



Full employment is not just a dream

Europe's leaders have pledged themselves to ambitious targets for employment by 2010. Richard Layard and Stephen Nickell here present them with a manifesto for how it can be achieved.



In Europe unemployment is too high and employment is too low. Over 7½% of Europe's workforce is unemployed and only two thirds of people aged 15 to 64 are in work.

At their Lisbon summit in 2000 the EU heads of government set the target that by 2010 the employment rate should rise from 64% to at least 70%. For older workers, aged between 55 and 64, the employment rate should rise from 38% to at least 50%.

These are ambitious targets. They will require two big changes: more people must seek work and, among those seeking work, a higher proportion must get a job. So we need higher participation and (for full employment) we need a much lower unemployment rate.

Can it be done? A mere glance at the experience of different European countries shows that it can. As Table 1 shows, four EU countries already exceed the overall target for 2010 (Britain, Denmark, The Netherlands and Sweden). And eight of the 15 countries in the EU already have lower unemployment than the United States (the previous four, plus Austria, Ireland, Luxembourg and Portugal).

So there is no such thing as "the European unemployment problem". The fundamental problem is high unemployment in four of the five large countries: France, Germany, Italy and Spain. If high overall unemployment in Europe is to be reduced, these large countries will have to learn what they can from the experience of the rest of Europe. At the same time, no European country can be satisfied with its current performance. In every country unemployment is higher than in the 1960s and the participation rate (especially among older workers) is unsustainably low.

Many people doubt whether more jobs will result if more people look for work. Indeed, some believe that the only way to reduce unemployment is to reduce the number of people looking for work – for example through early retirement. This "lump of labour" fallacy is a profound error and, unless people understand the process of job creation, there is no chance of our hitting Europe's employment target.

At any particular moment, the number of jobs is determined by the amount people want to buy – that is by aggregate demand. Aggregate demand is influenced by many factors, mostly outside the direct control of policy makers. However, monetary policy, in particular, is very important. In a recession, aggregate demand is low and this is reflected in higher levels of unemployment. Monetary policy is then generally loosened in order to stimulate aggregate demand. As the economy recovers, at some stage it runs into labour shortages and inflationary pressure. In anticipation of rising inflation, monetary policy is then generally tightened. There is an unemployment problem if, at this point, unemployment is still high.

The key issue is how much unemployment remains when

Table 1. Unemployment rates and employment/population ratios (%)

	Unemployment rate*	Employment/Population**	
		aged 15-64	aged 55-64
Austria	4.0	68	27
Belgium	6.8	60	25
Denmark	4.2	76	57
Finland	9.1	68	46
France	9.2	62	37
Germany	8.1	66	37
Greece	7.3	56	38
Ireland	4.4	65	47
Italy	9.0	55	19
Luxembourg	2.4	63	25
Netherlands	2.6	74	39
Portugal	4.4	69	50
Spain	11.3	59	39
Sweden	5.3	75	67
UK	5.2	71	52
EU	7.5	64	39
EU Target (2010)		70	50
USA	6.0	73	58
Japan	5.2	69	62

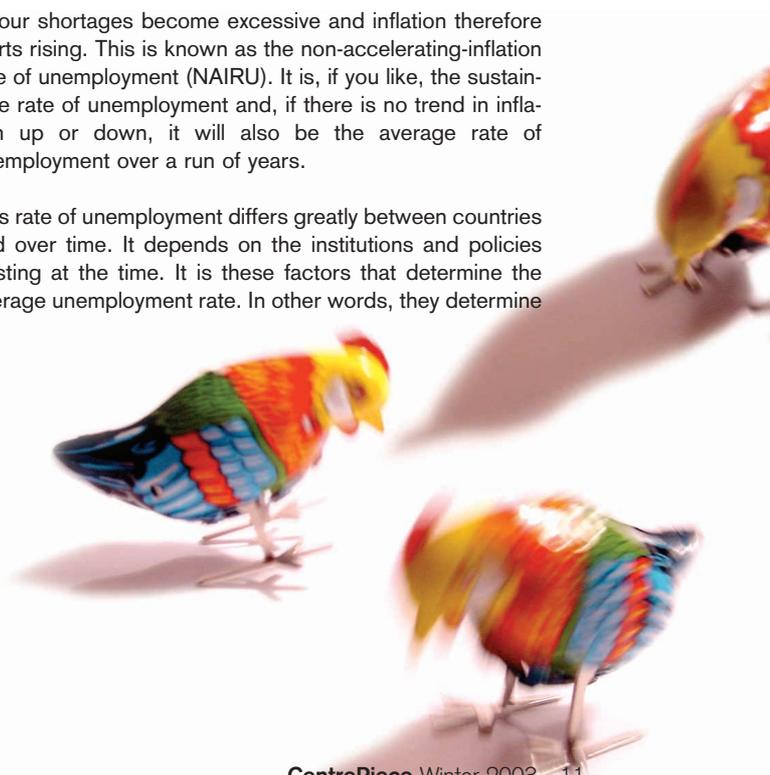
* April 2002

** 2001

Source: HM Treasury Pocket Databank, 31 July 2002; OECD Employment Outlook, July 2002 (pages 304-9).

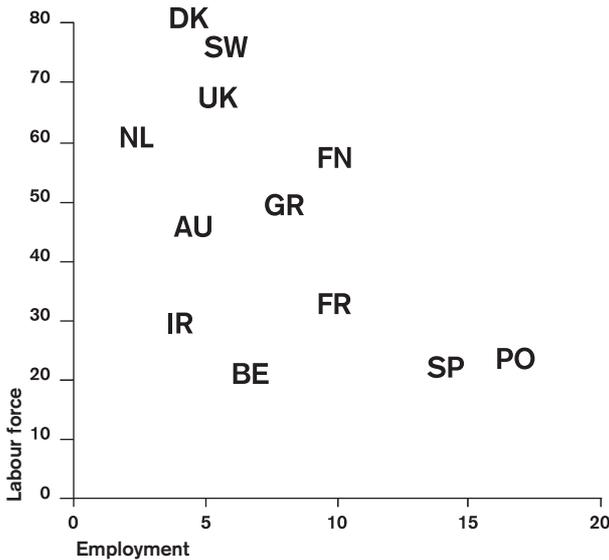
labour shortages become excessive and inflation therefore starts rising. This is known as the non-accelerating-inflation rate of unemployment (NAIRU). It is, if you like, the sustainable rate of unemployment and, if there is no trend in inflation up or down, it will also be the average rate of unemployment over a run of years.

This rate of unemployment differs greatly between countries and over time. It depends on the institutions and policies existing at the time. It is these factors that determine the average unemployment rate. In other words, they determine



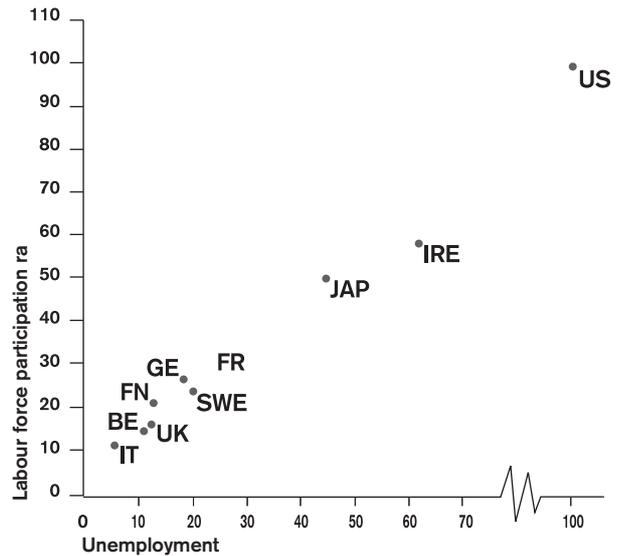
There is no such thing as 'the European employment problem'

Figure 1. % growth in the labour force and employment 1960-2000



Source: OECD Labour Force Statistics, 1958-1978 (pages 18, 24) and 1979-1999 (pages 11- 13); European Economy, 73, 2001 (pages 274-5)

Figure 2. Labour force participation rate (aged 15-64) and unemployment rate, 2000 (%)



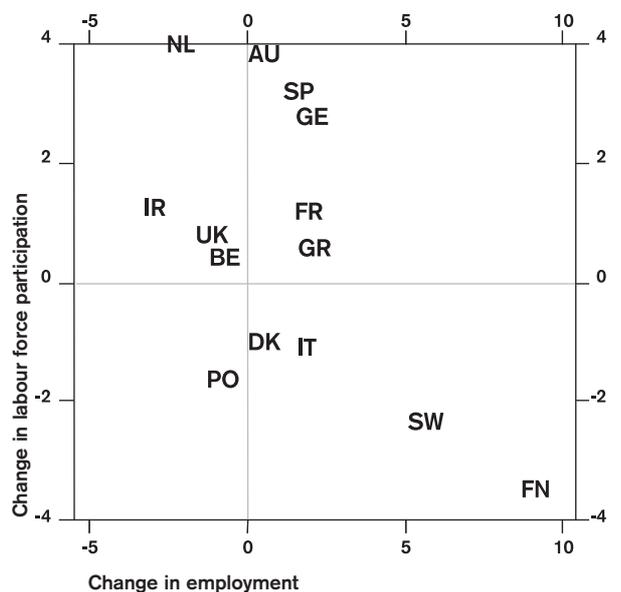
Source: OECD Employment Outlook, July 2002 (pages 208-9)

how many jobs there will be for a given total labour force. At all times the number of jobs will depend on aggregate demand. But, because of the inflation constraint, aggregate demand will be restricted by the amount of available labour. So, over a run of years, the number of jobs will ultimately depend on the available supply of those who are ready and willing to take up jobs. This proposition is crucial and many of the mistakes in employment policy come from a failure to understand it.

If you think of the changes in employment and labour supply over the centuries, it is quite obvious how wrong it is. There is further strong evidence from the recent past. As Figure 1 shows, the supply of labour has grown at hugely different rates in different countries. But the number of jobs in each country has grown more or less in line with the growth in labour supply.

Countries also differ in their levels of labour force participation. If the "lump of labour" theory were true, one might expect those with lower labour force participation rates to have lower unemployment. But, as Figure 2 shows, this is not so. If anything, it is the other way round. One might also expect that the countries that had lowered their participation rate most would have also lowered their unemployment most. Again, as Figure 3 shows, this is not so.

Figure 3. % points change in labour force participation rate (aged 15-64) and in unemployment rate (1990s compared with 1980s)



Source: OECD Employment Outlook, various issues

The 'lump of labour fallacy' is a profound error

So the starting point is that, if we increase the supply of labour, we shall increase employment. This has two implications. First, we can increase employment by increasing labour force participation (for example, that of single mothers or older people). Second, we can increase employment by increasing the effective supply of labour from people who are already searching for work unsuccessfully.

The key evidence concerns the relation between unemployment and vacancies. When vacancies are high, unemployment should be relatively low – because it is easy for unemployed people to find work. Yet, strikingly, in France, West Germany, Belgium and Spain vacancies in recent years have been extremely high by historical standards, despite high unemployment. (No vacancy data are available for Italy.) It is this high level of vacancies that helped to generate increasing European inflation in 2000/1, which led to higher interest rates and the end of the European recovery.

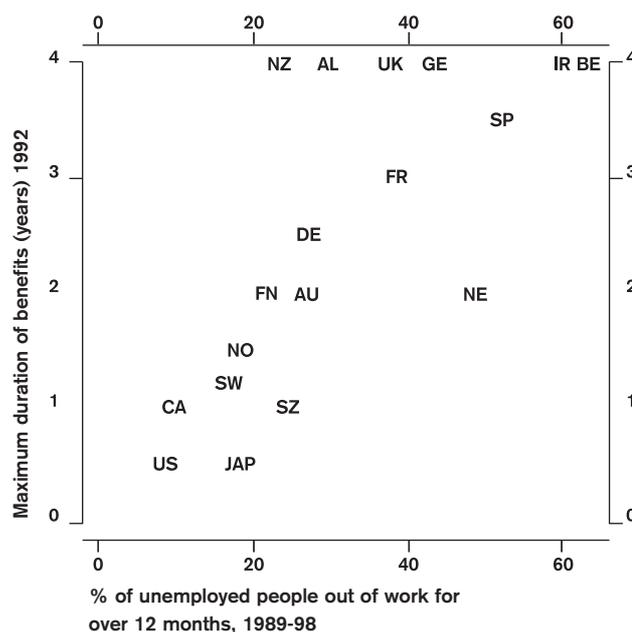
In all these four countries vacancies in 2000/1 were far higher than in 1975. One would, therefore, expect that unemployment would have been lower than in 1975. But in fact it was more than double (except in Belgium). The main upward shift of unemployment relative to vacancies occurred in the 1980s. During that period a similar shift occurred in almost every European country. But in Britain, Denmark, and The Netherlands something different then occurred in the 1990s. Unemployment fell back close to its level in 1975. This reflected a structural shift, since vacancies did not rise compared with 1990 – if anything the reverse. So in these three countries the unemployed became much more effective at filling vacancies, while in France, Germany, Belgium and Spain they did not. Why was this?

There is no evidence of any major change in the mismatch between the characteristics of the unemployed and the characteristics of the jobs available in any of the countries we are discussing. So the change must have been a change in the matching process – in how unemployed people are treated.

Even in the 1980s it was evident that unemployment differences between countries were influenced by how unemployed people were treated. It was striking that the United States had virtually no long-term unemployment (defined as a duration of over a year), while Europe had almost as many long-term unemployed as short-term employed. The most obvious explanation was the long-duration unemployment benefits that existed in Europe but not the US. This relationship is depicted crudely in Figure 4.

The duration and level of benefits are one set of factors influencing unemployment. But even more important is the help that unemployed people get in finding work and the conditions that apply to the receipt of benefit. These two

Figure 4. Long-term unemployment and the duration of benefits



Source: Benefit duration is from Nickell and Layard in Ashenfelter and Card (eds), *Handbook of Labor Economics* Vol. 3 and relates to 1992. LTU data are from OECD *Employment Trends* and relate to 1989-98.

factors, active labour market policy and benefit conditionality, work best in conjunction with each other.

Clearly, one way to reduce long-term dependence on benefits is to make sure that they are used for their intended purpose – to support people who are not working and who really cannot find work. In other words, the right to benefits must be matched by an obligation to get a job, if jobs exist. There must be a “test of willingness to work”.



The key concerns the relation between unemployment and vacancies

As a recent OECD conference revealed*, countries differ amazingly in the framework within which benefits are dispensed. Experience shows that unemployed people are more available to fill employers' vacancies, if

- (i) benefits are paid through the same office as that where people are placed in work;
- (ii) unemployed people have to attend regularly in person; and
- (iii) unemployed people are expected after a period to be available for most types of work, even if this involves substantial journey times or even (as in a few countries) moving home with the help of a subsidy.

The problem with imposing strict availability conditions is that these are difficult to apply unless the employment service is extremely active in helping people to get offers of work. So a "stricter benefit regime" to reduce "passive" dependence on benefits only makes sense if linked to an "active" labour market policy to help people back into work. The two should be complementary.

This is the policy known as "welfare-to-work". The phrase comes from America, where it mainly applies to lone mothers. But the practice as applied to unemployed people has been mainly developed in Europe. Denmark, The Netherlands and Britain all introduced major welfare-to-work policies in the 1990s. And in the last year or two France, Germany and Spain have taken more limited steps towards greater conditionality.

In labour market policy there has to be an especial focus on preventing long-term unemployment, since it is so destructive. This means ensuring that everyone gets offers of work or training within a year or so of becoming unemployed, as required by the EU Luxembourg Guidelines. Britain, Denmark and The Netherlands do this for young people, but only Denmark and The Netherlands do it for people of all ages. The aim must if possible be to channel offers of work from regular employers, mainly in the private sector. But, to prevent long-term dependence on benefits, we need to ensure some worthwhile activity for everyone. It must be actively aimed at employability, so that, when we cannot secure a regular job, we should offer meaningful work with NGOs or socially useful projects. The measure of success is the numbers who get regular work and keep it.

Welfare-to-work must involve the principle of mutual obligation. The state has an obligation to ensure that offers of work are channelled to every unemployed person within a reasonable time after becoming unemployed. But in return the citizen should take advantage of those offers, or lose some or all of their benefit if they do not do so, unless there are medical reasons to the contrary. The Luxembourg Guidelines should be extended to include this.

As always, there is the issue of whether such policies can

really expand employment. Many doubt whether active labour market measures can work owing to "displacement" and "substitution". In extreme form, these fears derive from the "lump-of-labour" fallacy: if the number of jobs is fixed and we enable Mr X to get one of them, then some other person must by definition go without work.

Evidence on substitution and replacement is by its nature difficult to obtain. In the past it has been mainly got by asking questions to employers. When a subsidy is evaluated, employers are often asked: 1. How many of those hired would you have hired anyway? ("Deadweight"); 2. How many of the jobs would have been filled by other recruits in any case? ("Substitution"); 3. How many of the new subsidised jobs represent an increase in your own employment at the expense of your competitors? ("Displacement"). The measure of net job creation resulting from the subsidy is then said to be the total number of subsidised jobs minus 1, 2 and 3.

Until recently this procedure has been used almost universally and often implies that net job creation is only 20% of the total number of jobs subsidised. Yet these estimates of substitution and deadweight are based on a theory of the labour market that is never used for any other purpose.

The theory being used is that, if somebody would have been employed in one place and that opportunity closes down, then unemployment increases permanently – by that amount. This makes no allowance for the possibility that people who find one channel of employment blocked will find another channel. The procedure is especially extraordinary when one considers that typically half the people

*See *Labour Market Policies and the Public Employment Service*, OECD 2001.]



Countries differ amazingly in their benefits framework

supposedly sent into unemployment by the process of substitution are people who already have a job and would have simply been changing jobs.

Only recently have economists began to realise that the old assumptions about substitution are invalid. Lawrence Katz of Harvard University, for example, has insisted on a more rational analysis of the main US wage subsidy programme for youth, the Targeted Jobs Tax Credit. Until 1988 it covered disadvantaged young people aged between 18 and 24, but from then onwards it ceased to apply to people aged 23 and 24. This change provided a good controlled experiment, enabling one to isolate the effects of the subsidy previously on the employment of 23 and 24 year olds. His conclusion was 40-52% of the subsidised jobs had represented net additions to employment.

Interestingly, evaluations of more intensive job search assistance have never suffered from the problems discussed above. They have generally shown good value for money. These can have the added advantage that extra effort is easily focussed on those who really need it. This is an important element in any active labour market policy and helps to reduce "deadweight".

One further point on unemployed people. Throughout Europe, ethnic minorities are a growing proportion of the labour force and their unemployment rates are usually much higher than the average. Ethnic minorities need especial help and the same principle applies to them as to all citizens: the principle of rights and responsibilities. They, more than most, need the right to offers of work or training but they also have the responsibility to master the language of their adopted country and to use the offers that are available to them.

Moving on to older workers and mothers, there are two issues that these two groups share in common. First, there is the issue of distortions. Those not working may for that reason be receiving state benefits, in which case there is a cost to the rest of society and, therefore, a possibility that incentives are inefficiently distorted away from work. Second, there is the issue, arising from higher longevity and lower birth rates, that we need to increase the numbers in work in order to pay for the growing numbers of dependent elderly. That said, the reasons for non-participation are very different for older people and for single mothers – and so are the policies needed to increase participation.

Among older people (aged 55 to 64) only 42% are in the labour force and only 38% are working – making an unemployment rate of 8%, the same as the overall rate. This highly unsatisfactory situation is very similar to what it was ten years ago. To find out what is causing it, we can learn a lot from the huge differences in participation rates and employment rates across countries (see Table 1) and their time series variation. There are a number of key explanatory factors.

The first is the standard age of retirement at which state benefits become payable. The second is the use of unemployment benefits as a form of early retirement benefit, with none of the usual job search conditions attached. And the third is the availability of invalidity benefits, often not properly monitored to see whether the person still suffers from the problem they had when they first went on to benefit. (Some 15% of all men aged between 55 and 64 are on invalidity benefit in Britain, Germany and Italy and 25% in The Netherlands.) To achieve higher participation of older workers will require changes in all of these practices, but especially in the standard age of requirement.

But there must also be wider changes in society's attitudes and approaches to older people. By 2006 at the latest every European country must have introduced laws against age discrimination in employment. But this will only succeed if at the same time older workers become genuinely more attractive to employers through progressive updating of skills, either by workplace learning or independent study. Continuous learning and adequate job mobility in middle age are important to prevent workers become burned out or bored before their natural working life is over.

Among people of working age, mothers are the other main group who are often not working. The number of non-working mothers is falling rapidly, but must continue to fall if employment targets are to be met. For policy purposes it is important to distinguish between those whose choice is relatively undistorted (married mothers) and those who may be eligible for state benefits. The single mothers face us with the more serious problem.

The first issue is the availability and conditionality of income support from the state. In some countries, like Britain, support is available without any job search requirement. In others, job search is required except when the children are very young. Generally, participation is higher where job search is required. A second issue is the availability of work with suitable hours. Where part-time work is readily available, some mothers who would not otherwise work will choose to do so. Then there is the question of leave. If a pregnant mother retains her right to return to her job, employment rates will be higher. And, finally, there is the issue of childcare – the more childcare is available, the more women will work. If Europe wishes to achieve its employment targets, all these issues will have to be addressed.

We have focussed so far on the supply side of the market, but the demand side is also important. If wages are held too high, employers will not employ the available supply. There are two issues here. One is the general level of real wages. At a given level of unemployment, these will be pushed too high, either if the unemployed are not effectively supplying their labour, or if there is autonomous wage push, due for example to union militancy or rises in import prices. Wage push is only likely in the context of unions and has been

40-52% of subsidised jobs represent net additions

avoided in many of the smaller European countries by coordinated efforts of employers and unions (The Netherlands), or sometimes by the unions on their own (as at times in Sweden), or by employer solidarity (Portugal).

The second and most serious problem concerns relative wages, across skills or regions. Unemployment rates are much higher for unskilled people. One reason for this is a greater rigidity of wages at the bottom end. However, most legal minimum wages in Europe are low enough to cause no problem. Indeed, in some monopsonistic markets they may even raise employment. The more serious consequences of wage rigidity occur at the regional level, where overly high wages are a major cause of unemployment in the former East Germany, southern Italy and southern Spain.

Experience in the US (and to a degree the UK) suggests that marked differences in unemployment rates across regions can be reduced whenever two re-equilibrating factors are at work. The first is wage adjustment. If unemployment is higher in one region than another, wages in the high unemployment region decline vis-à-vis wages in the low-unemployment region. This attracts investment, which leads to more jobs in areas of high unemployment. The second re-equilibrating factor is regional labour mobility: net migration away from the high-unemployment regions.

In Continental Europe, these two re-equilibrating factors are often not allowed to operate properly. Centralised wage-setting institutions deter the emergence of significant regional wage differentials. At the same time, a number of factors – including state transfers to the high-unemployment areas – reduce the pressure to migrate. Thus, large regional labour market imbalances – the North-South divide in Italy and Spain or the West-East divide in Germany – are a prominent feature of the European landscape. Persistently high unemployment in some regions is also associated with low participation rates and a deterioration of the environment in which firms have to operate. In high-unemployment regions the public sector tends to pay more than the private sector (at least in terms of entry wages) and provides more job security. If it is difficult to get a public sector job when already employed in the private sector, this encourages “wait unemployment”, where people (sometimes the most educated people) queue for public sector jobs to become vacant.

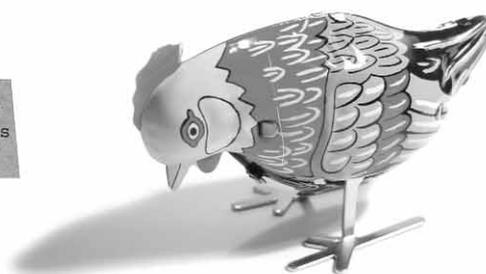
In order to move these regions away from the high unemployment/low participation equilibria in which they are

trapped, it is necessary to act on both the demand and the supply side. On the demand side, it is necessary to pursue greater decentralisation in collective bargaining; wages should be allowed to vary across regions so as to reflect more closely the differences in labour productivity and the cost of living. Decentralisation in pay determination should extend to the public administration and be accompanied by the introduction of incentives for higher productivity and hiring procedures that discourage queuing.

On the supply side, the task is to bring welfare-to-work principles into the cash transfers provided to non-employed individuals in these regions. A key requirement here is to have unemployment benefits, rather than other instruments (like early retirement and invalidity pensions) that merely encourage non-participation in the labour market rather than supporting job search. Welfare-to-work should encourage regional labour mobility, but should circulate information on jobs available in more buoyant labour markets and sometimes also subsidise moving costs. Regional mobility should not necessarily involve long-range migration, as there are often areas within the high unemployment regions that are more dynamic.

Finally, there is the thorny issue of employment protection. In public rhetoric it is common to attribute high European unemployment to high employment protection. But in fact employment protection is especially high in some European countries (like Portugal, Sweden, Norway and The Netherlands) where unemployment is well below the US level. The bulk of the economic evidence suggests that employment protection raises long-term unemployment (by reducing hiring), reduces short-term employment (by reducing firing) and has no clear effect on total employment. But specific policies to prevent the closure of enterprises are inefficient.

The main danger of employment protection is that it strengthens the hand of workers in wage bargaining, leading to excessive wage pressure even when unemployment is high. Any effort to reduce employment protection should have this issue firmly in view. Unfortunately, the famous Spanish labour market reform of 1984 did not. It introduced temporary employment contracts, while actually increasing the security of the insiders who were already employed. As a result, there was no reduction in wage pressure. All efforts aimed at creating a dual labour market are likely to fail in exactly the same way as the original Spanish reform.



There must be changes in society's attitudes to older people

Our conclusion is that what really matter are:

for unemployment

- how unemployed people are treated
- regional wage flexibility

for the employment of older workers

- reduced subsidies to inactivity, used if necessary to finance employment subsidies
- lifelong learning
- an older official retirement age, where appropriate
- anti-discrimination legislation

for single mothers

- reduced subsidies to inactivity
- more child-care help
- more opportunities to work part-time

Full employment is not an unattainable dream. We can eliminate long-term unemployment and ensure that all who want work can find it within a reasonable time. The principles to achieve this aim cannot usefully be summarised as simply a need for "more labour market flexibility". In many cases what is needed is more activism and even, sometimes, more regulation.

We must stop pretending that "more flexibility" is the answer to all our employment problems. What is required is a clear focus on the three main issues that will make a difference: the treatment of the unemployed, the flexibility of wages and the treatment of older workers.

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