The European Unemployment Challenge

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1. Introduction: where are we now?

Europe, like much of the World economy, is in the middle of a serious recession with GDP in many countries having fallen significantly. Interestingly enough, looking across the OECD countries, there has not been a very strong correlation between the rise in unemployment and the fall in GDP. For example, in the last year (up to 2009 Q2), GDP in the US has fallen by 3.8% and unemployment has risen by four percentage points. By contrast, German GDP has fallen by 5.9% but unemployment has risen by less than one percentage point. On the other hand, Spanish GDP has fallen by 4.2% whereas unemployment has risen by over seven percentage points over the same period. These variations will be analysed in the next section.

The overall prospects for the World economy indicate a recovery but its strength is the subject of much uncertainty. The balance of recent data is on the upside and there is some evidence of a slowdown in the rate of increase in unemployment. However, unless GDP growth in Europe rises above trend in 2010, it is hard to see how unemployment can fall to any significant degree. So, in section 3, we discuss the role of labour market policies in the context of a sharp fall in GDP followed by a gradual recovery. Then, in Section 4, we consider how we might tackle the problems of vulnerable groups both in the short run and the longer term. We conclude with a summary and some conclusions.

2. The rise in unemployment.

a) Macroeconomic policy.

It goes without saying that the recent rise in unemployment has not been generated within European labour markets but is a consequence of the worldwide credit crunch and the collapse in aggregate demand. So the immediate macroeconomic policy response is the major factor in determining the subsequent path of GDP. Across the world, we have seen expansionary fiscal policy accompanied by a dramatic loosening of the stance of monetary policy. This is a sensible response to a situation where aggregate demand has fallen and there was little in the way of core inflationary pressure even before this fall. This has not been a recession generated to squeeze inflation out of the system. So in our discussion of unemployment, and labour market policies we shall take the path of GDP as more or less a given.

b) Labour market policies and unemployment in the context of the recession.

As we can see from Table 1, there are large cross-country variations in the rise in unemployment relative to the fall in GDP in the recent downturn. To some extent these differences reflect the productivity levels in the hardest hit industries. For example, in Spain, there has been a huge contraction in the relatively low productivity construction sector generating large falls in employment relative to GDP. This was an almost inevitable consequence of the enormous build-up of the construction sector during the house building boom of the mid-2000s. In Germany, on the other hand, it is the high productivity capital goods sector that has been badly hit, leading to much smaller falls in employment relative to GDP.

Table 1

Changes in Unemployment and GDP

	% Change in GDP, 2008 Q2- 2009 Q2	% point change in unemployment May 08 – May 09	Employment protection laws index (2003)	% Share of short-term contracts (2004)
Belgium	-3.7	1.5	2.7	8.7
Canada	-3.2	2.3	1.2	12.8
Denmark	-7.2	2.8	1.6	9.8
Finland	-9.0	2.0	2.3	16.2
France	-2.8	1.6	3.0	13.0
Germany	-5.9	0.3	2.1	12.4
Ireland	-7.3	6.7	1.4	3.4
Italy	-6.0	0.6	3.4	11.9
Netherlands	-5.4	0.4	2.4	14.6
Spain	-4.2	7.4	2.3	32.1
Sweden	-6.0	3.2	2.7	15.1
UK	-5.5	2.3	1.4	5.7
US	-3.8	4.0	0.6	4.2

Sources: OECD, Allard (2005, OECD (Employment Statistics)

Allard's employment protection series is based on OECD methodology.

A second important factor explaining the differences in unemployment rises relative to GDP falls is the strictness of employment protection legislation. The stricter the rules governing redundancy, the slower will be the rise in unemployment for any given fall in output. Strict rules can, however, be avoided if a high proportion of employees are on short-term contracts, for when these contracts come to an end, employment can be costlessly

adjusted downwards. Thus, while Spain has relatively strict employment protection rules, the fact that nearly a third of employees are on short-term contracts means that there can be a very sharp downward adjustments in employment. Italy, on the other hand, has the strictest employment protection laws in the OECD and a relatively small number of short-term contract employees. As a consequence, downward employment adjustments are likely to be very sluggish in response to falls in output. By contrast, the United States has very low levels of employment protection which helps to explain why there is a very large rise in unemployment relative to the fall in output.

The final important factor in this context is the extent to which subsidies are provided to firms whose employees are placed on short-time working in response to falls in demand. Of course, even without subsidies, firms who wish to retain valuable workers in the face of a downturn will negotiate a shorter work week, extra unpaid holidays and the like. But when the government subsidises this type of response directly, obviously such responses will be much more widespread. Extensive subsidy policies of this type have been introduced in Belgium, Denmark, France, Germany, Italy and the Netherlands (see European Commission, 2009). These policies are often accompanied by incentives to use some of the workers “spare-time” for extra training. The advantage of short-time working subsidies is that they maintain the attachment of workers to the labour market over the period of the recession. Subsidies of this kind have been particularly successful in maintaining employment in Germany, with well over one million workers involved in subsidy schemes. Two problems arise with schemes of this type. First, they are generally time-limited because they are not cheap. So if they finish before the economic recovery is complete, this may impede the recovery process. Second, they may interrupt the movement of workers to more productive activities and prevent the contraction of less productive industries or industries where there is general overcapacity. For example, competitive protection of automobile manufacturing across the world may ensure that overcapacity is sustained even as the world emerges from the recession. Of course, there is a collective action problem here since no one country wishes to contract its domestic car industry to the long-run benefit of the rest of the world. This kind of problem means that short-time working subsidies should generally be used for firms whose long-term prospects are strong, such as the capital goods producers typical of Germany. They cannot possibly be used for construction firms which have grown significantly in the sort of construction booms seen in Spain and Ireland, because after the recession they are bound to employ far fewer people.

Overall, therefore, the industrial pattern of the recession, the structure of labour market institutions and the use of specific subsidy policies to sustain employment interact to generate the large observed cross-country differences in the increases in unemployment relative to the falls in output.

3. Labour market policies and the recovery.

a) Policy in the short run.

The speed of the recovery in GDP in different countries will, of course, depend crucially on how macroeconomic policy develops, how credit markets recover and how the manifest problems facing the world economy are resolved. In particular, it is important not to tighten policy too early because of anxieties about the sharp rise in public debt. Generally speaking, those economies which have seen faster falls in employment relative to GDP in the downturn will probably see faster rises in employment relative to GDP in the recovery. Indeed, the existence of flexible short-term contracts and, particularly, widespread temporary employment agencies may allow faster expansion of GDP without excessive inflationary pressure.

b) What measures are to be avoided?

In order to prevent unemployment persistence and, indeed, to sustain labour supply more generally, it is crucial to continue the labour market attachment of those who lose their jobs. Historically, we have not been good at this. Under the pressure of rising unemployment, the force of the “something must be done” argument tended to grow and it was easy to succumb by removing people from the labour force via early retirement, disability and so on. While this reduced the number of the non-employed who were actually looking for work (the unemployed) in the short run, in the long run the inactive population became larger while the unemployment rate was unaffected. The growth potential of the economy was reduced and the fiscal position was worsened.

There is a long and unfortunate history of this policy response so, as we can see in Table 2, by 2007, in the vast majority of OECD countries there were more inactive men aged 25-54 than unemployed men in the same age group, mostly long-term sick or disabled. Furthermore, in many countries, inactivity rates among men aged 55-64 had risen to very high levels in the three decades up to the mid-1990s, despite male life expectancy having risen steadily throughout. The consequences for pension systems were plainly adverse. Indeed it is these consequences which have led many countries to stop providing incentives to encourage

early retirement. Thus, after 1995, we see falling rates of inactivity for older men. Overall, therefore, one thing to avoid above all others, is to be tempted into providing individuals with incentives to retire early or to enter long-term sickness or disability. Sustaining and enhancing long-run labour supply is the direction in which to move.

Table 2

Inactivity Rates Among Prime Age and Older Men

	Men aged 25-54 (%)		Men aged 55-64 (%)		
	1971	2007 (Unemployment rate in brackets)	1971	1995	2007
Finland	7.2	9.7 (4.8)	26.8	58.4	40.8
France	3.2	6.0 (6.3)	25.4	58.8	57.4
Germany	3.7	6.2 (7.5)	21.5	47.3	40.3
Ireland	2.8	8.2 (4.3)	9.0	36.1	30.0
Italy	5.9	9.0 (4.0)	40.7	55.9	53.7
Netherlands	5.1	8.3 (2.2)	19.4	58.6	36.7
Spain	3.5	7.4 (5.4)	15.4	45.1	36.9
Sweden	5.3	7.1 (4.1)	15.3	29.6	23.6
UK	1.6	8.4 (3.7)	11.6	37.6	31.1
US	4.5	9.1 (3.7)	17.9	34.0	30.4

Notes: Individuals in institutions are not included. The numbers are generally small except that close to 2% of the prime age male population in the US is incarcerated.

Sources: *OECD Labour Market Statistics* and *OECD Employment Outlook*, Table C, various issues. For the UK in 1971, we use the *UK General Household Survey* (1972).

c) How do we maintain labour force attachment?

As we have already noted, the key to maintaining the long-term growth potential of the economy is to prevent those who lose their jobs from getting into a situation where it is very hard to get back into work. So they must avoid going into long-term unemployment, early retirement or the disability benefit system. In normal times, it is sensible to devote significant resources to assisting those who are already in one or other of these states back into the labour market. In a recession, given limited resources, the main focus has to be on

those entering unemployment. There will, of course, be much larger numbers of these than in normal times.

The standard policy shortly after entry into unemployment is mandatory participation in an activation programme, monitoring of job search, counselling and job search assistance in return for receipt of benefits. For those lacking skills, policies to enhance employability may be in order although such evidence as we have suggests that training for the unemployed is not a very successful policy. Targeted recruitment subsidies can be more effective. EU countries vary greatly in the rigour and effectiveness of their activation policies. For an excellent discussion of activation policy, see Chapter 5 of the 2009 report of the Swedish Fiscal Policy Council. (See also Martin and Grubb, 2001 and Eichhorst and Konle-Seidl, 2008).

When unemployment duration reaches a given point, six months or twelve months say, then to sustain labour market attachment it is worth introducing a job/training guarantee in return for continuing receipt of benefits. The work would be temporary (6-12 months) and part-time with the individual continuing to search for a regular job at the same time. The work would be socially useful, requiring minimal training, organised at public expense by local authorities or voluntary groups. Only a small minority of EU countries have mandatory schemes for all the unemployed who reach a certain duration although in most EU countries unemployed individuals can be referred to such schemes by the employment service.

There are two problems with all these kinds of policies. First, they are expensive. However, in a serious recession, fiscal policy is going to be expansionary and some of the extra expenditure should be diverted in this direction. Second, a highly professional and well organised employment service is required. Furthermore, its capacity must be increased rapidly as the inflow into unemployment rises, otherwise activation and related policies may be overwhelmed.

d) European Economic Recovery Plan

It is worth briefly commenting on the labour market aspects of the European Economic Recovery Plan in this context. This Plan covers a number of the points considered here. In particular, it focuses on using flexible working time to avoid “wasteful” labour shedding due to temporary demand disturbances. The problem is, of course, knowing what demand disturbances are going to be temporary. We can be fairly certain that the demand for

sophisticated capital goods will recover with the world economy and that the demand for new housing will not recover rapidly in countries which have seen huge house building booms. But, in many industries, the longer term prospects are less certain.

The Plan rightly concentrates on activation measures for the unemployed and the necessity of avoiding long-term unemployment, recommending the use of temporary hiring subsidies. It also recommends reducing social charges on lower incomes to support the low skilled. As a temporary measure as part of a recovery plan this is, perhaps, not a well-targeted policy. It is expensive, it has little impact on poverty since most low paid individuals are not in poor households and will probably have little impact on employment.

4. Tackling vulnerable groups in the short and long run.

a) The short run.

The vulnerable groups are the young, the unskilled and those potentially suffering from long-term sickness or disability. As we have already noted, for the first two groups, the focus has to be on assistance in obtaining work and enhancing employability which should start immediately upon entry into unemployment. For the third group, if individuals lose their jobs because of sickness or ill-health, it is vital to mobilise support before they enter long-term disability. This plainly involves medical support, a focus on the sort of work which the individual can manage and immediate access to effective psychological therapies for those affected by depression and anxiety disorders which may indeed be worsened by unemployment. The worst strategy is simply to allow general practitioners to sign people off work with no further intervention.

b) The long run.

For the young, the evidence suggests that countries which have so-called dual systems have lower levels of relative youth unemployment and smoother and more rapid transitions from education into work (See OECD, 2008, Chapter 1). A dual system is simply one where a national apprenticeship is the way into skilled work for those outside university. The essence of these schemes is that they are national, there is a contractual relationship between employers and workers, the training is of high quality and there are standards which are imposed at a national level, like a driving test. These schemes have been around for a very long time in Austria, Denmark, Germany and Switzerland, and are hard to start up from

scratch. However, some countries feel that it is worthwhile trying to move in that direction, notably Norway, Australia and the UK, because the benefits for the young are so great.

For the unskilled and those without qualifications, it is plain that the quality of schooling at the lower end of the ability range is a key factor. Evidence from the International Adult Literacy Survey indicates that there are huge cross-country variations in the proportion of the population of working age who have minimal skills (See OECD, 2000). It is clear that the labour market will work much better and poverty will tend to be much lower if there is only a small group of individuals with very low literacy and numeracy skills. Those at the bottom of the ability range require additional resources for them to receive effective education. If they can develop marketable skills when young, their entry into the labour market is much easier to organise effectively.

In many, if not most, countries of the developed world, there are more prime age men (aged 25-54) on disability benefit than there are on unemployment benefit. This was not the case in the 1970s. The key factors are the structure of the disability benefit system and the way in which individuals are moved into this system from employment or unemployment. In order to reduce the numbers on disability benefit, two things are required. The first is to control the inflow using policies described above. The second is to apply the standard activation mechanisms allied to medical support to individuals who are already on disability benefit. A good example is the Pathways to Work scheme introduced recently in the UK which has already had some success.

Overall, policies should be work friendly and always aim at enhancing labour supply over the longer term.

5. Summary and Conclusions

The key in a recession is to sustain the attachment of workers to the labour force and to protect those who lose their jobs.

- i) It is worth subsidising worker retention in those sectors where demand is likely to return to pre-recession levels. This can be a very effective policy for sustaining attachment to the labour force.
- ii) At all costs countries should avoid providing individuals with incentives to retire early or to enter long-term sickness or disability.

- iii) Those entering unemployment should participate in an activation programme including monitoring of job search, counselling, job search assistance and medical/psychological support for those suffering from ill-health. Policies to enhance employability and targeted recruitment subsidies may be worthwhile. It is important to expand the capacity of the system to cope with the increased inflow into unemployment.
- iv) Beyond a certain level of unemployment duration, it is worth introducing a job/training guarantee in return for continuing receipt of benefits.
- v) National apprenticeship systems generate smoother and more rapid transitions from education to work and lower youth unemployment than average. Things are even better if those towards the lower end of the ability range have achieved high levels of literacy and numeracy by the end of compulsory school.
- vi) Strict controls over entry into long-term disability and activation mechanisms plus medical support for those already in long-term disability help to control the number of inactive individuals in the working age population.

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