employees at the workplace level, either collectively through Certified Agreements or individually through Australian Workplace Agreements, thereby reducing the role of awards in setting pay and conditions. This formed a framework of rights and responsibilities for employers and employees to choose the most appropriate form of agreement for their particular circumstances. However, workplace relations laws remained complex, particularly in relation to unfair dismissal laws.

Research by Harding (2002) found that unfair dismissal laws made it difficult for the most vulnerable job seekers to find work and contributed to the loss of about 77,000 jobs. The regulatory burden on employers and flexibility in hiring and firing decisions are key factors affecting labour utilisation. Employment protection legislation (EPL) — the set of rules governing the hiring and firing process — tends to limit firms' ability to fire workers. As a result, firms may be more reluctant to hire workers if they face high lay-off costs so the unemployed may face longer durations of unemployment. Chart 14 shows that Australia is relatively lenient on EPL, although not as flexible as some countries including the UK and the US.



Chart 14: Summary index of employment protection legislation strictness, 2003

Source: OECD 2006a.

The Government's Work Choices reforms which came into effect in March 2006 have a number of interrelated elements designed to reduce unemployment, improve productivity and participation and deliver higher real wages. Work Choices involved the introduction of a national workplace relations system; the simplification of the agreement making process with a greater emphasis on direct bargaining between employers and employees at the workplace level; the creation of the Australian Fair Pay Commission and the Australian Fair Pay and Conditions Standard which are enshrined in legislation; and changes to the unfair dismissal laws.

Under Work Choices firms with 100 or fewer employees are exempt from the operation of unfair dismissal laws. In addition, for employees of larger firms there is a six month qualifying period and any dismissal on the grounds of operational requirements is permitted.

The OECD has identified cross-country factors that have been important for achieving employment and economic growth. Increasing the flexibility of the labour market is central. The OECD (2006d) stated that 'the increasing scope for direct negotiations between employers and employees has probably also helped to raise productivity, as enterprise bargaining allows firms to adopt productivity enhancing practices and promotes a more co-operative work environment where performance and reward are more closely linked.'

Other findings in the OECD survey included the greater use of bargaining over working conditions, including wages, at the collective and individual level due to the introduction of a number of reforms. These reforms included reduced complexity in awards and the reduced number of allowable matters in awards. There has also been an increased take-up of collective and individual agreements by employees in recent years, with a continued decline in employees on awards.

Lawson and Bierhanzl (2004) look at the relationship between labour market flexibility and unemployment and find that the five OECD countries with the least regulated labour markets had, on average, unemployment rates of 4.7 per cent. This compares to an average unemployment rate of 7.3 per cent for the five OECD countries with the most regulated labour markets.

More flexible labour markets are also important for an economy to more easily adjust to external shocks. The OECD (2006d) stated that 'Recent experience confirms the importance of policies to assure that wages adjust flexibly in response to supply- and demand-side pressures, so as to support high levels of employment in a constantly changing economic environment.' Kent, Smith and Holloway (2005) and Cotis and Coppel (2005) found that labour market reform in OECD countries results in fewer economic downturns and reduces the size of the downturns if they do occur.

#### Education and training

The link between educational attainment and increased labour utilisation is well established. The OECD (1998) found that, on average across countries, individuals with below upper secondary education attainment spend more than twice as much time unemployed as tertiary graduates in the course of their working life. A more recent study by the OECD (2006b) suggests that the employment rate for graduates of tertiary education is markedly higher than the rate for upper secondary graduates.

Looking specifically at Australia, Kennedy and Hedley (2003) found substantial variation in labour force participation rates of males and females with different levels of educational attainment (Chart 15). Workers with no post-school education participate less in the labour force at all ages. Employment rates rise with educational attainment in most OECD countries.

In 2003, the proportion of Australians aged 55 to 64 with at least an upper secondary education was 11 percentage points below the weighted average of the rest of the OECD, but the proportion of 25 to 34 year olds with the same qualification was marginally above the OECD average. As older workers retire, the secondary education attainment gap will narrow under existing policy settings. The proportion of Australians with a tertiary education (including vocational education and training) is above the OECD in all age groups.





In recent times, Australia has performed better than the OECD average on some indicators of education quality. For example, Australia ranks above the OECD average, and well above the US, on mathematics performance of 15-year old students, based on data from the Programme for International Student Assessment (PISA) (OECD 2006b). Countries with a higher ranking than Australia include Finland, Korea and the Netherlands. Improving education outcomes does not always correspond with higher expenditure. Australia spends around US\$ 7,500 per student per annum, in line with the OECD average but achieves above average outcomes. In contrast, the US spends around US\$ 12,000 per annum but falls at the lower end of the PISA scale.

The Australian economy is currently operating somewhere near full capacity. In this macroeconomic environment further gains in labour utilisation are unlikely to come from policies that target aggregate demand. Instead, policies will need to focus on resource allocation and resource creation. Improving the skills of the Australian workforce is one such approach, given the positive link between education and workforce participation and productivity. Those with higher levels of education are generally more employable and able to earn higher wages than those without.

A high quality and responsive education system is vital to increasing skills. With the right policy settings, the Australian education system will deliver the workforce that Australia needs for future prosperity. It will be an education system responsive to the needs of students and employers. It will also improve the capacity of individuals to participate in society. This budget includes a comprehensive package of assistance to Australia's education system through the *Realising Our Potential* package that covers the university, vocational and school systems.

Source: Kennedy and Hedley (2003).

# Immigration

With the economy at near full capacity and in the face of an ageing population, migration, with particular emphasis on skilled migration, continues to be a priority source of labour for Australia. As a result of net migration, one in four Australian residents is foreign born, the highest proportion in the OECD after Luxemburg and well above the OECD average of one in twelve (OECD 2004b). Net overseas migration has been increasing recently and reached a record high of around 125,000 per annum over the past few years, with most migrants being highly skilled.

Migrants tend to be younger, on average, than the resident population but they also tend to have lower participation rates. The Productivity Commission (2006) found that the average participation rates for all immigrant groups in 2004, was 62.1 per cent compared to 67.3 per cent for those born in Australia. The difference can be explained by compositional differences across the two groups in terms of education, location, gender, age and English ability.

Australia's emphasis on skilled migration will help lift total labour utilisation rates, however, as skilled migrants have significantly higher participation (82 per cent) than Australian born. Skilled migrants are, on average, more highly educated and of prime working age. By contrast, the participation rates for humanitarian settlers and those entering under the family stream are significantly lower, at 39.6 per cent and 57.9 per cent.

There is little evidence that migration adversely affects the labour market outcomes of Australian born workers, and studies have found that immigration has not resulted in higher aggregate unemployment. Employed immigrants worked an average of approximately half an hour longer per week than Australian-born workers based on data obtained from 1986 to 2001. The difference in hours worked can be explained by differences in age, industry and occupation of employment of migrant workers.

In recognition of the valuable economic contribution and high participation rates of skilled migrants, the size of the migration programme will increase by 8,800 in 2007-08 to up to 152,800 places. Of these additional places, 5,000 will be migrants in the skilled stream. This expansion will build on previous expansions of the skilled migration programme over recent years.

Migrants also add to general demand in the economy. Immigration programmes can selectively reduce particular labour market pressure points, but can also shift excess demand pressures to those parts of the economy where supply is relatively unresponsive — in particular, the housing market.

## EMPLOYMENT FLEXIBILITY AND SECURITY

Casual employment is an important feature of Australia's flexible labour market. In this section, the characteristics of casual employment are examined and the relationship between flexible labour markets and job security is discussed.

# Characteristics of the casual employment market

The structure and operation of the Australian economy has changed markedly over the past two decades. These changes have produced more flexible working arrangements for the 'traditional' full-time permanent workforce. At the same time, changes in the structure of the economy have resulted in increased demand for non-traditional workers such as the young, students and females who, because of non-work commitments, tend to engage in the labour market on a part-time, non-permanent or casual basis.

Changes to traditional working arrangements have given firms more flexibility to allocate labour resources, resulting in improvements in productivity in the workplace. The growth in non traditional, part-time and casual employment opportunities has also resulted in increased labour force participation.

International comparisons show Australia has a very high rate of casual employment (OECD 2004a). Casual employment has been growing in many OECD countries and the average has crept up from 10 per cent in 1984 to around 12 per cent in 2004. Spain has the highest rate of casual employment in the OECD, followed closely by Australia.



Chart 16: Casual employment as a proportion of total employment

Source: ABS cat. no. 6310.0. and Treasury calculations.

Casual employment has been growing steadily in Australia. In 2004, around 28 per cent of the workforce was employed on a casual basis, up from 23 per cent in the early 1990s (Chart 16). While the proportion of female casual employment has changed little, the growth in male casual employment as a proportion of total male employment increased from around 17 per cent in the early 1990s to around 25 per cent in 2004.

Age plays a significant role in determining the likelihood of being employed on a casual basis. Casual employment has, as mentioned previously, provided employment opportunities to a range of people whose non-work commitments, including senior secondary and tertiary education, make it more difficult to engage in traditional employment arrangements. Young people (aged 15 to 24) in particular have benefited from these opportunities. Of those in employment, young people were almost three times more likely to be employed on a casual basis in 2004 than people 25 years and older (Chart 17). An interesting development is that the decline in older female casual employees has offset the rise in the young female casuals. For older males, casual employment grew sharply during the 1990s before levelling out somewhat since the late 1990s. This suggests that since that time, increases in male casual employment have been driven largely by younger males.



Chart 17: Casual employment as a proportion of total employment by age

Source: ABS cat. no. 6310.0. and Treasury calculations.

Casual employment may be a useful transition to more traditional forms of employment. The Productivity Commission (2006) found that casual employment may be a pre-cursor or 'stepping stone' to full time employment.

#### Job security

Concerns have been raised that the benefits of flexible labour markets come at the cost of job security. Growth of non-traditional forms of employment, such as casual employment, had been viewed as inferior to 'traditional' full-time, permanent employment arrangements. The evidence does not support this view. Employment duration has changed little over the past two decades and direct measures of job security are around record highs. The best approach to maintaining job security at high levels is to ensure that macroeconomic policy is aimed at maintaining a strong, flexible economy that keeps unemployment low.

A recent survey (ABS 2005), found that despite 50 per cent of casual employees having current employment durations less than 1 year, over three quarters expect to be in their current job in 12 months time. For all other employment types, around 95 per cent expect to remain with their current employers for the next 12 months. There is very little difference between men and women in each category. Despite changes in the survey methodology, perceptions of job security remain largely unchanged from the two previous surveys carried out in 2001 and 1998.



Chart 18: Employment security and the unemployment rate

Source: Morgan Job Security Poll and ABS cat. no. 6202.0.

The Morgan Poll (2007) has carried out an annual job security survey since 1975 making it the longest time series of job security perceptions available in Australia. The latest survey, carried out in December 2006, suggests that a record proportion of employees feel secure in their current jobs. Chart 18 shows that the perception of job insecurity, at least over the last 20 years, is related to the unemployment rate. As the unemployment rate falls, so does the proportion of people who feel insecure in their job.



Chart 19: Testing job security perceptions

Another question in the same Morgan Poll series is 'if you became unemployed, would you be able to find another job fairly quickly?' People's perceptions may not be correct because employed people do not necessarily know what conditions are like for the unemployed. Chart 19 shows the Morgan Poll series against ABS data that shows the probability of remaining unemployed from month to month and suggests that respondents over the last 20 years have relatively accurate perceptions of conditions they will face if they find themselves unemployed. Based on this series it appears that as the probability of remaining unemployed falls so does the proportion of respondents who think it will take longer to gain employment.

# POLICY PRIORITIES FOR MAINTAINING FULL EMPLOYMENT IN THE FACE OF GLOBAL CHANGE

The previous sections of this statement took a retrospective look over time and across countries at the characteristics of Australia's labour market and the policy and non-policy factors that have contributed to the labour market outcomes over the past decade and a half. In this section, a forward look is taken at the likely trend in labour utilisation.

Chart 20 extends Chart 1 presented at the beginning of this statement by adding Australia's projected labour utilisation and productivity over the next 40 years to 2046-47. As the historical segment (up to 2005-06) of the chart shows, there has been a general north easterly movement of the line, reflecting generally rising labour utilisation and productivity growth. The product of labour utilisation and productivity at each point on the line gives a measure of GDP per capita. The line represents Australia's path of economic growth in GDP per capita over time.

Source: Morgan Job Security Poll, ABS cat. no. 6291.0.55.001 and Treasury calculations.

Increases in labour utilisation are projected to continue from 2005-06 to around the end of the decade, reflecting the continuation of the rise in the proportion of the working age population. By 2009-10, Australia will have reached its demographic 'sweet spot', where the dependency ratio is at its lowest level.

From the beginning of the 2010s the dependency ratio is projected to rise, reflecting mainly the retirement of the baby boomer generation. This will reduce the proportion of the traditional working age population and consequently reduce labour utilisation. By 2046-47, labour utilisation is projected to have declined to levels experienced in the mid-1990s.



Chart 20: Labour utilisation and productivity

Source: Australian Bureau of Statistics and Treasury calculations.

Implicit in this projection is the future impact of current policy settings — the bundle of macroeconomic and microeconomic reforms, including labour market reform, that have been introduced over the years. The projected decline in labour utilisation makes it more difficult for Australia to achieve strong economic growth and necessarily places greater reliance on productivity to drive economic growth.

Although labour utilisation is projected to decline, the impact on Australia is much less severe than for other advanced economies. As Chart 21 shows, the demographic 'sweet spot' is relatively deep for Australia (deeper than for France, UK, New Zealand and the US). Also, the rise in Australia's dependency ratio beyond this decade is lower than for Japan, France, and Canada and similar to New Zealand and the UK. The implication is that the economic adjustment and the consequent policy task is more severe for other advanced economies than it is for Australia.



Chart 21: International dependency ratios

Source: United Nations 2006 Revision Population Database, medium variant.

The *Intergenerational Report 2007* identified that significant progress has been made since the first Intergenerational Report to arrest the backward trend in Australia's projected labour utilisation. The improvements are due mainly to higher projected participation rates of older workers and higher levels of skilled migration. These improvements have been large enough to more than offset negative impacts on labour utilisation arising from lower mortality rates and higher birth rates. They have shifted the path of economic growth in Chart 20 in an easterly direction relative to where it was in the previous Intergenerational Report, whilst maintaining the movement northward reflecting the contribution of productivity to economic growth. The challenge is to maintain these improving trends.

In broad terms, best practice labour market outcomes involve policy priorities for (i) ensuring that the labour market is flexible so that the existing labour force remains fully utilised and allocated to its most productive uses as the economy continues to respond to demographic and other change and (ii) expanding the supply of labour.

It is widely recognised (OECD 2006a) that Australia has a robust macroeconomic policy framework that has bolstered the economy's stability and reduced uncertainty. The priority is to continue to make timely adjustments within this framework in response to changing economic conditions. The broad thrust of existing labour market policy is to provide flexibility so that the economy is able to adjust quickly to internal and external shocks and shift resources to areas of new comparative advantage and, in so doing, provide opportunity for those who want employment to find employment and to reward effort. In terms of Chart 20, the path of economic growth is likely to be more stable relative to historical trends.

In an economy approaching full capacity utilisation, all activity, including of governments, that commands additional real resources without at the same time expanding supply capacity must impose a cost. Employment creation under such economic conditions essentially requires an increase in labour force utilisation. This may come about, for example, through raising the labour force attachment of older workers, providing assistance for people with disabilities to enter employment, or employment of Indigenous Australians who would otherwise face a life of passive welfare dependency. Another avenue is to increase the size of the labour market through immigration of suitably skilled workers. In terms of Chart 20, the path of economic growth would move in an easterly direction, raising GDP per capita for any given level of productivity.

Measures in the 2007-08 Budget continue the series of initiatives over recent years to promote participation and, thereby, higher labour utilisation. They will boost incentives to work in a number of ways.

Among the changes to the personal income tax system are increases to the 30 per cent, 40 per cent and 45 per cent thresholds and an increase in the Low Income Tax Offset. These changes will increase the returns from working. In particular, the increase in the 30 per cent threshold from \$25,001 to \$30,001 is likely to have a strong impact on participation, given the large number of people affected and the higher labour supply responsiveness of workers on lower incomes.

A high quality education system is crucial to enhancing the skills and productive capacity of Australia's young people and is an essential building block of economic growth prospects.

This budget includes a comprehensive package of measures to improve education outcomes across the university, vocational and school systems. A key component is the establishment of a new, perpetual Higher Education Endowment Fund (HEEF) with an initial investment of \$5 billion funded from the 2006-07 surplus. This significant investment will broadly double the existing financial investments and endowments accumulated in the university sector. The earnings from this endowment will be distributed to institutions on a competitive basis annually to use for capital works and research facilities. The Budget also includes initiatives to promote the flexibility and diversity of the higher education sector, increase assistance for vocational education and training students, and enhance high quality teaching and learning in Australian schools (see Budget Statement 1 for further details).

As noted above, reductions in the cost of child care will encourage increased female labour force participation. The 10 per cent increase in the hourly rate of Child Care Benefit, included in the 2007-08 Budget, will provide a boost to participation. Furthermore, the new arrangements for payment of the Child Care Tax Rebate, by bringing the timing of the rebate closer to the time when child care is used, will sharpen the participation incentives provided by this component of child care assistance.

# CONCLUSION

This statement has illustrated the remarkable performance of the Australian economy and, in particular, the labour market. Across a broad range of indicators, Australia's economic credentials, including its labour force utilisation, have been impressive. Unemployment rates are at historic lows, employment growth has been high and Australia's participation rate has increased and is well above the OECD average.

There are a number of factors which are important in explaining the strong performance of the labour market. These affect both the demand and supply of labour and include monetary and fiscal policies to maintain macroeconomic stability as well as ongoing economic reform initiatives in the areas of taxation, welfare, labour markets, education and training and immigration.

However, Australia cannot rest on past success. A number of challenges are on the horizon. In particular, in terms of labour market participation, the *Intergenerational Report 2007* highlights the impact the ageing of the population will have on reducing Australia's overall participation rate. In addition, the Productivity Commission has highlighted Australia's relatively low levels of participation for certain key cohorts (particularly, prime aged males and females of child bearing age).

For Australia to maintain its impressive economic performance and rates of economic growth into the future there needs to be a continuous focus on maintaining an economic environment which provides the ways and means of improving labour market utilisation. The Productivity Commission estimates that if Australia were to achieve the best practice participation levels of OECD countries, the number of workers would increase by around 600,000, or 5.7 per cent of the current workforce.

While this statement has shown that improving Australia's labour utilisation rate will be important in maintaining strong economic growth, it is only part of the story. As outlined in the beginning of this statement, the other key source of continuing growth in per capita incomes is productivity. Given the demographic trends outlined in the *Intergenerational Report 2007*, and the trends outlined in this statement, Australia needs to maintain the current policy thrust to get best labour market outcomes while at the same time continuing with the ongoing task of improving productivity performance. The combination of these factors provides the greatest prospect for continuing growth in living standards in the long term.

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