The Road to Recovery: Getting Britain Back to Work

the work foundation

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Executive Summary

The global context

- The global economy remains in recession, but there is a strong possibility that there will be a return to growth in 2010.
- The risk is that the recovery will be slow, sluggish and initially jobless. Further co-ordinated action by the G20 is needed to ensure that the global economy returns to a stable growth path.
- Unemployment is rising across most of the G20. So far as the developed countries are concerned there is no linear relationship between the fall in output and the rise in unemployment – German and British unemployment is lower than one would expect given the reductions in GDP in both countries. The differences are explained by labour market policies.
- Stimulus policies have been implemented by all major economies. No country is proposing to either withdraw the stimulus or embark on a deficit reduction programme for the duration of the recession.
- Monetary policy has been accommodative in most major economies. Both the Federal Reserve and the Bank of England have experimented with quantitative easing although the results are not yet clear.
- The UK entered the recession with a rather low debt to GDP ratio. While the level of debt will be higher than the Chancellor's preferred prudent level of 40 per cent, it is not out of line with other major economies.
- All countries have seen their budget deficits rise. The UK's deficit is more a result of declining tax revenues following the collapse of property prices and financial markets than a consequence of profligate spending.

UK labour market overview

- Given the fall in output the UK's labour market performance has been good – or at least not as bad as one might have anticipated.
- This may be because employers are hoarding labour. Workers are agreeing to reductions in pay and hours to avoid becoming unemployed. Employers benefit from retaining valuable human capital so that they can avoid bottlenecks and labour shortages when the recovery comes. Most of the narrative about this form of flexibility is based on anecdote or small sample surveys rather that robust evidence.
- In previous recessions it has taken up to four years to reach the pre-crisis level of output. Employment takes much longer to recover – sometimes taking almost a decade to reach the pre-crisis level. We are in an early phase of the recession in the UK and, while unemployment will probably rise further, there is uncertainty about where joblessness will peak and when significant reductions in unemployment will occur.

- So far long term unemployment (as a percentage of all unemployment) is remaining stable, suggesting that the UK does not yet have a problem of rising structural unemployment. Much depends on monetary and fiscal policy. A rapid withdrawal of stimulus and rising interest rates could have a very damaging effect on the unemployed.
- Far from being a middle class recession, the groups worst affected are those employed in low skill occupations. Moreover, unemployment has risen fastest in those regions where it was already high.
- A consequence of this process is an acceleration of structural change in the economy. Processes that would have unfolded over a decade – the decline in elementary jobs and the rising numbers employed in knowledge intensive occupations is happening faster than predicted. This will have big implications for the structure of the economy post-recession and the opportunities available to those with low skills.
- A moderately pessimistic outlook would assume that employment levels in distribution and hospitality return to their pre-recession levels but do not grow significantly beyond them and public service employment levels remain at their current level. This implies that market based knowledge services would have to grow much faster than in previous recoveries if the return to previous employment levels is to be achieved by 2020.

Policy measures

Government must focus on two priorities:

- Minimising the inflow of new claimants onto the unemployment register;
- Preventing the scarring effects of youth unemployment.

Specific policy proposals include:

- The introduction of a short-time working scheme similar to the arrangements that apply in Germany. This has helped to keep German unemployment low and it has been matched by a more ambitious stimulus package than in the UK.
- A one-off expansion of HE places in 2010 so that all suitably qualified applicants are guaranteed a university place. There is an increase in the size of the age cohort in the next year (which will disappear in 2011). We are not calling for a reduction in standards or entry requirements, simply an increase in resources so that the grades good enough to secure access in 2007 are the same as the grades to secure access in 2010.
- The adaptation of the job guarantee so that:
  - An assessment is made at six months whether a young person will find a job before the ten month period expires;

  - More intensive job search support for those most likely to find jobs;
  - A strong skills development element in the job guarantee itself and full integration with other employment programmes;
  - Continued job search during the job guarantee period;
  - A link to a real job at the end of the programme: what is the job on offer at the end of the job guarantee? The DWP should build on the success of Local Employment Partnerships in widening opportunities for young people who have been through the job guarantee.
- An immediate increase in JSA of £10 per week. This is a symbolic policy change designed to provide more support to the unemployed and open up a sophisticated discussion about the UK's labour market model and the extent to which insights can be derived from those countries that have adopted a flexicurity model.

1. The global context

Introduction

Over the last year The Work Foundation has offered regular commentary on the performance of the UK's labour market, outlining the necessary actions for policymakers at national and international level. We have also called for the recapitalisation of the banking system, a fresh approach to financial market regulation, the continuation of flexible monetary policy and experimentation with quantitative easing. These are now all matters of consensus and have been embraced by governments of all political persuasions across the globe. The level of intervention has been on an unprecedented scale in peacetime and the cumulative cost of the bank bailouts, fiscal stimulus and operation of the automatic stabilisers is astonishing.

It can also be said with confidence that prompt action by policymakers has prevented the recession turning into a catastrophic depression. To that extent the lessons of the 1930's have been learned. Indeed, the IMF's recent World Economic Outlook recognises the successes of the last year and emphasises the importance of continued counter-cyclical measures.[1] In other words, the fiscal stimulus packages should remain in place until it is clear that recovery is under way and only at that point should governments begin to implement a policy of fiscal consolidation. Earlier action could run the risk of throttling the recovery before it has had a chance to mature – and with private investment and consumption still weak across much of the developed world, the case for continued action is irresistible.

What is most surprising, perhaps, is that this international consensus is not reflected in a comparable domestic consensus in the UK. The national economic policy discussion has been refocused on the scale of the public debt and deficit, not the risk of deflation or a double dip/w shaped recession. Moreover, the Conservative Party takes the view that the stimulus package was unaffordable when it was implemented and that fiscal consolidation should begin immediately. This looks like a serious policy error which, if applied in practice, could delay the process of recovery and ensure that at best the UK grows more slowly than comparable European economies or at worst that the economy is tipped back into recession. According to the IMF, the policy stance in the UK and internationally is rooted in sound economic analysis. Indeed, the most significant risk next year is that the withdrawal of fiscal stimulus planned in some countries (including the UK) could lead to a fall in demand before the recovery has become embedded. This is far more problematic than the risk of inflation following the recent application of unorthodox monetary policy (quantitative easing). In our view there is no case for an immediate cut in public spending. To accept this argument would be to surrender to a flawed analysis and would ignore the IMF's injunction that a further stimulus may be needed if the private sector is failing to drive the recovery forward.

[1] IMF, *World Economic Outlook, October 2009: Sustaining the Recovery* (2009)

The purpose of this paper, published in advance of the chancellor's pre-budget report, is to review the global context, evaluate the UK's labour market performance and outline some policy measures for further consideration. We will return to all of these issues at greater length in our formal budget submission. At this stage the most important task is to rebalance the curiously lopsided debate about economic policy in the UK. International comparisons are invaluable for this purpose and that is where we begin our discussion.

Growth

It has been clear for some time that 2009 will be a difficult year for the global economy. Most of the major developed countries are in recession and in some cases the decline in output has been dramatic (Figure 1.01 on the next page). Both Germany and Japan will see their economies shrink by almost 5.5 per cent this year, largely as a result of the collapse of their export markets. Ireland has been worst affected of all the economies under review, with GDP projected to fall by 7.5 per cent in 2009. While a return to growth is forecast for 2010, there is, as the IMF suggest, a serious risk that the recovery will be

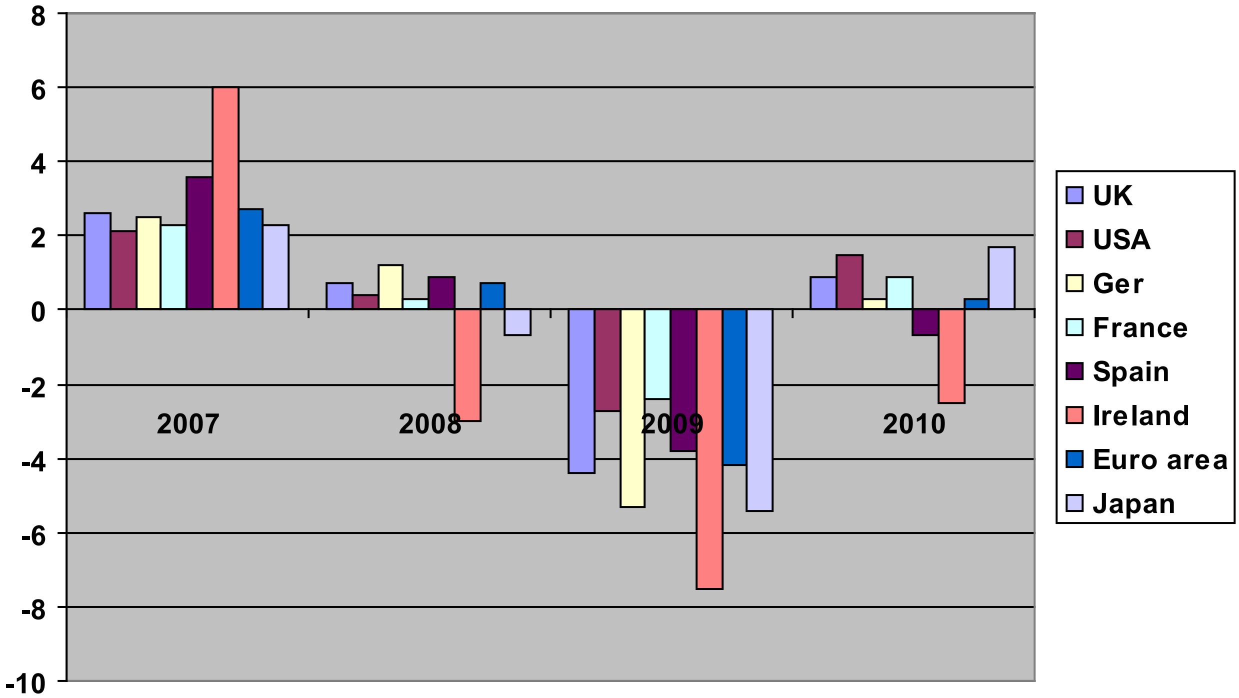
> *sluggish, credit constrained and, for quite some time, jobless*.[2].

This observation is made in the context of the statement that the global recession is ending, but the prospects are far from bright. So, for example, banks in the developed world are still holding large quantities of bad debt. According to the IMF's recent financial stability report, global bank write downs could reach $2.8 trillion of which fully $1.5 trillion has yet to be recognised. These same banks also face a wall of maturing debt (debts about to become due), which will reach $1.5 trillion by 2010. These figures are astounding and suggest that much ground remains to be covered before it can be said that the world has discovered the route to a robust economic recovery.

A further cause for pessimism is that there is plenty of spare capacity remaining in many of the advanced economies. Households are consolidating their own finances and are repaying debt. Organisations are witnessing a reduction in demand that encourages a cautious approach to investment. Even the rosiest scenario predicts that subdued demand will restrain the process of recovery in the advanced economies.

[2] Ibid, p.1

Figure 1.01: GDP growth 2007-10



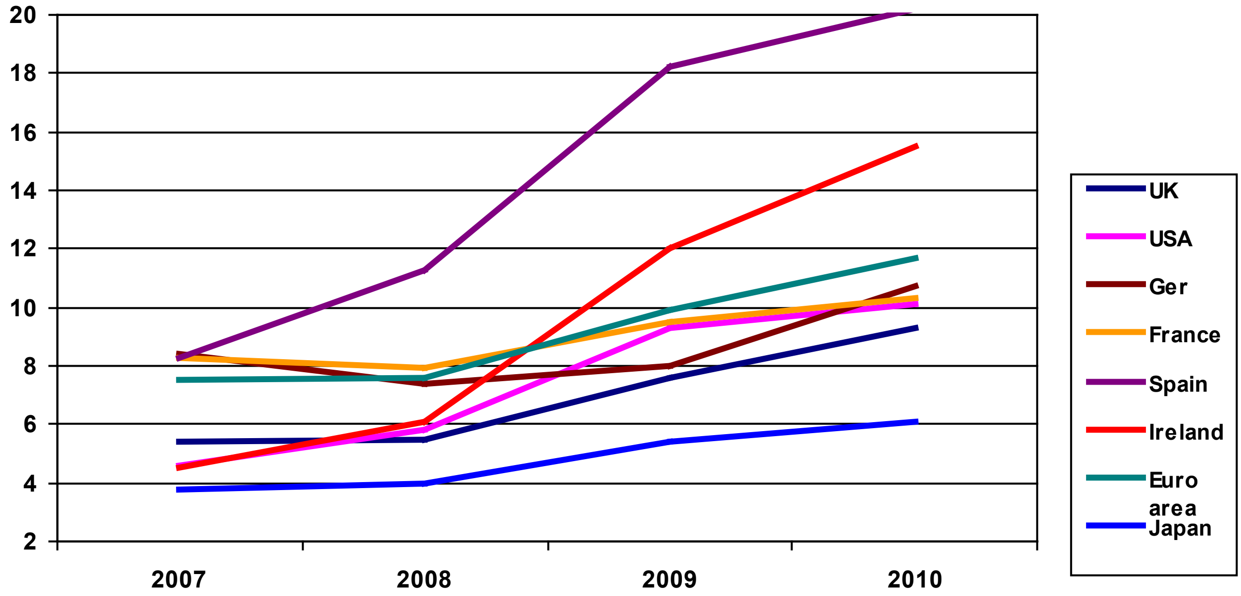
Source: IMF

Unemployment

It is hardly surprising then that unemployment has continued to rise over the last year (Figure 1.02 on the next page). What is striking of course is that different labour markets have responded very differently and that the extent of labour market adjustment is not simply explained by the extent of the fall in GDP. So, for example, unemployment in Spain is expected to exceed 20 per cent in 2010, whereas unemployment in the UK will lie at 9.3 per cent, despite the fact that the downturn in the UK has been more severe than in Spain – although the Spanish have seen a similar property and construction boom come to the same ignominious end.

Ireland, which has witnessed a catastrophic collapse in GDP (-3 per cent 2008, -7.5 per cent 2009, -2.5 per cent forecast for 2010) has experienced a very significant rise in unemployment but remains below the Spanish level. In part this can be explained by the fact that Irish unemployment was starting from an already lower base, but the insider-outsider nature of the Spanish labour market (where almost a third of workers are employed on temporary contracts) may also encourage employers to shed highly 'flexible' labour in a downturn, secure in the knowledge that there will be a ready supply of workers willing to accept temporary contracts when the recovery materialises.

Figure 1.02: Unemployment 2007-10 (%)



Source: IMF

Viewed in this light the UK's labour market performance looks rather good (an issue to which we return in the next section). We know that employers, employees and their unions have been negotiating agreements, with the specific intention of keeping people in work, allowing for a high level of pay and hours flexibility. Some firms in the automotive sector have used limited shutdown periods as an alternative to redundancies and, as the latest unemployment figures show, the labour market looks like it is performing better than in previous recessions.

Another important insight is that public policy can make a big difference to the number of employees flowing on to unemployment related benefits. Germany is a good example of decisive and effective action. The government has given explicit support to agreements between employers and trade unions trading off reductions in hours and earnings for a guarantee that there will be no job losses. Most importantly perhaps, the government guarantees to pay the affected workers up to 67 per cent of their lost net earnings. Obviously this has the advantage of protecting workers' purchasing power and maintaining demand in the economy. From the employer's perspective, short-time working enables the business to retain human capital and avoid any bottlenecks in filling vacancies when the recovery arrives. These arrangements are generally accepted as an important element in the German response to the crisis and are treated more as an automatic stabiliser than an unusual policy instrument suitable only for critical conditions. A more detailed account is given in Section 3, where we examine the possibility of implementing a similar scheme in the UK.

It should be obvious that the structure of the labour market and such factors as the level of contingent employment, the protection of 'insiders' (those with decently paid secure jobs) and the availability of short-time working can influence the dynamics of unemployment. Once again the IMF analysis is helpful, pointing out that:

> *The more moderate increase in the unemployment rate in Europe reflects these economies' greater tendency to adjust payrolls in response to changes in demand by lowering hours worked rather than the number of workers, a practice encouraged in part by labour market policies and institutions.*[3]

In simple terms, Anglo-Saxon or liberal market economies shed more jobs than co-ordinated market economies (like Germany) as the recession starts to bite. But the corollary of this phenomenon is that job creation is faster in liberal market economies as a recovery begins to mature. The question for policymakers is whether more of an effort should be made in countries like the UK to smooth the fluctuations in employment and unemployment over the course of the cycle. Our answer is an unequivocal yes, largely because of the clear evidence that work is better for life chances and life expectancy than worklessness. Moreover, there is a serious risk that what begins as cyclical unemployment can rapidly become structural unemployment unless determined action is taken to integrate the jobless back into the labour market.

That the increase in unemployment has, with some major exceptions, been less than catastrophic (just before the New Deal in the USA the level of unemployment was around 25 per cent), reflects the effectiveness of both domestic and international action. The international policy response to the crisis has four elements:

- Fiscal stimulus;
- Monetary policy (both conventional and unconventional);
- Stabilisation of the banking system;
- The operation of the automatic stabilisers.

[3] Ibid, p.7

Fiscal measures

Two previous papers in our 'crisis' series (*Hard Labour* and *A Boost for Britain*) have documented the extent of fiscal activism in the USA and Europe. We noted that the UK's stimulus package was modest by international standards and, contrary to the strictures of the IMF, was due to be withdrawn in large measure by the end of the year. Moreover the capital component of the package was investment planned for 2010 brought forward to 2009, and the natural consequence is that public investment will fall as a share of GDP in 2010 (Figure 1.03 on the next page). This fiscal tightening could be implemented at a time when there are significant downside risks. It is the stimulus package that has helped to keep the economy afloat for the last year and the case over the next twelve months is for continued stimulus rather than consolidation and debt reduction. That is the clear implication of the communiqué from the G20 summit in Pittsburgh, where world leaders made clear their belief that the case for activism remained strong.

Indeed, the UK is unique in this context in planning to *withdraw* stimulus in 2010. Of course, there is an argument that the labour market has performed much better than expected (of which more in the next section), but bank lending remains sluggish, retail sales are subdued and the IMF's most optimistic forecast is for weak jobless growth in the next year. Inaction is completely inconsistent with the laudable aspirations adopted by the G20.

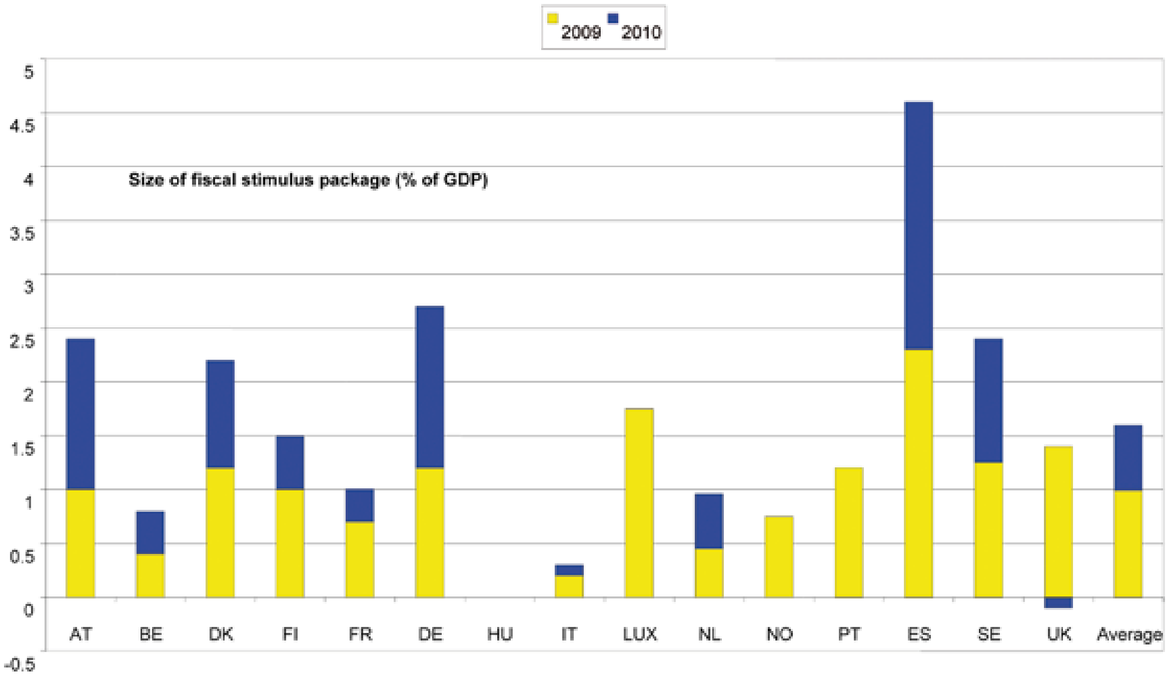
As the IMF has pointed out, it has proved difficult to measure the detailed implementation of the stimulus packages because not all countries are publishing detailed information.[4] Equally, it is proving difficult to assess the impact of the packages because the multiplier effects are not entirely clear. Nonetheless, the IMF have reviewed the literature and identified the following conditions for fiscal policy success:

- Spending increases are more effective than tax cuts.
- Multiplier effects are larger when monetary policy is pulling in the same direction as fiscal policy.
- Fiscal action is most effective when co-ordinated across countries.
- The effectiveness of fiscal action can be undermined if there is a lack of credibility about the government's commitment to return the budget to balance as the recovery matures.

Not only is the UK's package set to be withdrawn in 2010, but the principal component, the reduction in VAT, is self-evidently a tax cut rather than an increase in spending. That said, it is impossible in the short term to make a judgment about whether the VAT cut has worked or not.

[4] Horton et al, *The state of the public finances: A cross country fiscal monitor*, IMF Staff position note, July 2009, IMF (2009)

Figure 1.03: Distribution of fiscal stimulus packages over 2009 and 2010



Source: European Commission

Retail sales may be subdued, but the position could have been even worse without government intervention. Furthermore, the action in the UK *has* been co-ordinated internationally through the G20 and monetary policy has supported the objectives of fiscal policy. We will consider whether the government has made credible commitments for deficit reduction later in our more developed budget submission, but it should be obvious from the 2009 Budget that the UK government plans to take action to rein in spending before many other major economies. Given the scale of the current crisis this could be too cautious. Prudence should remain the watchword, but not at the expense of economic recovery.

The international evidence also demonstrates that the UK, far from being an outlier by adopting an unconventional policy mix, has adopted a consensus approach that embraces centre-right governments (Germany, France) and progressive governments (Spain, the USA). This is a quite remarkable change from earlier periods when policymakers were more concerned with squeezing inflation out of the system using a rather orthodox set of pro-market policies – tight fiscal policy, labour market deregulation, tolerance of a high level of unemployment. Equally, the experience of the last year suggests that policymakers at international level have been keen to avoid the errors made in 1929-1930 that deepened the great depression. Ramsay McDonald's London conference was an abject failure. Gordon Brown's has been a modest success, confirmed by the consistency of approach demonstrated subsequently by G20 countries.

Monetary policy

The broad approach to monetary policy has also been co-ordinated across the G20, although slightly complicated by the independence of central banks. Certainly, monetary policy has been 'accommodative' across the developed world, with central bankers being willing to use unconventional measures (like quantitative easing) to increase the supply of money in the system and improve liquidity and the core function of setting interest rates has also been undertaken with a view to supporting the real economy. For example, the Bank of England's most recent Inflation Report argues that in the immediate future CPI inflation will remain below the 2 per cent target. The amount of spare capacity in the economy is likely to grow and it is therefore right to keep interest rates low (effective interest rates are close to zero). Explicit reference is made to the Bank's asset purchase scheme which has now reached the level of £175 billion and it is argued with some force that these measures are necessary because conventional monetary policy has reached the limits of its usefulness.

The policy has not been allowed to unfold without criticism, and some commentators have accused the Bank of being half-hearted in its approach, not least because the governor's comments suggested he had some doubts about the effectiveness of the policy. Perhaps the most important point here is that the Bank must retain the discretion to act appropriately as circumstances change. If there is little or no fiscal stimulus in the next financial year, for example, there is a case for saying that monetary policy should take more of the strain.

Conventional ways of thinking can constrain rapid decision making in times of crisis – and can potentially prolong the downturn. That was the obvious experience of the 1930s. On the other hand, it is hardly surprising that cautious central bankers should be unwilling to risk an unleashing of the inflation monster – and this helps to explain the approach of both the Bank of England and the Federal Reserve. It was believed that the Fed was about to embark on a significant programme of quantitative easing, with a purchase of $300 billion of Treasury debt to be completed by the end of September (the date was subsequently moved back to the end of October) as a precursor to a bigger programme of QE. This now seems to be off the agenda. But in the central bankers' defence it might be said that a 'wait and see' approach has some merit, not least because these judgments are more matters of art than science. Economics is not like physics: policymakers are not applying hard and fast laws with predictable results.

David Miles, a member of the Monetary Policy Committee, has expressed the ambiguities of the policy with great clarity:

> *It is not possible to feel very confident about the precise impact of QE upon the economy. There are economic models which would imply that the impact is small – though I believe they rely upon unrealistic assumptions, specifically about the completeness of financial markets. The evidence suggests to me that large purchases by the Bank of England will help to support spending and do so in a way that helps in a transition to a more stable situation where banks may well play less of a role than in the recent past.*[5]

This is a fascinating statement, not least because it confirms that central bankers are 'learning by doing', testing the limits of policy, assessing the results and taking further action if necessary. But more importantly, perhaps, QE is seen as a route to a more sustainable banking system that is focused on supporting the real economy. The argument here is that there will be a lower reliance on bank debt by the private sector, higher levels of capitalisation (because QE is associated with a reconstruction of the regulatory regime around higher capital requirements) and an improved ability by the banks to handle fluctuations in their sources of funding.[6]

Stabilisation of the banking system

Stabilising the banking system was the necessary condition for the success of almost every other element of policy. If no action had been taken following the collapse of Lehman Brothers, then our discussion about a co-ordinated approach to fiscal and monetary policy would have been supremely irrelevant. A global meltdown of the banking system would have been an unprecedented economic catastrophe.

The action that was taken has been amply documented elsewhere and we will return to the next steps on the regulatory front in our Budget submission. Suffice to say that while some progress is being made, the return to business as usual in the City and on Wall Street shows little understanding of the legitimate public anger directed at investment bankers. This suggests that bankers are lacking in a degree of self-awareness about their responsibility for the crisis and highlights the challenges facing policymakers as they try and reconstruct a more modest financial sector.

Automatic stabilisers

All major economies have allowed the automatic stabilisers to operate in response to the crisis. In other words, as economic activity declines tax receipts will fall and benefit payments will rise as a consequence of rising unemployment. By allowing spending to continue at the pre-crisis

[5] Miles, *Money, Banks and Quantitative Easing*, speech to the 14th Northern Ireland Economic Conference (2009)
[6] Ibid, p.9

level and by replacing some lost income for those who become jobless, government intervention acts to sustain demand, maintain purchasing power and stabilise the economy. The process is automatic to the extent that governments must make a deliberate choice to act otherwise – to cut spending and benefits as the economy falls into recession. Few economists would now advocate retrenchment in the face of a global downturn – although this consensus seems to exclude today's Conservative Party.

One reason given by HM Treasury for the relatively small scale of the UK's stimulus package is that the automatic stabilisers are having a bigger effect in the UK than in other major economies. In one sense this is entirely logical – a big fall in tax revenues is commensurate with an equally large increase in the fiscal deficit. But in another sense it masks the fact that the automatic stabilisers in other countries may have a more significant effect in maintaining the purchasing power of the unemployed by offering higher benefits (Figure 1.04 on the next page). This is why The Work Foundation recommended a £10 a week increase in the level of Jobseekers Allowance as an immediate response to the crisis. Concern remains about the level of benefits more generally in the UK and in particular whether the government has removed all disincentives to work from the system – particularly in the housing benefit regime. We believe that the government should return to the issue as a matter of urgency to demonstrate both command of the crisis and a capacity to think creatively about how the UK should prepare for recovery.

Self-evidently, replacement rates are much lower for highly paid employees (those paid 150 per cent of average earnings on the chart). But at the bottom end of the labour market all welfare systems in this group except the US (and Italy on one measure) are more generous than the UK. Nor is it right to believe that higher benefits are associated with higher unemployment. It is the duration of benefits and the conditions attached that determine the efficiency of the system, as HM Treasury have recognised.[7]

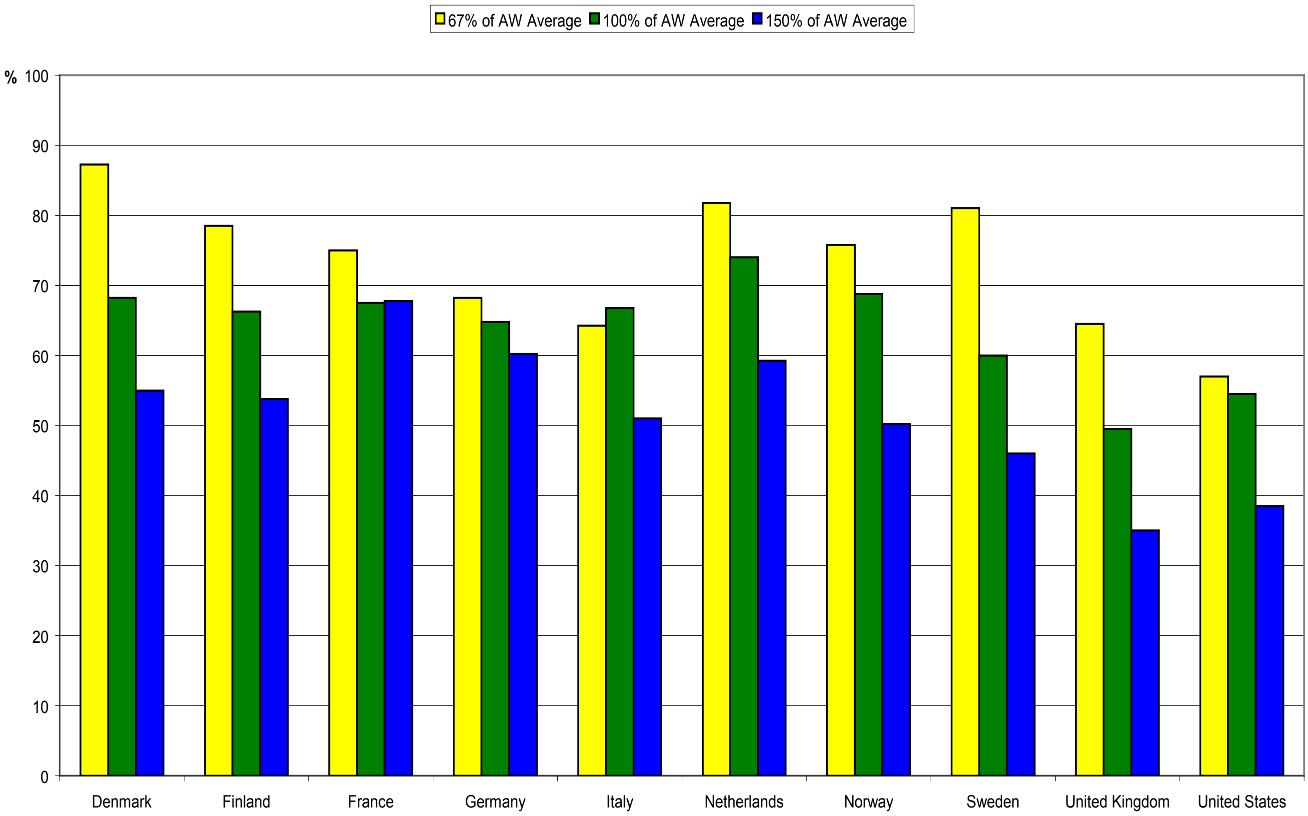
It is possible therefore to offer the unemployed slightly higher benefits with no apparent risk that a return to labour market participation will be made more difficult.

Deficits and debt

We have already noted that a natural consequence of the operation of the automatic stabilisers is that both the fiscal deficit and the overall debt to GDP ratio will rise. This is entirely as it should be. Indeed, one of Keynes's critical insights was that governments should be reducing (and repaying) debt in boom times to create fiscal room for manoeuvre (rising debt and deficits)

[7] H M Treasury, *EMU and Labour Market Flexibility* (2003)

Figure 1.04: Net replacement rates for OECD sample countries (2007 data)



Source: OECD

in recessions. We can see (Figures 1.05 and 1.06) that this is broadly what has happened.[8] Moreover, government must act to stimulate the economy to compensate for declining consumer demand and private investment. At the heart of the argument is the belief that increasing the level of public investment is essential if the economy is to get moving again. And more recent theoretical insights have emphasised that stabilising the banking system is another necessary condition for economic recovery.[9]

Looking first at the deficit, we can see that the UK entered the recession in a reasonable condition. Deficit levels in 2004 were below Germany, the USA, Japan and the average for major advanced economies. Unfortunately, and largely as a consequence of the collapse in

[8] Although there is a case that the deficit in the UK was higher than it should have been in the 2004-06 period given the performance of the economy.
[9] Akerlof and Shiller, *Animal Spirits: How human psychology drives the economy and why it matters for global capitalism*, Princeton (2009)

tax receipts rather than profligate spending (the fiscal stimulus package amounts to less than 1.5 per cent of GDP in 2009), the deficit is projected to reach 13 per cen of GDP in 2010 before rebounding to around 7 per cen by 2014 – around the same level as the USA, lower than Japan, but higher than the euro area or advanced economy average. No one would argue that deficits at this level are sustainable in the long term and HM Treasury have already indicated (in the 2009 Budget) that there is a period of fiscal consolidation ahead. There are two critical arguments at stake here. The first is whether the period of fiscal retrenchment should begin now – as recommended by the Conservative Party. And the second is whether the only route back to stability is through savage cuts in public spending. As a matter of logic there is another alternative – increasing taxes for those who are affluent but not wealthy in a system that is more progressive. Once again, this is an issue demanding further exploration in our Budget submission.

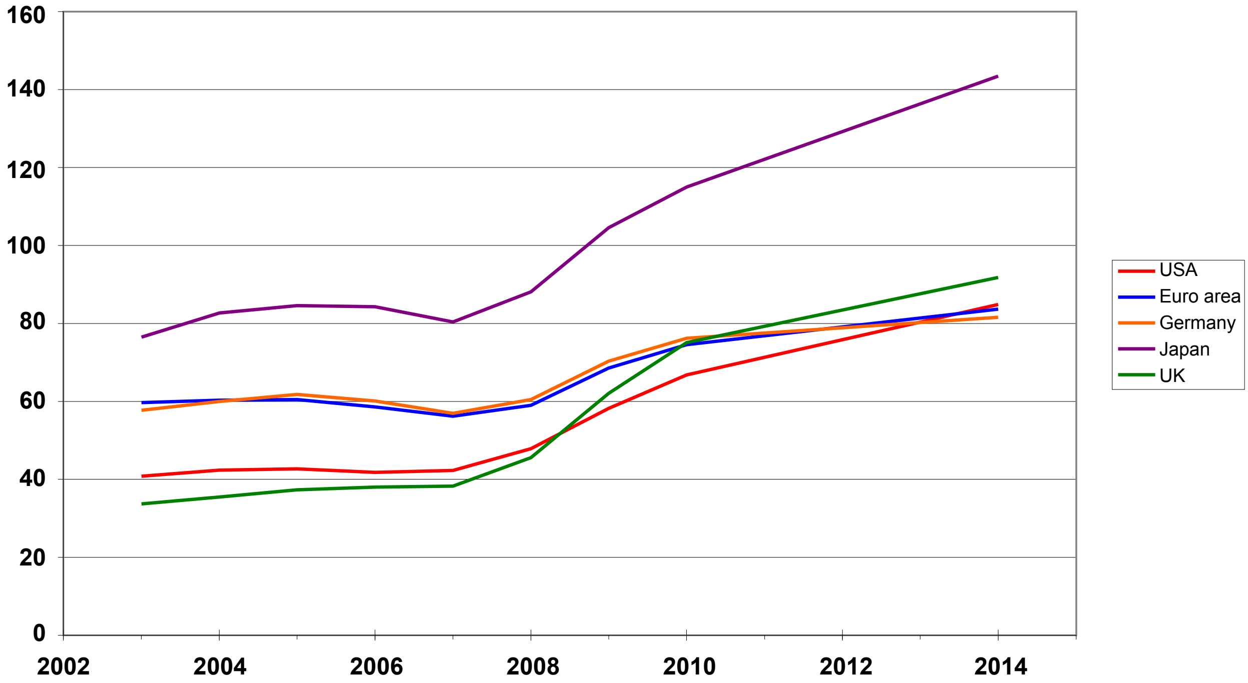
Figure 1.05: General government fiscal balances 2003-2014

Source: IMF

A similar story can be told about the ratio of public debt to GDP. In the early part of this decade, the UK had one of the lowest levels of public debt of any major economy. The debt level rises to 2014, but is not entirely out of line with comparable countries and is significantly lower than some others. Italy and Japan in particular manage to survive with levels of public debt that would be seen as eye watering elsewhere. And in neither case have these countries witnessed anything like a gilt strike (investors being unwilling to buy government securities) that would indicate an unwillingness to lend in the belief that the government will default.

It is important to be clear. We are not recommending that the UK should accept a higher level of public debt than is currently projected. Indeed, it would be prudent to reduce the debt to GDP ratio over time to ensure that government has adequate fiscal room for manoeuvre in the future. On the other hand it is wrong (perhaps even irresponsible) to say that the UK has run out of money, that the public finances are unsustainable or that the government has been guilty of gross economic mismanagement. Taken in the round the UK's performance looks good by international standards. The labour market position is improving, monetary policy is oriented to supporting the recovery, the automatic stabilisers have been allowed to operate, the banking system has been recapitalised and some initial commitments have been made to restore the public finances to health (most obviously the withdrawal of the VAT cut at the end of the year).

Figure 1.06: General government net debt 2003-2014 (% GDP)



Source: IMF

Nonetheless, it would be unwise to be over-optimistic and there are still many unforeseen events that could lead to further setbacks, even though the last year has been better than anybody anticipated. The major economies are recovering and, barring a catastrophe, the worst may be over. This still leaves open the question, of course, whether enough has been done to prevent a further crisis of a similar kind, which brings us once again to the importance of co-ordinated international action.

Conclusions from the Pittsburgh Summit

As we outlined in our paper published before the London G20 Summit, *Tackling the Global Jobs Crisis*, international action is critical if we want to get the global economy moving again. The Pittsburgh Summit developed the framework established earlier in the year, entrenched the G20 as the forum for global economic governance and began to get to grips with unravelling the global imbalances that lie at the root of the current crisis – the collapse of the banking system was a consequence of a global savings glut meeting new forms of financial innovation, a weak regulatory structure and dysfunctional remuneration policies. Investment banks took risks by purchasing assets whose precise value was uncertain. When the sub-prime mortgage market collapsed, banks were left holding assets that were essentially worthless because the mortgages on which the income stream depended would never be repaid.

It looks very likely that the concerted action over the last year will continue, that the fiscal stimulus will remain in place until the recovery begins to mature and that an agreed approach to financial market regulation (with higher capital requirements and regulatory authorities paying close attention to systemic risk) will act to limit the scope for crises in the future. As the ILO has pointed out, the action taken so far has saved between 7 and 11 million jobs across the world. This helps to explain why the UK's labour market performance has surpassed the expectations set at the beginning of the year. And it is to an evaluation of the UK's labour market performance that we now turn.

2. UK labour market overview

Introduction

We have already noted that the UK's comparative employment performance is good. Indeed, given the depth of the recession and the sluggishness of a return to growth one might have expected the situation to be considerably worse. Of course, there has been a rapid rise in unemployment on both the claimant count and ILO measures (from 1.6 to 2.4 million over the period June-August 2007 to June-August 2008, and from 5.5 per cent to 8.1 per cent). But the percentage of the population actively seeking work has risen very slightly over the period and the economic inactivity rate has remained unchanged. Most importantly, perhaps, while long-term unemployment (those unemployed for more than 12 months) has been rising, the changes are less significant than in earlier recessions – of which we will have more to say later. Obviously, unemployment remains a traumatic experience for those who lose their jobs and there is absolutely no room for complacency, but the labour market does seem to be adapting better to changing economic circumstances than during previous recessions.

As we explained in *Hard Labour*, there is incontrovertible evidence to support the argument that work is better than worklessness. Unemployment is associated with higher levels of physical and mental illness, difficulties with personal relationships and increased risk of drug and alcohol abuse all of which can inhibit a return to work. Worse, unemployment reduces life expectancy too. It is hardly surprising then that governments across the world have attached such priority to keeping unemployment as low as possible despite the recession.

Youth unemployment is particularly damaging and has a scarring effect on individuals, increasing the risk of unemployment over the course of a working life. In a recession employers are always inclined to make young workers redundant first – or to take on fewer young people entering the labour market – and it is a universal phenomenon that youth unemployment rises faster than adult unemployment. That is why The Work Foundation welcomed the government's job guarantee for the young unemployed, although we have some suggestions about the implementation of the policy that we believe will lead to better outcomes.

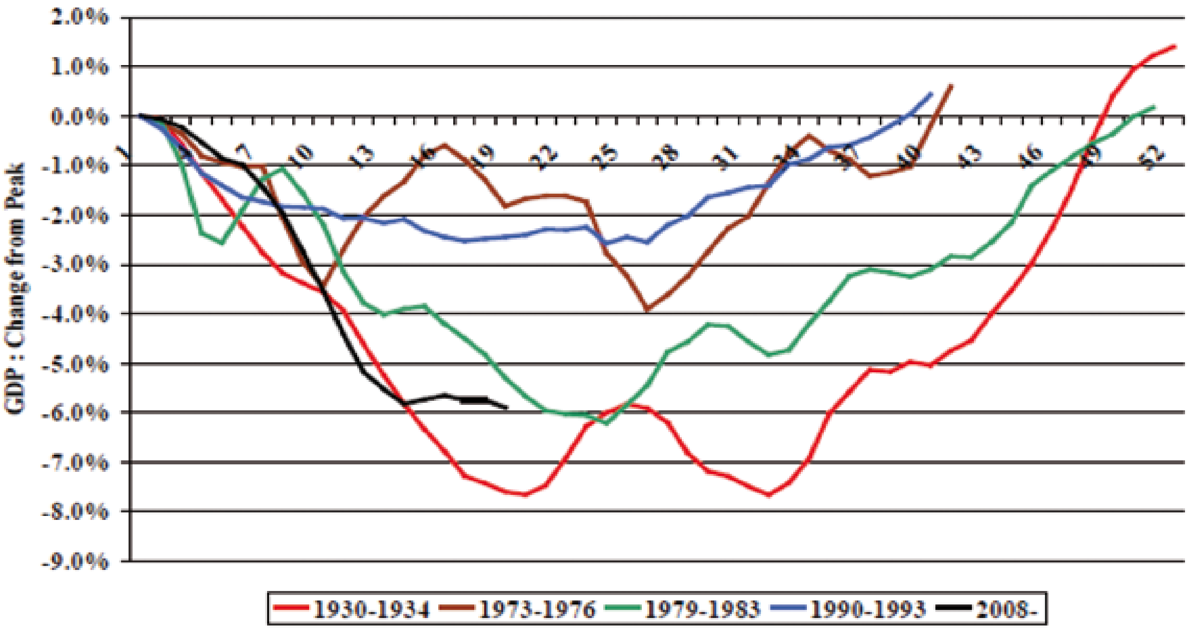
The remainder of this section offers an overview of the UK's labour market performance and compares recent experience with previous recessions. We also examine: the likely speed of the recovery in employment; the impact of the recession on particular occupational groups; the geography of the recession; and, an outline assessment of the effectiveness of public policy.

The recession: How bad? How long? How deep?

Critics of government policy have suggested that there is something unique and different about the current recession. It is said that the UK has never experienced such poor economic performance, that the recession is deeper in the UK than in other major OECD countries and that unemployment has never risen as fast. We have already seen that the UK's employment performance looks good by international standards and that other countries (Germany, Ireland and Japan for example) have witnessed much sharper falls in output. The question, of course is whether the UK will recover as fast as the IMF predict or whether a double dip recession is in prospect? At this stage the question is unanswerable, but we do know that premature withdrawal of fiscal stimulus would potentially hold back the recovery and could tip the economy back into recession. This was the experience in the USA and the UK in the 1930's where the great depression had a classic w shape – see Figure 2.01).

What we also know is that output normally takes at least four years to recover to the pre-crisis level and this obviously has an impact on the trajectory of unemployment (an issue to which we return below).

Figure 2.01: Four recessions compared – GDP growth



Source: NIESR

The fall in GDP in the current recession has been faster than during the Great Depression, but most policy makers and commentators would agree that the worst is now over. If we believe that we have reached the trough of this recession then it is no worse than the low point of the 1979-83 period and unemployment is unlikely to reach the level of that time. This assumes of course that a slow but steady recovery is in prospect and, given the continued action by the G20 countries to stimulate the global economy, this is not an implausible assumption. Moreover, the use of unconventional monetary policy by the Federal Reserve and the Bank of England has apparently staved off a more catastrophic collapse. Some economists have offered a more pessimistic assessment, suggesting that quantitative easing, far from leading to increased lending to business is fuelling another speculative asset price bubble.[10] While there is no doubt that asset prices have recovered dramatically, it would be remarkable for central banks and governments to adopt policies that will simply lead to another (and more catastrophic) bust. Fiscal consolidation is in prospect in many countries in 2011 (and possibly earlier in the UK) and the quantitative easing programme has probably come to an end. Moreover, it seems likely that interest rates will begin to rise in the middle of 2010. Irrational exuberance should be met with a robust response, which ought to prevent a repetition of the policy mistakes that led to the crisis.

Previous experience suggests that it will take between three and four years for output to return to pre-crisis levels. Employment may take somewhat longer to recover. For example, Reinhart and Rogoff, in a review of financial crises over the last thirty years, conclude that unemployment increases by about seven per cent overall and rises for five years from the beginning of the crisis. If this were to happen in the UK it would suggest that unemployment will peak in 2012-13 and will rise to 12-13 per cent.[11] One might say that this is also a little pessimistic, not least because the financial crises under review tended to be country or region specific rather than global in scope and were met with a tightening of policy rather than the global expansion put in place by the G20. Recent experience in the UK offers grounds for moderate optimism (although as Figure 2.01 on the next page shows, we are still in the early stages of the recession/recovery cycle) and it is to a more detailed consideration of employment performance that we now turn.

Unemployment in three recessions

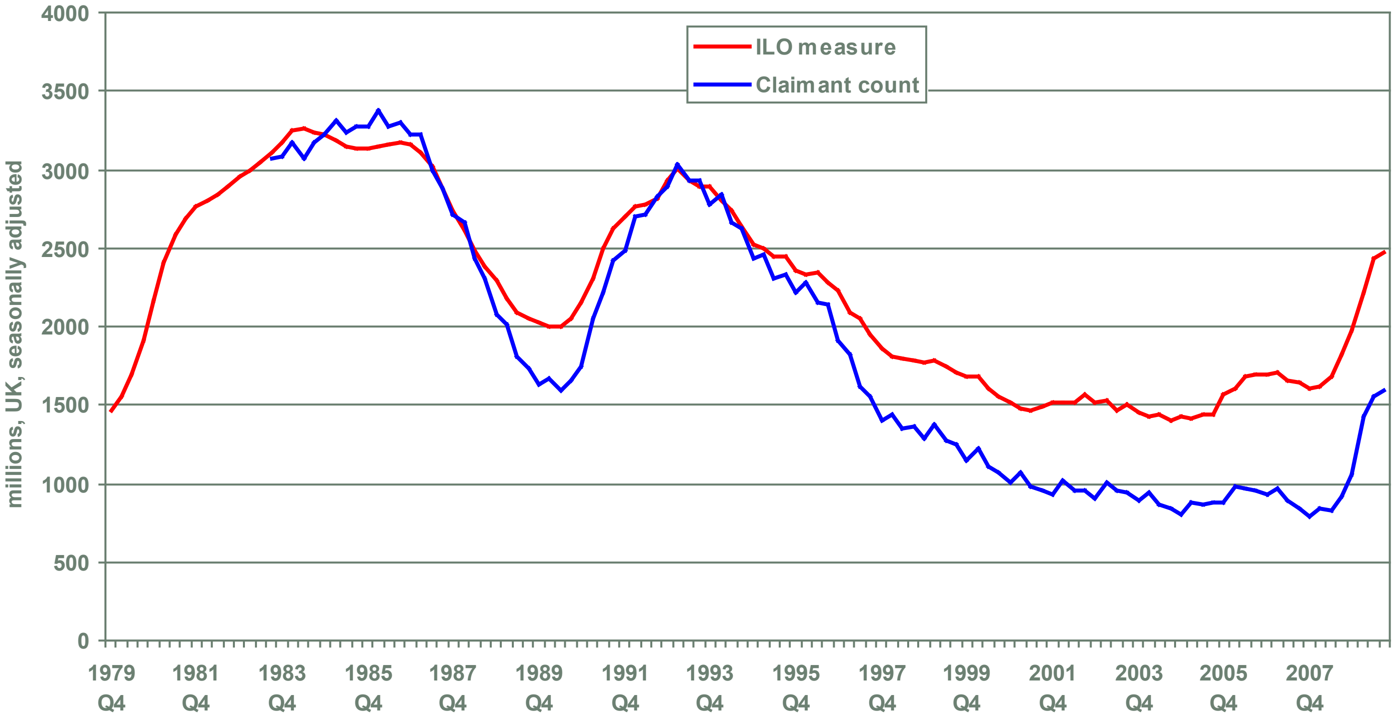
In *Hard Labour*, the first of The Work Foundation's crisis commentaries, we suggested that unemployment could rise to around 2.5 million on the ILO measure by the end of 2009. This was seen as rather optimistic at the time, with many commentators predicting that unemployment would rise to 3 million or more by the end of the year. The most recent figures suggest that the 2.5 million projection is broadly in line with the projected rise in unemployment to the year end.

[10] See for example, Roubini, The mother of all carry trades faces an inevitable bust, *Financial Times*, 1/11/09

[11] See Reinhart and Rogoff, The Aftermath of Financial Crises, http://www.economics.harvard.edu/files/faculty/51_Aftermath.pdf

This is devastating for those who have lost their jobs, but a rather better performance than in the previous two recessions (Figure 2.02).

Figure 2.02: Unemployment in three recessions, 1979-2009



Source: LFS

Of course, unemployment has yet to reach its peak and is almost certain to rise to close to above 3 million sometime during 2010. What is most striking, perhaps, is that the dramatic fall in output would, other things being equal, have been expected to lead to a much larger rise in unemployment. Those predicting 3 million by the end of 2009 were also predicting 3.75 million sometime in 2010 – a level higher than in the previous two recessions. If the labour market continues to perform in the future as it has in the recent past then the worst fears expressed in the early part of this year may not materialise.

For most of the 1980s and 90s the ILO measure (‘actively seeking work’) and the claimant count measure (those receiving unemployment benefit or JSA) were reasonably close together. A break seemed to occur in the 1990s as the economy expanded, with the claimant count falling much faster than the ILO measure. This phenomenon is difficult to explain. It may have been that the overall buoyancy of the labour market encouraged more people to look for work even if they were not receiving benefits. Alternatively, this could be a welfare to work effect, with the government's activation policies – the various new deals for lone parents, young people, older workers and the disabled – encouraging a higher level of job search and a higher level of joblessness on the ILO measure. If the first explanation is right then one might have anticipated a convergence of the claimant count and the ILO measure as the recession started to bite; some of those who had been seeking work would make the entirely rational decision to abandon job search. If the second explanation is right one would expect the gap to remain (which is exactly what has happened), suggesting that the welfare to work agenda has been effective in activating job search. On the face of it the second explanation is more plausible, but rather more research is needed to understand why the dynamics of unemployment changed so rapidly in the 1990s.

We also need to subject our moderately optimistic assessment to further scrutiny – is there anything more we can learn from the experience of the previous two recessions? A swift glance at the labour market data from previous recessions may help us in this assessment (Figure 2.03 on the next page).

It must be emphasised that the world is in the early stages of the current recession and that it is therefore difficult to predict the trajectory of unemployment. So far the rate of increase has been somewhat slower (although still significant) and this may augur well for the future – especially if there is a rapid return to growth in 2010. What we can conclude from previous experience is that it can take between *eight to ten* years for employment to recover to pre crisis levels. This is a challenging finding, which suggests that government should strain every sinew to keep unemployment at the lowest possible level for the duration of the recession.

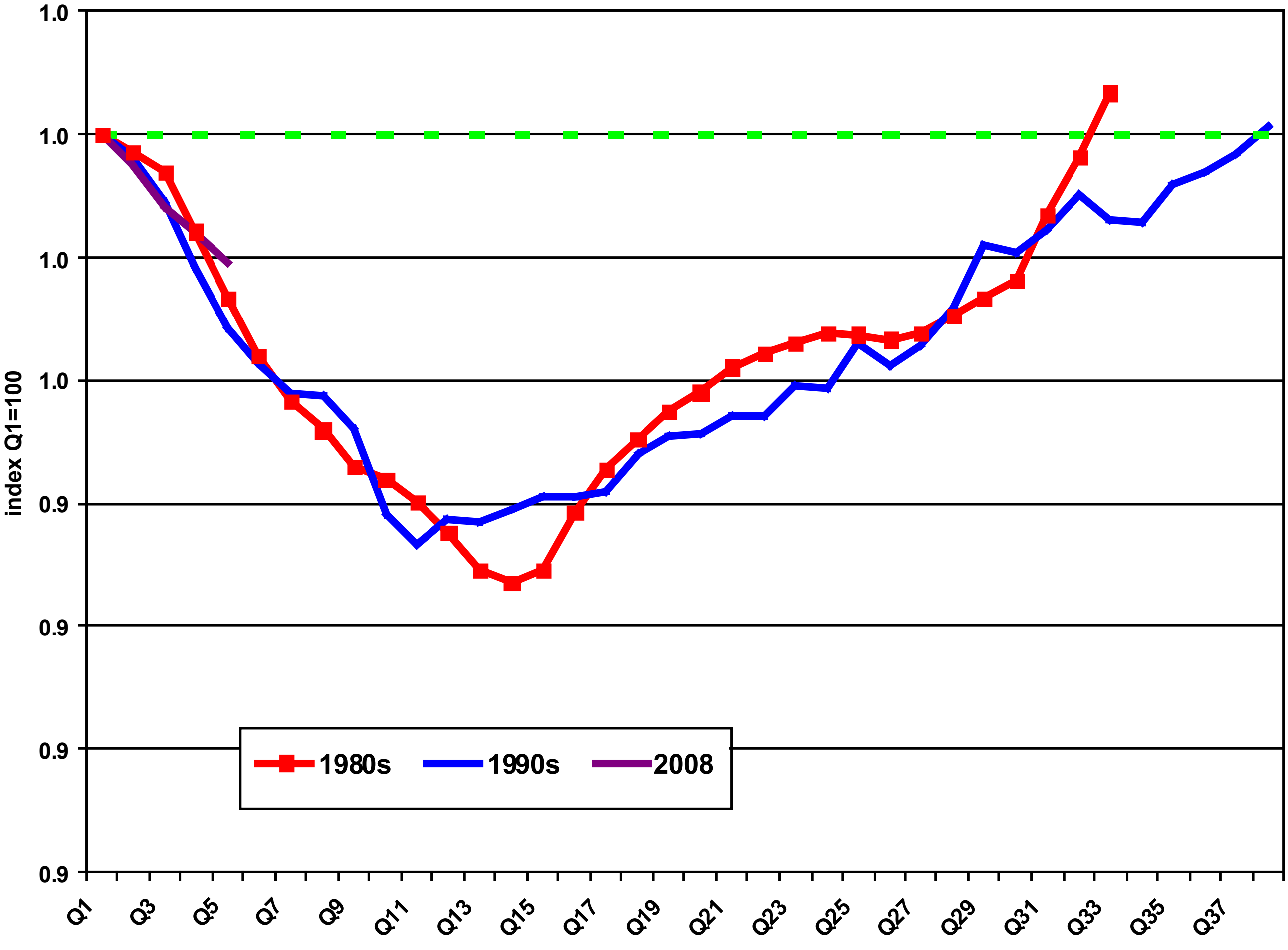
Structural and cyclical unemployment

The most important challenge is to prevent cyclical unemployment from becoming structural (long-term) unemployment. It is long-term unemployment that blights communities and diminishes life chances. And it is long-term unemployment that is hardest to tackle successfully – labour market exclusion is an inevitable consequence of prolonged joblessness. So far the UK's performance on this measure is better than in previous recessions (Figure 2.04 on page 26). The most recent data suggests that long-term unemployment is rising in absolute numbers but is stable as a share of the total unemployed.[12] What we also know is that *employment* is continuing to grow.

[12] ONS, *Labour Market Statistics: November 2009* (2009), Table 9(1)

Figure 2.03: Employment recoveries from previous recessions

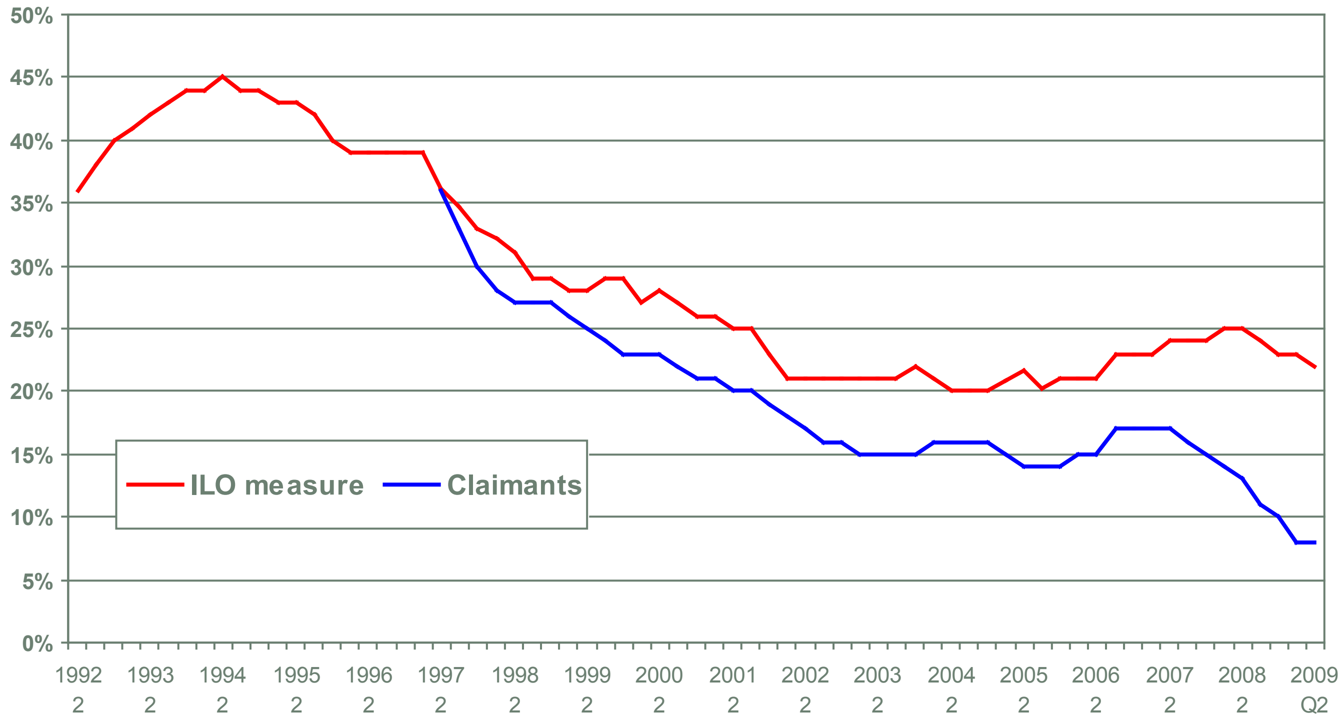
Pre-recession peak of employment (1979 Q4/1990 Q2) = 100 Q1. Workforce jobs, UK seasonally adjusted



Source: Workforce Jobs, ONS

Given the phase of the cycle in which the UK finds itself, this is a remarkable performance. A degree of caution is required of course and it is possible that the situation could deteriorate rapidly. Similarly, because unemployment is a lagging indicator, it would be quite wrong to conclude that the period of job loss and employment insecurity is over. Nonetheless, it does seem that employers are less willing to lay workers off than during previous recessions, partly because they are reluctant to lose valuable human capital and partly because they understand that they may experience damaging bottlenecks in labour supply when the economy returns to growth. A labour surplus can rapidly metamorphose into a labour shortage.

Figure 2.04: Long-term unemployment 1992-2009 – share of total unemployed (%)



Source: LFS

We might also conclude that there has been a higher degree of wage flexibility than in previous recession too, enabling employers to manage costs and by reducing real wages. Much of the evidence here is little better than anecdote – we know a great deal about the arrangements in the motor industry and other parts of manufacturing, but we have no comprehensive assessment of the extent to which these arrangements are being replicated elsewhere. Average earnings excluding bonuses in private services have fallen to an exceptionally low annual growth rate of 1.6 per cent comparing the three months to September to the previous three months. Hours flexibility where employers cut hours to save some jobs will also have had a role, but it is harder to demonstrate how significant it is from the aggregate figures.

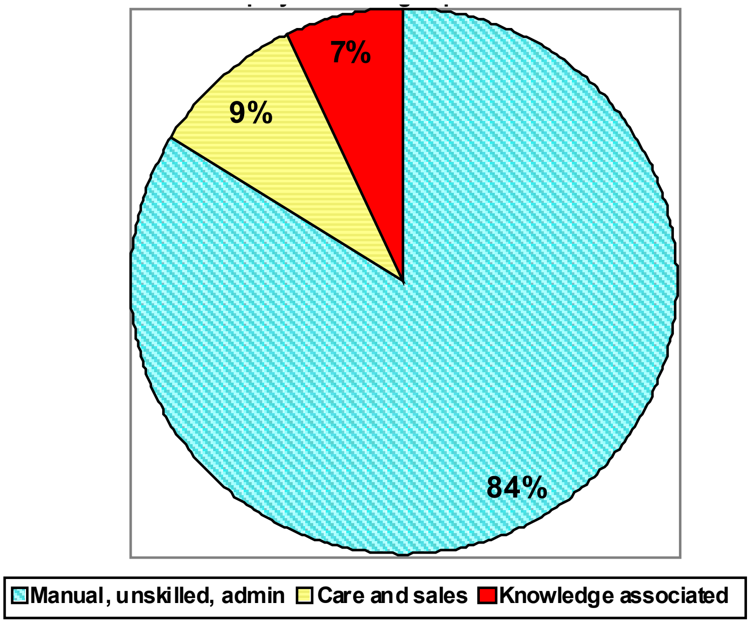
A measured assessment would suggest that the UK labour market has displayed continued dynamism (new jobs are being created and employment is rising) as well as a high degree of flexibility. An important question, of course, is whether more progress could have been made if the government had offered an explicit incentive for hours and wage flexibility through a short-time working scheme. In Germany, for example, the employment rate has risen by 0.5 per cent in the last year despite the fall in output and unemployment has risen by 0.5 per cent to 7.6 per cent.[13] We return to this issue in Section 3, but at this stage we should note the consensus in Germany that this is largely attributable to the success of the institutional arrangements (unions and employers *negotiating* wage flexibility), reinforced by government incentives. The case for considering similar arrangements in the UK remains compelling.

Who has been worst hit by the recession?

When the recession began, much of the media commentary predicted that this would be a largely middle class phenomenon. The argument was that there would be a big shake-out of jobs in financial services (especially investment banking) and other knowledge intensive sectors. Restructuring of the economy, especially the decline in manufacturing employment and the growth of high skill knowledge intensive services would inevitably mean that the salariat would find themselves in the same position as the proletariat in previous recessions.

Figure 2.05: Recession speeds up structural change

Total employment change April-June 2008-2009



Source: LFS

These views were never based on anything more than anecdote and the official data tells a very different story. In other words, the principal victims of this recession are employed in lower skill occupations. They are manual workers and workers in retail or the care sector. The pattern of

[13] Ibid, table 19

job loss is at the bottom not the top of the labour market and tells a story that is very similar to the experience of the 1980s and 1990s recessions.

A consequence of this process is to speed up the pace of structural change across the economy. Most authoritative predictions have identified a continued decline in unskilled employment, growth in the top three occupational groups (managers, professionals and associate professionals) and growth in knowledge intensive industries. The occupational impact of the recession reinforces the geographical impact of the recession. We know, for example that the regions and localities worst affected by job loss are those that were struggling before the recession started to bite principally because they never recovered from the travails of the 80s and 90s recessions.

Regional impact

The regional impact of the recession is demonstrated most clearly in Figure 2.06. and confirms the geographical concentration of unemployment in previously disadvantaged areas.

- The highest increases in claimant count, using the latest data by local authority district, have been in Limavady (Northern Ireland), Cookstown (Northern Ireland), Merthyr Tydfil (Wales), Corby (East Midlands), Walsall (West Midlands).
- The most severe labour market impacts to date (the largest increases in claimant count) have been clustered predominately in areas that have not experienced growth in the knowledge service based industries to the same extent as other parts of the UK. These areas, with high proportions of employment in manufacturing, include South Wales, the West Midlands, central Scotland (North Lanarkshire), and parts of the North East, North West and Yorkshire and Humber.
- Areas with high employment in public services don't appear at this stage to have been hit as hard – using 2001 employment by industry data there is a negative and significant correlation with employment in education and claimant rate rises. Future cuts are likely to lead to substantial job losses in these areas however.
- Areas that have been hit hardest also tend to have lower skills (Figure 2.07). There is a positive and significant relationship between the proportion of a local population with no qualifications and claimant rate increase. Swindon is an example of somewhere with relatively high skills but high employment in the automotive industry has led to huge increases.

- Within London, whilst unemployment has been historically high in some areas, claimant rate increases continue to fall behind the national average.

In other words, what we can see here is a very traditional pattern of unemployment. Low skilled workers in poor communities are seeing their life chances diminished. Weakness in knowledge intensive sectors is a recipe for industrial decline and continued deterioration on the most important social and economic indicators.

Achieving a return to a stable growth path must be the priority, but it is equally likely that the communities worst affected by the recession will be the last to benefit from recovery if they benefit at all. An obvious conclusion might be to focus on improving levels of skills in the most disadvantaged areas, but this is likely to prove only a partial solution. What government needs is a comprehensive strategy for rebuilding these communities, identifying where they might develop comparative advantage and building on those strengths. This analysis cuts with the grain of the government's developing story about industrial policy activism – not just guaranteeing that markets are competitive but ensuring that the UK is well positioned to maximise the opportunities of the industries of the future. It also demands an effort to improve the effectiveness of all public sector interventions in a locality. Policy is already moving in this direction, exemplified by the Total Place pilots that attempt to co-ordinate all the interventions in a locality across departments and tiers of government with the intention of achieving a specific policy goal. This approach, if it works, should be applied as widely as possible, not least because more effective collaboration could generate cost savings and efficiencies at a time of public spending constraint.

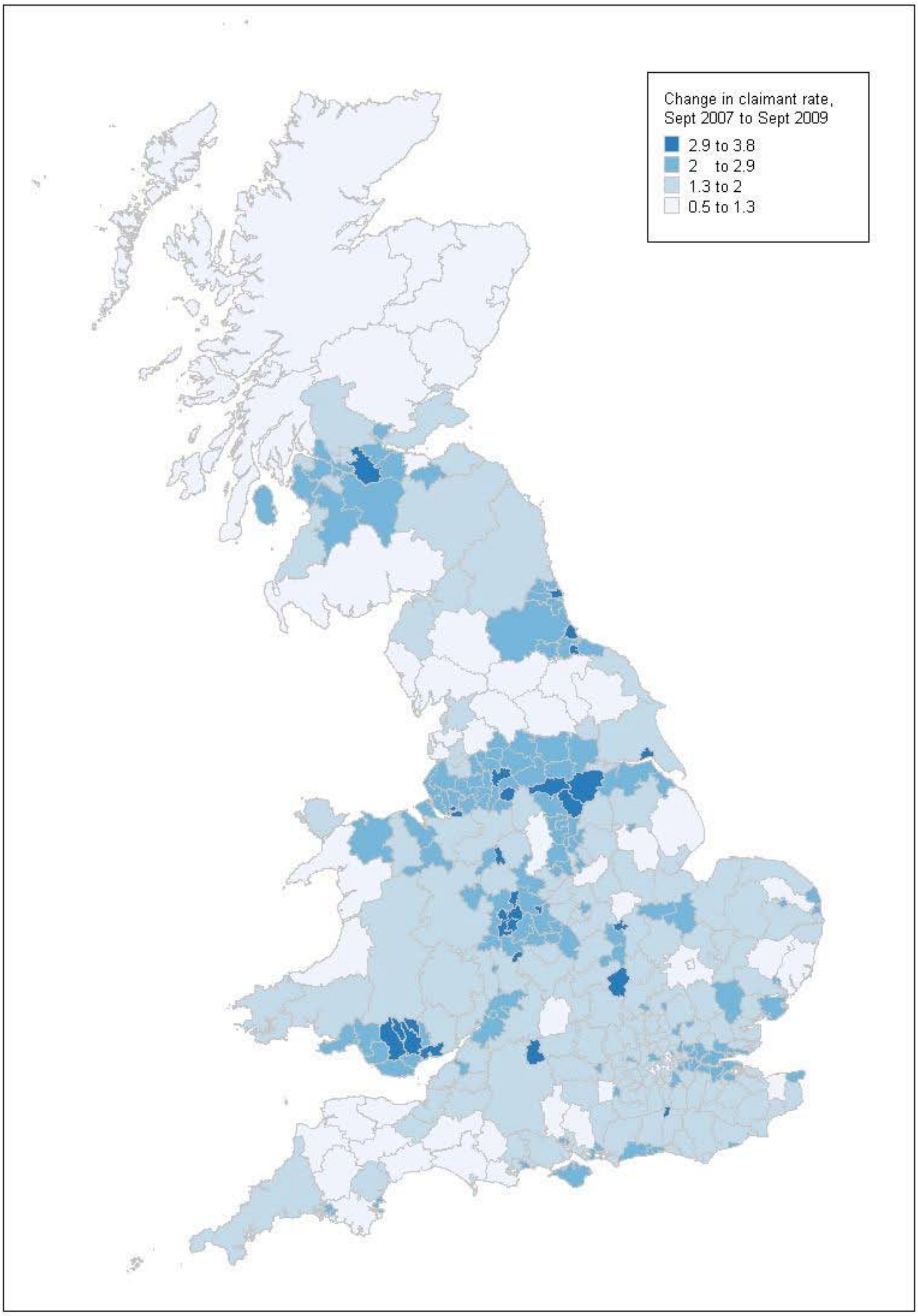
The corollary of the 'low skills-high unemployment' story is that high skills are associated with low unemployment. This helps to explain the good performance of the South East of England and the relatively good performance in London, although we have already noted that highly concentrated pockets of unemployment remain.

Where will the new jobs come from?

If the recession is speeding up the process of structural change then what does that mean for the recovery? Just where will the new jobs come from and how do we ensure that workers are able to find a secure foothold in a more challenging world of work?

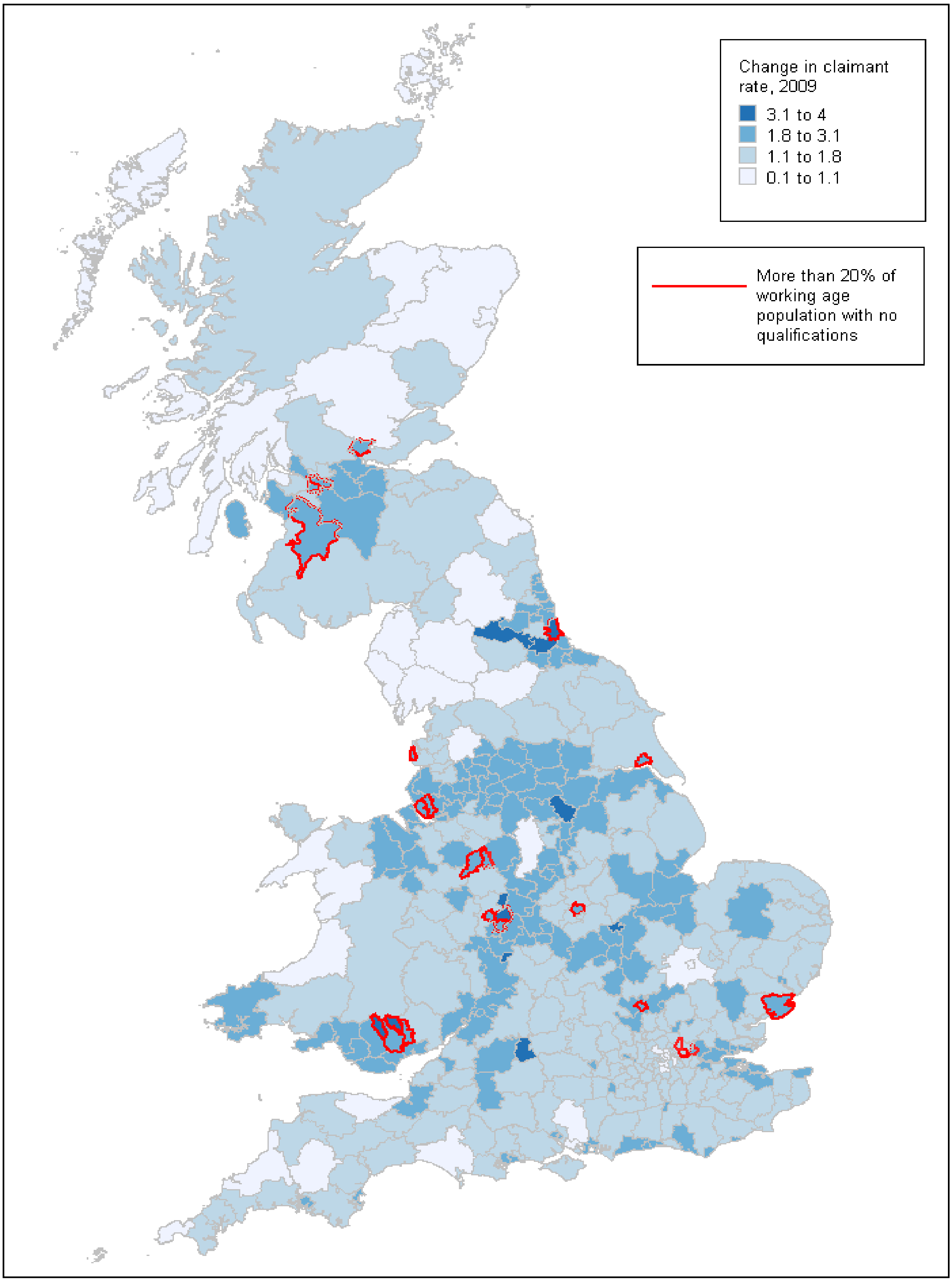
Prediction is always difficult, especially when it concerns the future so the account we offer here is tentative. What we do know of course is that the projections of structural change have been

Figure 2.06: Change in claimant count, September 2007-September 2009



Source: LFS

Figure 2.07: Areas with low skills are hardest hit



Source: LFS

broadly correct in recent years – we have seen a decline in elementary jobs and growth in the more highly qualified occupational groups. Identifying the sectors that may grow and shrink is slightly more problematic, but once again recent experience offers some indications of what may happen in the future.

First, the jobs that have been lost in financial services are unlikely to be recreated. The sector generated relatively few jobs even in the boom markets of the pre-recession period; and there will be much slower growth in the market for financial services post recession and even greater pressure to reduce headcount through automation. The huge white collar factories one found in banks and insurance companies are almost certainly in decline – a straightforward capital for labour substitution is taking place and many routine administrative jobs will disappear.

Second, there will at best be modest increase in employment in the public sector in healthcare and education related employment, but potentially more jobs in private and other non-government providers of these services.

Third, areas of professional services will show strong growth – for example, the Institute of Employment research has identified computer related services as a major growth area and overall employment levels in this sector has so far been unaffected by the recession.

Finally, employment in labour supply agencies[14] will return as demand for new hires picks up across the economy. It would be unwise to overestimate the significance of this trend – employment agencies are playing a bigger role in the labour market in both the UK and the USA, although they constitute a relatively small share of total employment.

We have looked in more detail at how employment recovered from the two previous recessions to see how the recovery to 2020 might be different, factoring in our expectations about the recovery. We have divided the workforce up into knowledge economy (KE) market based services (telecoms, high tech services, business, and financial services); KE public based services (education and healthcare); non-KE services (distribution, hospitality, and other services) and manufacturing.

Both recoveries follow a common pattern: market based knowledge services grew the fastest and created the biggest number of jobs and public based knowledge services also expanded significantly. Together, the knowledge based industries created over 2 million new jobs in the

[14] As well as employment agency staff, these figures also include those with a contract of employment with the agency but who work elsewhere.

recovery of 1983 to1990 and 1.7 million new jobs in the recovery of 1993 to 2000 (Figure 2.08 on page 34, Figure 2.09 on page 35). More traditional services also grew, providing around 1 million new jobs in both recoveries.

The growth in education and healthcare services is surprising given the impression that this period was one of public spending austerity. For example, public spending fell as a share of GDP from 48 per cent to 39 per cent between 1982-83 and 1989-90 and from 44 per cent to 37 per cent between 1992-93 and 1999-2000.[15] Public spending on health and education was less subject to constraint, but between 1992-1993 and 1999-2000 remained steady at around 10 per cent of GDP. One conclusion might be that employment was also expanding in the private sector in areas such as care for the elderly and private health care and also among business schools, language and other specialist providers of education courses.

In our analysis of future trends in jobs we agreed with the IER assessment that fewer jobs could be expected in sales in the future because of investment in job saving technology and growth of on-line sales. But in addition, if overall consumer spending growth is weaker than in previous recoveries and demand continues to rise for high value added services, it must follow that a smaller share of expenditure will be devoted to other services than in previous recoveries. This in turn implies a weaker growth in employment in the other services category.

To put a precise number on this at the moment would be plucking figures out of the air. If we take the more pessimistic outlook and assume that employment levels in distribution and hospitality return to their pre-recession levels but do not grow significantly beyond them and public service employment levels remain at their current level, then it implies that market based knowledge services would have to grow much faster than in previous recoveries if the return to previous employment levels is to be achieved by 2020.

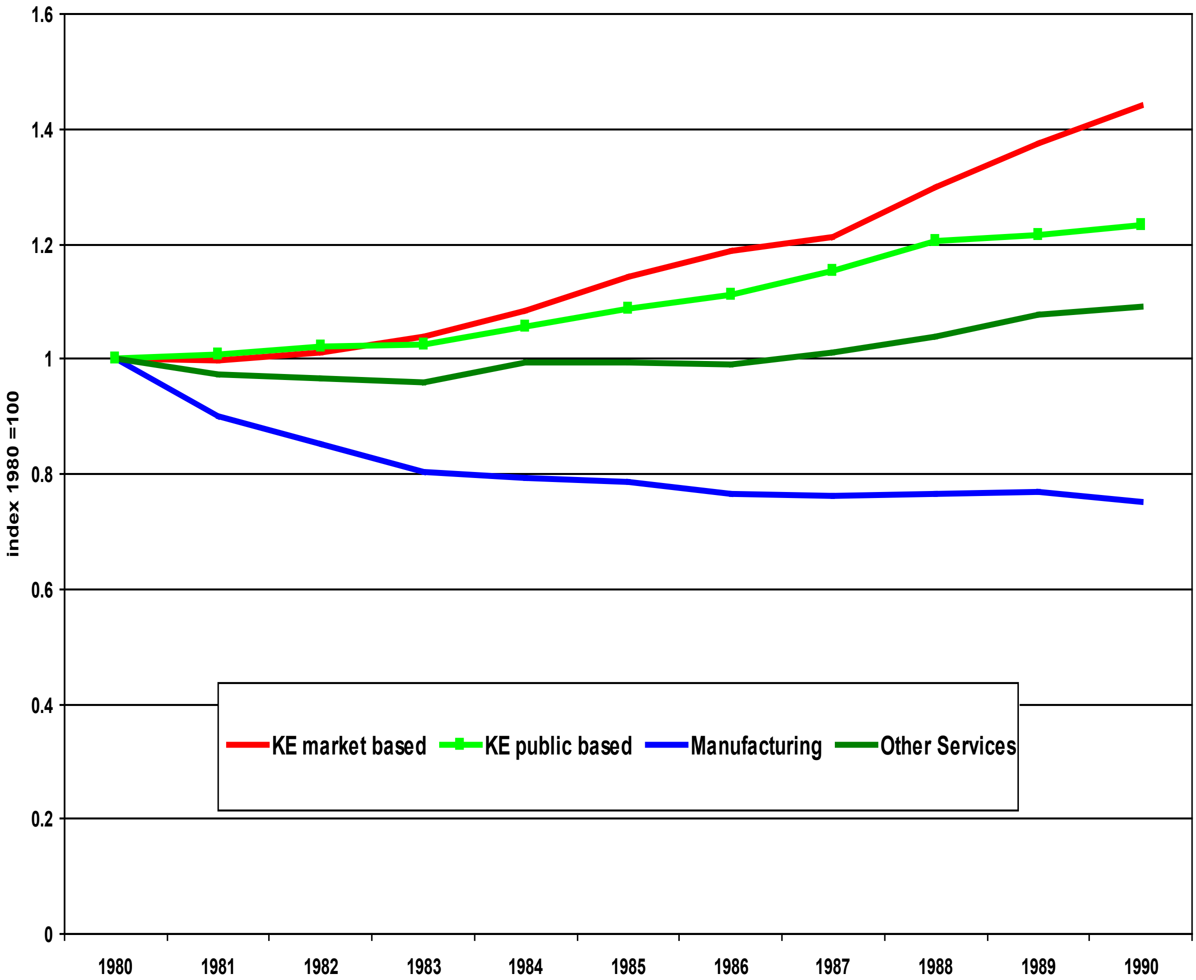
Interim assessment of policy effectiveness

What can we say about the effectiveness of policy so far? To begin with, perhaps, we should note that there are limits to what the government can do to affect the dynamics of unemployment in a recession. Much depends upon whether policy action is co-ordinated across the globe and much depends too on how employers react to adverse economic circumstances. On both dimensions the UK's recent experience hold out some promise for the future. Concerted action by the G20 has saved the world from catastrophe. The situation would be significantly worse without the bank bailouts, stabilisation of the financial system, fiscal stimulus and accommodative monetary policy.

[15] HMT 2009 Public Expenditure Survey Analysis. Total spending also includes spending on social protection and government debt interest

Figure 2.08: Knowledge economy and the 1980s recession and recovery

Total employment, EU KLEMs database distribution 1980=100. KE market based is telecoms, high tech, business, financial and cultural services; KE public based is education and healthcare

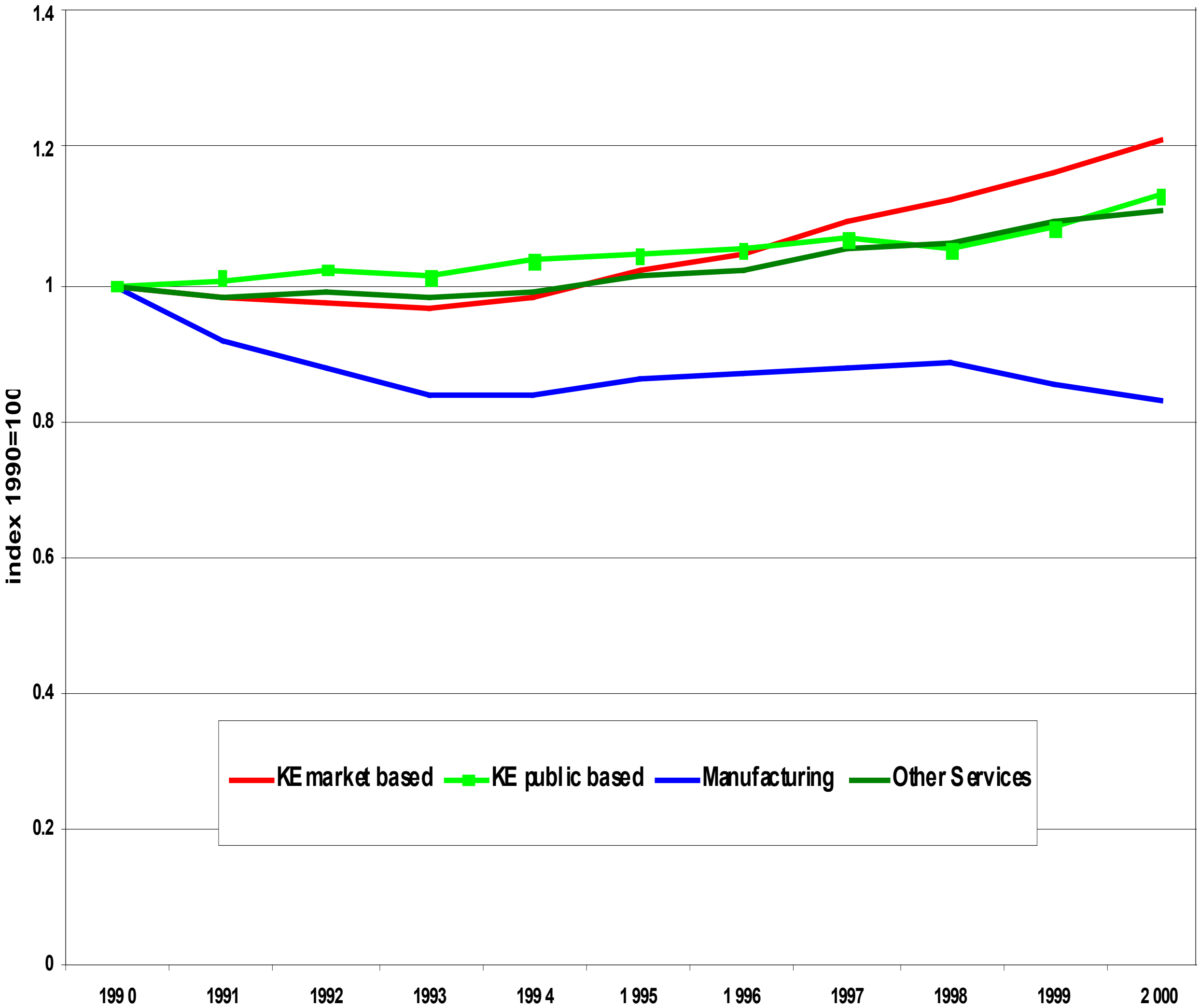


The second point to make is that the UK government reacted in a timely fashion to the profound challenge of the crisis. Even though The Work Foundation would have preferred a larger fiscal package in 2009-10, we recognise that the UK government has done a great deal and even a modest fiscal boost is better than nothing.

Most importantly, perhaps, overall labour market performance has been good – or, more accurately, not as bad as one would have expected given the precipitate fall in output over the last year. Government has also been right to focus on the plight of young people and

Figure 2.09: Knowledge economy and 1990s recession and recovery

Total employment, EU KLEMs database distribution 1990=100. KE market based is telecoms, high tech, business, financial and cultural services; KE public based is education and healthcare



offer a meaningful job guarantee for the young unemployed. Once again, we have some concerns about the design of the job guarantee programme, but these are questions about the practicalities of delivery, not an objection to the whole programme.

Our overall assessment of the labour market is that government is adopting broadly the right approach – stimulate the economy to generate growth, minimise the risk of scarring effects for the young unemployed, work with employers to get people back to work through programmes like the Local Employment Partnerships. We do not argue that the situation is desirable – after all, unemployment is still rising – but we do believe that the position could have been much worse and that the social catastrophes of earlier recessions may have been avoided.

Perhaps we should make the point again for the avoidance of any doubt about our position. We are offering a measured assessment as an antidote to excessive optimism and pessimism. The UK labour market still faces significant challenges. Unemployment will continue to rise in the short term and a return to pre-crisis levels of employment could take almost a decade to materialise. Youth unemployment in particular remains a severe problem (of which more in a moment) and there is no cause for complacency. But unemployment has risen more slowly than many anticipated, employment is still growing, long term unemployment is stable and the worst experiences of the previous two recessions have so far been avoided.

This then brings us to our next set of questions. Is there anything more that government could do? We have outlined some policy ideas in the course of the analysis so far and it is to a more systematic exposition of these polices that we now turn.

3. Policy measures

Introduction

What should the government do in the pre-budget report? Obviously the more significant measures will be published for consultation and key decisions will be taken in the budget next year. Nonetheless, we believe that there are some further steps that might be taken immediately, or announcements that can be made now about principle changes in policy, with the precise implications for spending to be specified in the budget. In addition, there are policies already in place (like the government's job guarantee for the young unemployed) that might be revised, adapted or developed to improve their effectiveness.

We have kept our recommendations short, partly because the PBR is not the budget and we will be making a more developed submission in the New Year, but also because we have sought to identify policies that will have a labour market and a political impact. The remainder of this section is therefore focused on:

- The introduction of a short-time working scheme;
- The expansion of higher education;
- The revision of the government's job guarantee;
- Higher benefits for the unemployed.

Short-time working

We pressed the case for a short-time working scheme in both *Hard Labour* and *A Boost for Britain.* The chancellor resisted this suggestion in his budget speech by arguing that the tax credits system offered the same support for families as the short-time working arrangements in Germany. In his view workers and employers could agree reductions in pay and hours confident in the knowledge that the state would offer appropriate support. No doubt there is some truth in this argument, but it is not entirely accurate to say that tax credits and the German scheme have the same effect. To begin with, the short-time working arrangements are specifically designed to incentivise reductions in pay and hours to preserve jobs. Much effort has been invested in promoting the scheme and it remains the centrepiece of the German government's reaction to unemployment. There can be no doubt either that both employers and workers are aware of their eligibility for the scheme and understand the effect that it will have in maintaining household income.

Unfortunately the same cannot be said of the tax credits system. While The Work Foundation remains supportive of the government's overall approach, we note that there have been significant problems with the administration of tax credits. Negative media coverage may have exaggerated the problem, but it would be difficult to make the case that workers who have so far not been eligible for tax credits would be confident that the system will work to their advantage. Equally, the German scheme is available to *all* workers, no matter what their household income may be. It offers an explicit incentive to everybody – and the application is made by the employer. Tax credits are different. Only those whose incomes are sufficiently low will qualify, those who qualify may not know that they are eligible and employees (rather than the employer) must make the application. It would be wrong to say that tax credits offer no incentive to short-time working, but it is a much weaker incentive than anything offered by the German scheme.

Our principal reason for making the recommendation was based on the dynamics of unemployment. In our view, the joblessness total is rising because more people are losing their jobs, not because fewer people are leaving the unemployment register – in other words, the outflow has remained the same but the inflow has risen. If this is right, the focus of policy has to be in two areas: first, reducing the inflow to unemployment; and, second, preventing the scarring effects of youth unemployment. These are not alternatives; government needs to act on both fronts.

Another criticism made of the short-time working proposal is that the moment has passed, the economy is about to recover, the most catastrophic predictions of rising unemployment have not materialised and that to act now would be an unnecessary intervention in the labour market. One can understand why some people take this view, but the sad reality is that unemployment will continue to rise for at least another 12 months and there is still a powerful argument that government can take intelligent action to minimise the inflow.

It is worth noting, perhaps, that the German government is continuing to implement stimulus policies in 2010 – and potentially beyond if the tax cuts proposed by the new coalition are implemented – at the same time as they reinforce the operation of the short-time working scheme. It is entirely legitimate for critics of our proposal to say that the costs are open-ended and the benefits uncertain, but they must offer rather more than a mere reliance on the status quo. If the UK labour market has demonstrated significant flexibility so far, just think what might be possible if the government offered a further incentive to employers and workers.

As we pointed out in both our earlier papers, we accept that short-time working schemes designed to slow the pace of structural change in good times are undesirable. We accept that creative destruction is the dynamo of capitalism. On the other hand, we are opposed to destructive, destruction, which is how one might reasonably describe rising unemployment in a recession.

By the early part of this year the German scheme was supporting more than a million employees in 36,000 companies. Were it not for the scheme many, if not most of these workers would have lost their jobs. German unemployment increased by only 0.5 per cent to 7.6 per cent in the year September 2008-September 2009, despite the collapse in output (a forecast of -6 per cent for 2009). British unemployment rose by 2.1 per cent (also to 7.6 per cent) over the same period. During the boom period German unemployment was consistently higher than unemployment in the UK, but there has been a convergence of both employment and unemployment rates during the recession. In fact, the German employment rate rose over the period June 2008-June 2009.[16] At the very least the short-time working arrangements will have made some contribution to these outcomes, even if they cannot take all of the credit for the relatively good performance of the German labour market.

We should also note of course, that German workers have strong institutional guarantees that negotiated hours and earnings reductions will be open, transparent and fair. The universal coverage of collective bargaining, combined with effective workplace representation through works councils help to ensure that workers are participants in these processes rather than the victims of events beyond their control. Workplace institutions are weak in the UK and we know little about employee perceptions of the concessions they have made. Inequality of bargaining power is a relevant factor here and, while the UK labour market has demonstrated remarkable flexibility since the crisis began, we cannot be confident that workers believe this flexibility has been entirely to their advantage.

At this point perhaps it is worth explaining how the German scheme works, not least to see whether analogous arrangements could be implemented in the UK. The *kurzarbeitergeld* (short-time working compensation programme) is administered by the German equivalent of JobCentre Plus. From January 2009 the programme was redesigned to take account of the severity of the crisis:

- To be eligible for the programme, companies simply had to show that the affected employees had suffered a reduction in wages of more than 10 per cent (hitherto employers have to show that one-third of employees had been affected.
- The eligibility period was extended from 18 to 24 months (having initially been extended from 12 to 18 months when the crisis began to bite.
- Extra financial support has been introduced to offer incentives to organisations that offer employees training opportunities if the short-time working scheme is being used.

[16] See ONS, Labour Market Statistics: November 2009 (2009)

- The government will now cover half of the employer's social insurance contributions and all of their associated contributions relating to the payment of short-time work allowances after six months of the programme, or all of their associated contributions from the beginning of the claim if the employer offers the workforce the required training opportunities.

As the German labour ministry has pointed out, the scheme makes financial sense because the costs of the short-time work allowances are generally lower than unemployment benefit.[17] Moreover, if the training option is used, the German economy will benefit from an improvement in human capital, ensuring that the employer can respond well to the economic recovery when it materialises.

There are no restrictions imposed on the programme – all companies in all sectors are eligible. As we have noted, if the employer has a works council then the hours and pay reductions must be agreed with the workers representatives, if not, then each of the affected employees must consent to the arrangement. At that point the employer can make an application to the regional unemployment service that:

- At least one employee has suffered a reduction in wages of at least 10 per cent as a result of a fall in demand caused by the current economic conditions;
- It is reasonable to assume that the situation will improve in 24 months, allowing for the reinstatement of normal weekly working hours; and
- All other options for managing the reduction in demand have been exhausted.

This last condition is more that a formality. The employer must be able to offer evidence that they have considered and implemented other courses of action – an important limitation preventing abuse of the scheme.

If the employer's application is accepted, the federal authorities (essentially the employment service) compensates the employees for the sacrifice of wages at the level of 60 per cent of lost net earnings for employees with no children and 67 per cent for those employees with children. The reimbursement of employer social security contributions is another incentive to agree reductions in hours and earnings. The German scheme is not unique and analogous arrangements can be found in 11 other EU member states and Norway.[18] Some of these

[17] Federal Ministry of Labour and Social Affairs, *Germany's short-time work allowance programme* (2009)
[18] A longer exposition can be found in *Tackling the Recession: Employment related public initiatives in the EU Member States and Norway*, European Foundation for the Improvement of Living and Working Conditions (2009)

schemes offer incentives for skills development and others do not. The most important point of course is that the labour markets of the EU are diverse and there is no in-principle reason why arrangements of this kind could not be applied in the UK.

A relatively small experiment supported by the Welsh Assembly Government reinforces the point. The ProAct scheme offers a specific incentive for investment in human capital where short-time working has been agreed. Up to £2,000 per individual is available to subsidise training costs. The subsidy here is for costs incurred by the employer – rather than a direct compensatory payment to the employee for lost wages – but it is another example of government support that enables businesses to equip themselves with the skills they need to respond to the opportunities of the recovery. As with the German scheme rather rigorous eligibility criteria are imposed:

- The business must demonstrate that it was inherently viable before the economic downturn and can demonstrate the need for some additional support for skills development – in other words, they do not have the resources they need to invest in workforce skills.
- Short-time working must have been introduced with a 20 per cent reduction in working time (one day a week) for at least 40 days.
- Introducing short-time working must be demonstrably a response to the downturn and a means of avoiding redundancies.
- The business cannot have received EU funding of more than €200,000 over the previous three years.

ProAct has a budget of £68 million with £38 million coming from the European Social Fund. To date more than 6,000 employees working for 115 companies have benefited from the scheme. Evidence from the companies affected suggests that the skills development programmes have led to reductions in wastage, increased productivity and new contracts.

Of course this is on a small scale and is only designed to improve human capital rather than prevent unemployment. The incentive effects for pay and hours reductions are relatively weak. Nonetheless, it does demonstrate a capacity to innovate within the UK's systems and makes the case that interventions of this nature are not incompatible with our culture and traditions.

For all these reasons, The Work Foundation believes that the case for a short-time working scheme remains compelling. The Chancellor could offer an outline scheme in his pre-budget report and could perhaps set aside a small amount of money for piloting and testing, reserving any larger initiatives to the budget itself.

Expanding higher education

We have already referred to the scarring effects of youth unemployment and the need for determined action to minimise the numbers of young people affected. A suggestion made in both *Hard Labour* and *A Boost for Britain* is that the government should guarantee a university place for all suitably qualified applicants in both 2008 and 2009. University applications are rising – by 9.7 per cent for the 2009-10 academic year and by 12 per cent for the 2010-11 academic year. This is a consequence both of rising unemployment, as young people choose to continue their education and an increase in the number of young people in the age cohort – the numbers are set to fall after 2011. We remain committed to the argument for a one-off expansion in 2010-11, simply because these rising numbers mean that some people who would have found a university place with little difficulty in 2008 (given their A level grades) may experience rather more problems in 2011. It should be straightforward for the government to make a choice between leaving a young person on the unemployment register and offering the prospect of a degree.

It would be absurd to deny that there is a cost attached to this proposal, but it is time limited and will not add in any way to the UK's structural budget deficit. Offering all suitably qualified applicants the opportunity of participation in higher education has obvious economic benefits (both for society and the individuals concerned) given the strong evidence that the economy is restructuring in the direction of knowledge intensive employment.[19] For the avoidance of doubt, we are not suggesting that anybody who submits an application to UCAS should be guaranteed a university place. Nor are we suggesting that standards should be lowered. But young people may experience a justified sense of unfairness if their achievements at A level would have made university entrance certain in 2007 and uncertain in 2010.

If government is committed to the principle that individuals should be equipped with the capabilities they need to choose lives that they value, then continued investment in HE and a short-term expansion of university places is an eminently reasonable use of limited public money and an intelligent response to the recession. We continue to commend this approach to policymakers.

[19] See Brinkley et al, *Knowledge Workers and Knowledge Work* (2009)

The job guarantee

So far the centrepiece of the government's response to youth unemployment is the job guarantee supported by the Future Jobs Fund. We have set out some of the practical questions related to the implementation of the policy in our joint paper with ACEVO, *Unemployment and the Role of the Voluntary Sector* (2009).[20] Our focus here is on improving the operation of the scheme to ensure that it offers the greatest support to the young people most in need.

To begin with it was intended that the scheme would become operational once a young person had been unemployed for 12 months. This has now been reduced to ten months, a change that we support. Nonetheless, as professor Paul Gregg and others have argued, ten months may be too late and there is a case for earlier intervention (probably at six months) to identify the young people who might find a job before the ten month period expires if they are given more job search support. This has implications for the deployment of resources in JobCentre Plus and inevitably it means that personal advisers will need to undertake a risk or capability assessment at the six month point. But the implication of taking a little more care here is that the flow of young people onto the job guarantee scheme can be reduced or, put another way, that those young people who find themselves on the programme will be those least able to find work on the open labour market and most in need of additional support.

A second important point is that participation in the job guarantee programme should not be seen as an alternative to job search. The young people participating in the scheme must be encouraged to look for work in the open labour market and must be supported by JobCentre Plus in doing so. The job guarantee is not just a device to park people in some kind of work experience for six months – it has to be an instrument that builds individual capabilities and enhances the opportunity for full labour market participation. We have addressed the issues around quality and skills development at greater length in our joint paper with ACEVO. Suffice to say at this point that employers should not be able to access the Future Jobs Fund unless they are offering worthwhile employment that meets a quality threshold – the government has specified that at least the national minimum wage must be paid, but we would suggest that attention should be paid to the skills formation elements of the programme too.

The final issue here is what happens to young people when their participation in the scheme comes to an end? Where is the real job at the end of the job guarantee? Participating employers could be invited to offer further job trials or probationary periods or, as with the Local Employment Partnerships could make a commitment to offer permanent employment to a percentage of those coming through the job guarantee programme. It is not acceptable for

[20] See https://www.acevo.org.uk/captest/download_file.cfm?filename=Will_Hutton_report.doc

young people to find themselves thrown back into the New Deal at the end of the job guarantee period. The scheme must offer real opportunities for development and progression, otherwise it will lose credibility with those people that it is designed to help.

Higher benefits?

We have already seen that the unemployment benefit replacement rates in the UK are lower than in most other comparable countries (except the USA). It is for this reason that we have called for an immediate increase in Jobseekers Allowance of £10 per week. The proposal has been subjected to some criticism on the grounds that it is a 'gimmick', taking no account of the other benefits to which the unemployed are entitled (housing benefit, council tax benefit etc). We would reject both of these observations, although we concede that this is a symbolic policy that would act as a statement of intent by the government.

The more profound questions of course are just what should the state provide for those who lose their jobs? What level of investment is needed in active labour market programmes? What is the relationship (if any) between social investment by the state and the opportunities for development and progression associated with jobs at the bottom of the labour market?

Some commentators and policymakers suggest that these questions may look interesting, but they are not entirely relevant. After all, the UK labour market works well, there has been a high degree of flexibility in response to the crisis and unemployment is lower than in previous recessions. Even though there is an element of truth here, this standpoint does come close to Panglossian optimism – that all is for the best in the best of all possible worlds. Our view is rather different. What is needed, perhaps, is not so much a celebration of the UK's labour market successes, but a dispassionate assessment of the strengths and weaknesses of the model. We know that other countries have done just as well on the employment front (especially the Nordics and to some extent the Netherlands) and have achieved better social outcomes – lower income inequality, better health and longer life expectancy, fewer low paid jobs, a higher level of social mobility, higher trust workplaces and either a better or equivalent productivity record.

The OECD have identified the flexicurity model in Denmark (and similar elements of policy in other countries) as a potential example to policymakers elsewhere. It is the combination of light touch regulation, universal collective bargaining coverage, significant investment in active labour market programmes, high benefits, tight job search conditions and an enabling welfare state that explain the dynamism of the Danish labour market.[21] Moreover, Denmark (and the other

[21] OECD, *Employment Outlook 2004* (2004)

Nordic economies) are amongst the most open in the world, are most exposed therefore to the supposedly chill winds of globalisation and yet achieve the best social outcomes of any developed countries. There is a strong sense here that a strong welfare state is a corollary of market openness, allowing individuals (and society) to manage disruptive economic change and avoid social disaster. A flexicurity model may therefore be better adapted to open and integrated global markets than other welfare state models.

Our intention in proposing the £10 increase in JSA is to reopen this discussion in the UK. The crisis offers a valuable opportunity to revisit the UK's supposed Anglo-social model and consider how it might be adapted to offer as much security as flexibility. The risk of course is that an emphasis on flexibility, even if it is linked to a story about the importance of human capital, will fail to satisfy the demands of workers under pressure on the receiving end of bad news. Unless government gets this right there will almost certainly be a political penalty to pay. Our suggestion therefore is that the government does more than simply consider whether the level of benefits and job search conditions are properly matched. A determined effort is needed to answer the questions outlined above and developing a compelling prospectus in response will have self-evident economic and political benefits.

Affordability and the public finances

Some readers may be surprised that we should be advocating additional spending at all (even on a modest scale) when the public finances are in such a parlous state. Our response is fourfold. First, if unemployment rises significantly then the process of recovery will be delayed: consumer confidence will remain subdued, demand will be sluggish, businesses will defer investments (because they cannot be confident that conditions are improving), bank lending will remain subdued (because banks cannot be confident that they will make a reasonable return on their investment, or that sluggish conditions make lending a bad risk) and the upshot of all this is that the economy will stagnate. Second, the best route to sustainable public finances is a rapid return to growth. This may require some additional spending in the short term, although credible commitments have to be given about deficit reduction in due course. Third, to *withdraw* stimulus spending before the recovery has matured will almost certainly tip the economy back into recession – causing a further reduction in tax revenues and a rising budget deficit. Fourth, government must at least allow the automatic stabilisers to operate for the duration of the recession. It is inevitable that tax revenues will drop, the volume of benefit payments will increase and borrowing will rise. To prevent the automatic stabilisers from operating is a pro-cyclical policy rejected by every developed country. It would be disastrous for the UK to adopt this approach and equally disastrous to start tackling the budget deficit today.

The absolute priority must be to return to rising output and falling unemployment. Policies not oriented to this end must be rejected.

Given the scale of the budget deficit growth alone may not be enough. Government may need to consider both tax rises and reductions in government spending – or at least no increase in government spending in real terms so that the focus turns to public service performance, efficiency and the quality of outcomes. Slash and burn is not the only option as the G20 have proved. International collaboration and the peer review of policy effectiveness is the right way forward. We believe that the government has got much right on labour market policy over the last year. Our suggestions here are designed to improve policy effectiveness and create space for an informed discussion about the kind of labour market the UK needs in the post crisis era. We do not pretend to have all the answers, but we do believe that we are asking the right questions. Our policy priorities can be rapidly implemented, at which point the focus must switch to the strategic medium term issues. We will return to these challenges in our budget submission, but in the meantime we commend our proposals to the chancellor.

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