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UNEMPLOYMENT: THE WAY FORWARD FOR EUROPE

R. LAYARD

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	Page
Introduction	1
1. The Problem	1
2. The New Approach	3
3. Displacement	5
4. Cost and Benefits	6
5. Strategy of Reform	7
6. Training Young People	8
7. Reform of Pay Bargaining	9
8. Worksharing	10
Conclusion	11
Endnotes	12
Figure 1	13

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Introduction

Mr. Delors has instituted a Europe-wide debate on how to reduce unemployment and Commissioner Flynn has called for unemployment to be reduced to 5 per cent by the year 2000. They are absolutely right. The unemployment we have endured for the last ten years is an absolute disgrace. It is not only a source of misery to millions but an economic waste that could be avoided by sensible policies. In Europe in the last 10 years we have on average had 10 per cent of our workforce unemployed. If we cut this to 5 per cent, we should increase our national income by as much as our whole expenditure on education.

But how is it to be done? I believe the key to progress lies in preventing long-term unemployment. If governments decided now to prevent any more long-term unemployment beyond the year 2000 they could do so. The new structures could be put in place step by step in a way that was quite feasible. And once long-term unemployment had been abolished no one would be out of work for more than a year - which is at least one definition of full employment.

1. The Problem

So why is the top priority to attack long-term unemployment? To answer this requires us to start from basics.

Let me begin with the problem. The problem is not that in Europe we now have 12 per cent unemployment. It is that since 1986 unemployment has averaged 10 per cent of the workforce. And inflation is roughly where it was in 1986. So with existing social arrangements there is no way of controlling inflation with less than around 10 per cent unemployment. What a terrible verdict on the way in which things are arranged. The story is similar in Britain, with unemployment since 1986 averaging 8 per cent of the workforce.

Is this really inevitable? We cannot just expand demand, reduce unemployment below 8 per cent, and hope for the best. That is what Nigel Lawson did, and inflation went up and up. It will do exactly the same again in the next boom, unless a completely fresh approach is adopted.

The fresh approach focuses on identifying which kinds of unemployment help to control inflation, and which do not. The evidence shows that long-term unemployment does very little to control inflation, while short-term unemployment does.¹ Once someone has been unemployed for over a year, he is in real trouble. His morale and self-

respect have been battered by endless rejections, and he looks unattractive to employers. We can see this very clearly if we look at the proportion of people leaving unemployment. Each quarter roughly a half of the newly unemployed people leave unemployment, compared with under 10 per cent of the very long-term unemployed. You can see this in Figure 1. This reflects demoralisation, deskilling, reduced information about jobs, reduced job-search and natural employer discrimination.

Employers are clearly unwilling to fill their vacancies with long-term unemployed people. Thus for given vacancies, you have higher unemployment the higher the proportion of the unemployed who have been out of work for over a year. This interesting fact was first discovered by the present government's Chief Economic Adviser.² If only the present government would now act on it.

For this fact explains why having a lot of long-term unemployed people in a society does almost nothing to control inflation. Such people are not seen as effective fillers of vacancies. So having them around does nothing to restrain inflation.

This in turn explains our initial puzzle. How can we really need 8 per cent unemployment to control inflation? The answer is that when we have 8 per cent unemployment, nearly a third of those 8 per cent are long-term unemployed. If we eliminated that long-term unemployment (and did one or two other things) we could surely reach the target of 5 per cent unemployment set by European Commissioner Flynn for the year 2000 without rekindling unemployment. But if we went for 5 per cent unemployment by reflation and worksharing, we should surely cause a conflagration.

So how can we eliminate long-term unemployment? There are two possible ways: prevention or cure. Of these, prevention is much the better. People are more difficult to help once they have become long-term unemployed. A key objective should be to cut short the process before it gets underway. Long-term unemployment should be prevented before it starts.

The cost-effectiveness ratio will be much higher for efforts to help people in the period from 6 to 12 months after they become unemployed than for efforts to help them later. Quite possibly the cause of active labour market policy has been damaged by ineffective attempts to help people too late. When people become unemployed, the key thing is that they should remain (or become) employable. If they come to feel useless, enormous long-term damage is done.

Much unemployment is the result of economic change, which kills old industries and generates new ones. It is not the workers' fault if they were in the old industries. But if they have good work records, they are potentially valuable recruits for the new ones - provided they have the

skills. To reskill the unemployed is a serious business. It cannot be done on a shoestring. Sweden spends as much on an unemployed trainee as on a university student. We spend half.

It is equally important that unemployed people keep their work habits and retain their self respect. So we need a completely new approach to how we treat unemployed people.

2. The New Approach

This new approach should be based on two ideas. First, the state has the duty to ensure that everyone gets reasonable offers of work or training within a year of becoming unemployed. Second, the individual has the duty to accept such offers or cease receiving benefit. Thus once a tried and quality-tested system of offers was in place, no one would receive benefit for more than a year unless he was on training or temporary work.

Such a system would take at least 5 years to put in place. In any one year there are constraints on extra money and extra personnel. But to build a new system one must have a clear idea of where one is going. I propose that **European governments should now announce that from the year 2000 they are going to prevent any new entry into long-term unemployment.** This would give them 6 years to build the higher quality services needed to achieve that objective. If Mr. Delors could persuade them to do this in his White Paper, it would be one of his greatest achievements.

So how can it be done? Let me outline an active labour market policy suitable for Britain and with modification for other countries.

(1) To prevent long-term unemployment the *Job Centres* would be instructed to help every unemployed person find some solution within 12 months of his becoming unemployed.

(2) Every unemployed person should have a *personal placement officer* whose job it is to help him or her. All vacancies in the country should be classified and accessible on-line to every placement officer - just as every travel agent or stockbroker has on-line data on the market he serves. The office should regularly send each client a print-out of relevant vacancies which he should pursue. In Britain we now spend only £200 million on helping to place the unemployed (compared with £350 million administering unemployment benefit, and billions on benefits themselves). This is a false economy.

(3) There should be two assisted routes out of unemployment. The first would be *high-quality training*. The training should be intensive and, though it could include periods of work experience, it should be essentially full-time. Training centres should be accredited by a national

body, and funds should be adequate to enable them to train on fully up-to-date equipment for nationally recognised qualifications. In Britain this would require an increase of roughly 100 per cent in the direct cost per trainee. The rate of return to higher quality investment is likely to be higher than to expenditures aimed mainly at reducing the unemployment cost. Unemployed people might have a right to training once they had been unemployed for 6 months.

(4) To break the cycle of dependency, it is important that once a person is trained he is quickly employed. Employers would therefore be asked to participate in an *adult training compact*. Under this the employers would play a role in designing the training, and in return might collectively guarantee to employ those who satisfactorily complete the course.

(5) But for some people training is not the answer. They would benefit little from it. The second route out of unemployment is thus directly to work. But employers need to be sure individuals really are ready for work. Anyone unemployed over nine months should become a member of an intensive Job Club, which would provide an accurate account of his capabilities. *Any employer hiring a worker from this club for a permanent job would be paid a financial inducement*. Employers could also try out a worker for up to ten weeks while the worker was still on benefit - provided the worker was happy with a *job trial* of this kind.

(6) By the end of the 12th month every worker must be placed. This means that temporary *public employment* must be the long-stop. Thus public employers (hospitals, local authorities) or voluntary organisations could employ people out of this pool for free. An unemployed person completing 12 months unemployment would be guaranteed such a six-month job but could not draw benefit unless he was thus employed or in training.

3. Displacement

Sceptics point out that efforts to help people get work are less valuable than they seem because if 100 people are helped into jobs, others are displaced. Thus the total number of jobs does not rise by the full 100. This argument, though important, is usually put forward in a very short run framework. But if more people become employable, the number of jobs will in due course increase by the full increase in the nation's effective labour supply. The real issue is how the policy affects the long-term employability of people.

One would expect all supply-siders to see the matter this way. But unfortunately, when Ministers want to shoot down this kind of proposal, they altogether forget their supply-side credentials. Instead they talk as

though there is a fixed number of jobs, determined by demand. This is bad economics. Over the cycle as a whole the size of the economy is determined by supply, not by demand.

So how can we evaluate the supply-side effects? The most useful basis on which to evaluate these policies is to assume that they last some time, and then ask how they affect the equilibrium level of unemployment. If a policy reduces long-term unemployment, that reduction in long-term unemployment might induce some small upwards pressure on wages, which could only be offset by some increase in short-term unemployment. Thus in equilibrium short-term unemployment would increase. These extra short-term unemployed would have been displaced from jobs by those people saved from long-term unemployment. This is the displacement we should allow for, but it will probably be small so long as the active labour market policies have been well targeted at people whose potential employability would otherwise have been low.

The main point is that policies should be evaluated in a dynamic context by how they affect the future employment paths of the individuals concerned, and not how they affect their current status.

4. Cost and Benefits

So how can we make an estimate of the benefits and costs of preventing long-term unemployment. To some people this seems unnecessary - they consider it obvious that we should reduce unemployment. But this is not obvious to other people who are properly sceptical, like those in the Treasury.

So what are the main benefits and costs? First I shall look at the social benefits and costs, which should be the main criterion - and only later at the impact on the PSBR. From a social point of view the main benefit is the gain in output from having more people employed. For those people employed on temporary work the value added may be low, but the main aim of the policy is to make people more employable and thus to increase regular employment. The main costs are the direct costs of a better employment service, and of extra training and supervision. It is difficult to see how the social benefits would not exceed the social costs.

The net effect on the PSBR is less obvious. Clearly the idea is to spend money (on active labour market policy) in order to save money (on benefits and lost taxes). When the programme has been at full strength for some time, the benefit and tax saving could be huge (in Britain say £8,000 a year times $\frac{3}{4}$ million people, or £6 billion pounds a year). This is of course less than the value of the extra output, but it could still easily exceed the public outlays on better employment services, training and supervision, and job subsidies.

However there is a start-up problem. The result of the programmes operated at time t is to prevent people being unemployed from time t onwards. Thus the benefits build-up slower than the costs. It requires a far-sighted government to embrace such a policy.

5. Strategy of Reform

So let me review the strategy of reform. There are three key points.

First, unemployment is a permanent problem. Unless we can improve our policies, it will be impossible to reduce unemployment in Britain below 8 per cent without steadily rising inflation. So it is quite wrong to devise unemployment policies on the basis that they can be temporary. We need a new structure that will endure, though of course it will need less resources in booms than slumps.

Second, in British social policy reform, the main successes have occurred where a long-term goal was identified and a date named, and a gradual series of steps were then adopted for approaching that goal. Given financial constraints, it is impossible to do a great deal in any one year, but it is wrong to take any one step without knowing roughly where the next step will be. It is quite wrong to develop schemes in the expectation that they will shortly be scrapped, but it is also quite reasonable to undertake experiments like Workstart as part of the process. Now that unemployment will be coming down is the ideal time to start putting in place the new system.

Third, the effectiveness of a system depends not just on the workings of each part but on how the public conceive the system as a whole. For 30 years the Swedish system worked well because people understood that it was considered unacceptable to live indefinitely on benefits. People were expected to help themselves, provided they also received help. It is probably difficult to make a new system work without at the same time persuading the public of a new concept.

The new concept would be that of reciprocal rights and duties. The citizen has the duty to help himself to the maximum possible. The state has the duty to help the person become (or remain) employable and to sustain the person's income. But no income maintenance would be paid beyond a year except for work done or training received.

I believe it is this commonsense idea which guarantees that in the end the active approach I have been advocating is accepted. We simply have to escape from the unhealthy system of "passive dependency" on income provided by the state year after year.

That is the main point I want to make in this lecture. However there is one obvious criticism of the approach - the problem is too big to be handled by this approach alone. I quite agree. For example in Britain at the

average point of a cycle some 800,000 people a year enter a 13th month of unemployment. If they all had to be placed in temporary jobs for 6 months, that would require 400,000 such jobs - a large order.

To reduce the flow, I have already suggested some active labour market steps that need to be taken - training and job subsidies provided for those unemployed for 6-12 months. But two other areas also need urgent attention: the training of young people and the system of wage determination.

6. Training Young People

To prevent long-term unemployment, retraining of adults is essential. But it is also essential that the basic initial training of the workforce be sound. Perhaps the single greatest cause of unemployment in Britain is the number of untrained people we have. In Britain two-thirds of the workforce have no professional or vocational qualification, compared with only a quarter in Germany. This affects the unemployment rate at all ages. But while we can provide only limited training to employed adults, we should act urgently to provide better training for young people, many of whom face unemployment very soon after they leave school.

If we followed Germany, we would require that all teenagers in employment are employed as trainees, with at least one day a week off-the-job training. We should also finance all vocational education and training from collective sources (taxes or levies).

These steps are vital if we are to stop producing further waves of youngsters too unskilled to hold down a properly-paid job in a modern economy.

7. Reform of Pay Bargaining

Thus much could be done to reduce unemployment by improving the employability of the workforce. This would reduce skill shortages and avoid the deadweight of the long-term unemployed. It would alleviate the problem of wage pressure. But it would not remove it. This problem also needs to be addressed directly, as Commissioner Flynn has pointed out.

The basic problem is that, as soon as the labour market tightens up, employers' wage offers leap-frog over each other in order to attract labour and retain and motivate existing workers. And unions leap-frog over each other to try and raise their members living standards.³

Collectively these actions achieve nothing positive: society cannot steal workers from itself, nor can living standards be artificially jacked-up. But the actions do have enormous destructive effects: inflation starts increasing even when unemployment is quite high. We saw this only too clearly in the late 1980s, and we shall see it again in the 1990s unless

governments and Central Banks again put on the brakes while unemployment is still unacceptably high.

So some form of collective action is needed to reflect society's objective of prosperity without inflation. Each country has to find its own way of dealing with this problem. However the evidence suggests that employer solidarity is very important in dealing with this problem. We see it in all the countries which have traditionally low unemployment - especially Japan, Germany, Holland, Austria and Switzerland. The German system is especially interesting, even though it is now struggling with the problem of reunification. Following an informed debate about what wage inflation the economy can afford, the German CBI-equivalent takes a view about an appropriate level of offers and the TUC-equivalent takes a view about an appropriate level of claims. The *Bundesbank* sets the frame for negotiations with a clear nominal growth target. The first negotiation (in one industry and region) then sets the pattern for the rest of the year.

Britain would gain greatly from a similar informed debate about what average pay increase is in the national interest, and the Bank of England Inflation Report and the Magnificent 7 are steps in the right direction. But to secure collective action would require concerted action by the CBI, pushed into action if necessary by the government. The CBI should set a target for maximum wage settlements, and firms exceeding this should explain publicly to a CBI Committee why they have exceeded it. Without some progress on this front, it will not be easy to reduce to a manageable flow the number of unemployed people entering their 13th month of unemployment.

8. Worksharing

I earnestly hope that Mr. Delors will press all the three main strategies I have advocated. But there is a danger that he may also advocate another more pessimistic line. This is worksharing. As a temporary expedient, it could play some role, but as a permanent feature of the system it would in my view be a disaster. It would fail to reduce unemployment and would only reduce national income.

Let me begin by putting the case for worksharing. Suppose that the level of output is somehow fixed, and thus the amount of work to be done is also fixed. Then it obviously makes sense to involve as many people in the work, subject to there being sufficient unemployment to control inflation.

But in the medium term at least the level of output and the amount of work to be done is not immutable. It is determined by the supply characteristics of the economy and these include the system of labour market organisation. Suppose that we started with equilibrium

unemployment under current arrangements and then introduced worksharing. Initially unemployment would fall. But this would generate wage pressure. Inflation would increase. The government or Central Bank would be forced to deflate until unemployment went back to its original level. In the meantime because each worker is working less, national output is reduced. In this way we should have impoverished ourselves to no effect.

If this seems an implausible story, it is in fact confirmed by most of the evidence. In explaining wage behaviour I find no evidence that shortening of hours of work has any effect on the relation between inflation and unemployment.

Of course if people choose to work shorter hours in response to a secular rise in income, then they should do so. But this will not affect equilibrium unemployment.

9. Conclusion

I have said enough. It is vital that unemployment should be reduced permanently below the intolerable levels of the 1980s and early 1990s. But only policies based on hard evidence will be successful. Deregulation may help in some highly regulated countries like France where the high minimum wage is surely a source of difficulty. But there are few policies in my view which will do much good except the three I have outlined.

As Europe begins to recover, it will be the ideal time to put in place a new system. It is indeed feasible to ensure that equilibrium unemployment moves down to 5 per cent by the year 2000, and that we never again see mass unemployment in Europe.

Fifty years ago in the depths of war the British government committed itself in its famous White Paper to a policy of full employment. Appropriately the Employment Policy Institute has now launched a Full Employment Year in Britain.⁴ Let us ensure that within this century we achieve at the least the barest minimum of full employment provided by a system where no one remains unemployed for more than a year.

ENDNOTES

1. Layard, Nickell and Jackman, Unemployment, OUP, 1991.
2. Budd, Levine and Smith, Economic Journal, Vol. 98, No. 393, 1988.
3. "How to End Pay-Leapfrogging", Employment Institute, Economic Report, Vol. 5, No. 5, 1990.
4. See Employment Policy Institute, Full Employment, Southbank House, Black Prince Road, London SE1 7SJ.

FIGURE 1

Outflow Rate from Unemployment and Expected Remaining Duration, by Uncompleted Duration, Britain 1985

(a) Outflow Rate

(b) Expected Remaining Duration

Sources: The data relate to registered unemployment and come from the Employment Gazette.