

# Hard Labour: Jobs, unemployment and the recession



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## Summary of recommendations

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### Introduction: The economic context

- The UK economy needs a fiscal boost of around 1 per cent of GDP (or £15 billion) including a £3 billion one-off tax credit for the poorest working families.
- To deal with the problem of perverse incentives and discourage excessive risk taking, government should introduce a financial services bonus tax taper, with a higher marginal rate of 75 per cent for annual bonuses, progressively falling to the normal income tax regime for bonuses paid over 5 years.
- The terms of the Bank of England's special liquidity scheme must be relaxed so that banks can more easily swap commercial paper for cash and Treasury bills. In addition, the Crosby scheme for insuring the nominal value of residential mortgage-backed securities should be introduced.
- The government should lower the 12 per cent interest rate on the coupon it is charging when it invests in banks via preference shares. This would cost around £1.5 billion in a full year.
- Action needs to be taken to reduce the insurance premium being paid to guarantee the £250 billion of unsecured debt in interbank lending. This would cost the government up to £1.25 billion in a full year.
- There is a strong case for the UK reproducing Barack Obama's campaign pledge to establish a US Infrastructure bank.

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### The national policy response

- An effective fiscal stimulus must be:
  - **Timely:** Because the stimulus needs to be administered at the right point in the economic cycle.
  - **Targeted:** So that money reaches the pockets of those most likely to spend rather than save, which in this case means those on lower incomes.
  - **Temporary:** Because a fiscal stimulus is precisely that – a stimulus to get the economy through a temporary slowdown. Government should borrow more during recessions and repay debt when the economy resumes a stable growth path. Some flexibility is needed in the application of the fiscal rules for the duration of the current crisis, but the “golden rule” (that government will only borrow to invest over the course of the economic cycle) should be reinstated when the economy recovers.
- However, the combination of monetary policy and the measures above is unlikely to offer the kind of boost the economy needs.
- Government should use all the policy instruments at its disposal to minimise the adverse consequences of recession. This should include supply-side as well as demand-side measures and a positive approach to the role of regulation.

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### Supply-side measures

- **Welfare to work – revisit the scale of ambition:** The government has recently indicated that it intends to press ahead with the intensification of job search and support measures for some groups of claimants on long-term benefits despite the worsening employment

position. While we support the goal of getting more lone parents and more Employment Support Allowance recipients into work, we question whether the full scale of the government's ambition (the 80 per cent employment rate) is achievable in the short term. Typically, such workers are less attractive to employers than other job applicants, even when vacancies are high, and they are likely to be pushed to the back of the queue even more firmly when vacancies are low and the competition for jobs from those already on the claimant count is intense. Moreover, careful consideration must be given to the resourcing of the "core" functions of JobCentre Plus, given that today's jobseekers will soon be joined by many more unemployed people looking for work with good employment records and up-to-date skills.

- **Sustain high-quality job search and support services:** The key priority will be to ensure that the sheer number of claimants flowing through the employment services does not dilute the quality of job-search support. The employment service is undoubtedly too small at present to provide the same levels of individual attention that are a key feature of New Deal. The government will have to build capacity rapidly, either by expanding JobcentrePlus or accelerating the involvement of private sector and voluntary providers, or through some combination of the two.
  - **Invest in skills:** There is a case to expand the training elements within the New Deal for those claimants who might benefit. Drawing on the experience of the MG Rover closure, where training and education played an important role, provision of training and further education as an option may be especially suitable for dealing with the immediate consequences of industrial closures. The types of assistance and support that people found most helpful were free travel to a training course or job interview; a free place on a training course; being sent on a training course by a new employer; and help with setting up a business.
  - **Expand the provision for employer placements, including in the public sector:** The elements of the New Deal that allow for subsidised employment and short-duration training courses could be expanded and extended to other claimant groups. More capacity can be developed rapidly in the public sector. However, the scheme should be strictly time limited and should be suspended when the claimant count starts to decline.
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- Demand-side measures**
- **Increase out-of-work benefits:** A central part of any fiscal stimulus must be to put more money into the pockets of those most likely to spend rather than save. The unemployed fall into this category. The levels of benefits in the UK are low by international standards and could be increased to (say) 60 per cent of net earnings from work. This would be consistent with the effort to get more people back into the labour market as long as benefits were time limited and included enforced job search conditions.

- **Implement a temporary expansion of tax credits for the poorest families:** The Institute for Fiscal Studies has proposed an expansion of tax credits for the poorest families that would cost around £2.7 billion per year. Further consideration would need to be given to making such a measure a permanent feature of the tax and benefits system.
- **Short-time working and labour hoarding:** Incentives could be offered through a publicly funded short-time working scheme. This would encourage employers to retain human capital by reducing working hours rather than by dismissing workers. The state would offer partial compensation to affected employees for the net loss of wages. A German scheme of this kind offered net wage compensation of 67 per cent in the 1990s. Any scheme in the UK should be suspended once the economy returns to a stable growth path, although it might be reactivated at some point in the future during an economic slowdown.
- **Public works:** The government should help bring forward as many construction projects as possible and authorise new projects able to start quickly. Institutions, such as the Housing Corporation and housing associations, together with local authorities and regional agencies, should be given increased funding if necessary. Where access to private finance is holding projects back it should be replaced with public finance. There should be particular attention given to smaller scale and more labour-intensive projects in areas such as social housing, hospitals, schools and transport. The government should ensure resources and authority to act are devolved as fast as possible to regional and local authorities and agencies.

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### Other regulatory interventions

- **Extending the right to request reduced hours of work:** The government should implement the extended right to request as planned. This could be a valuable source of flexibility for employers and employees during a downturn. Essentially it can be viewed as a short-time working scheme with no wage compensation.
- **Moving to a limit on the length of the average working week:** The government has resisted the implementation of the 48-hour week because it would reduce employers' flexibility and employees' earnings. Progress could be made on a constructive agenda to improve performance and productivity while less overtime is being worked in the economy. Businesses would then be well positioned to respond to rising demand in a recovery without a return to excessive working hours.

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### Cities, regions and partnerships

- **Labour market initiatives:** The recession will affect different areas differently depending on demographics, industrial structure, occupational structure and skill levels. Labour market interventions will be most effective if they are informed by a subtle understanding of what is happening in a city/regional economy. We favour the wider application of the approach adopted by City Strategy Pathfinders and believe that much can be learned from the Manchester Multi-Area Agreement and the proposal for a "Greater Manchester Flexible New Deal".

- The “core” functions of JobCentre Plus and other labour market interventions at city-region level will need more attention in the future – although that does not mean that tailored support for “hard-to-reach” groups should be abandoned.
- **Access to capital and business support:** Some regional development agencies (RDAs) have already begun to consider how they can offer more support to SMEs under pressure. We believe that the approach of Advantage West Midlands, with a £3 million transitional loan scheme, offers a model for other RDAs too. RDAs should also use their business support activities to encourage improvements in productivity and performance so that firms are well positioned to respond to the upturn when it comes.
- **The stabilising role of the public sector:** For some cities and regions public sector employment will play a very important stabilising role in the downturn. Reductions in public expenditure would have a pro-cyclical effect and will make it more difficult for these cities to weather the economic storm.
- **Using public procurement to support the local economy:** A total of £3.45 billion is spent by the public sector on purchasing goods and services. Local and regional government procurement professionals should examine the local multiplier effects to assess how support for local businesses might be increased through the public sector supply chain without compromising on quality.
- **Public works programmes:** Existing major projects (like the London Underground modernisation, Crossrail and the Olympics) must be sustained. RDAs and local authorities must act to improve the supply of social housing, both through building programmes and through buying homes that private developers are currently unable to sell. Investment in transport infrastructure – as set out, for example, in the Leeds City Region transport plan – must continue to be a priority. These programmes will offer valuable employment opportunities over the recession and will position city-regions to grow rapidly as the recovery matures.
- **Partnerships and collaboration:** Effective collaboration between institutions is essential if the above objectives are to be delivered. The experience of the MG Rover closure shows what can be achieved when all the stakeholders work together. A similar principle should be applied in all city-regions as local actors work out how they can respond most effectively to the decline in economic activity.

# 1. Introduction: The economic context

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Until 7 days ago the Bank of England and the CBI were both forecasting only shallow recessions. Now they have revised their forecasts down dramatically, both predicting that the recession will be on a similar scale to 1990–1992. The Bank of England predicts there will be a fall of GDP from peak to trough of 2 per cent; the CBI believes the fall will be 2.5 per cent with a rise in unemployment to 3 million. It is the knock-on effects of the collapse of Lehman Brothers in September that changed the world, they argue, and which induced such an intensification of the credit crunch to provoke even stronger recessionary forces than they anticipated in September.

Whether Lehman Brothers alone is responsible for such a transformation of UK and global economic fortunes is doubtful. The world financial system, as the Financial Stability Report states, is currently carrying \$2.8 trillion of mark-to-market loan losses as a result of the overextended growth of securitised assets and the sharp fall in the value of the property against which they were collateralised. Lehman is the event that triggered awareness of the precariousness of the western banking system, but it alone could not cause it. Rather it was a casualty of a very intense credit crunch whose impact forecasters are belatedly recognising.

IMF research suggests that recessions induced by financial crises are both deeper and last longer. All the risks are therefore that the CBI/Bank of England consensus will prove too optimistic so that the peak to trough fall in GDP could be even larger – on the scale of the 1974–1975 recession or even 1931–1933. Last week's letter from the chairman of HBOS, Britain's largest mortgage lender, to shareholders should have dispelled remaining doubts about the gravity of the financial position. The alternative to merger with Lloyds TSB was not a temporary period of "conservatorship" or nationalisation with a majority of the equity held by the state before resuming independence, he wrote; rather the bank was so stricken that without Lloyds TSB the alternative might be wholesale nationalisation and run-down of its operations like Northern Rock.

Every demutualised building society, with the Halifax part of HBOS being the most conspicuous after Northern Rock, has been unable to sustain a business model reliant on access to the wholesale money markets and sale of residential mortgage-backed securities – effectively shut since the summer of 2007. The banks are no less troubled. Royal Bank of Scotland is facing significant retrenchment; Barclays is raising expensive funds from sovereign wealth funds; Lloyds TSB is anxiously preparing for merger with HBOS. All the banks are finding that the escalating flight of capital from the UK – three-quarters of all capital that came into the country between 2004 and 2008 left in September and October – means that they are relying increasingly on the Bank of England's expensive special liquidity scheme for short-term funds. This makes their lending, already under pressure because of their problematic balance sheets, even more constrained and expensive. The poor availability of not just mortgage finance, but

of working capital, is now severely impacting on the level of housing transactions and even the provision of normal trade credit.

The extent of the depressive impact on the wider economy is very difficult to assess; economic model builders have no recent past experience on which to build their predictions. The concern, however, is that the impact may be very large. Sweden and Japan after their credit crunches in the 1990s both suffered deep recessions and very faltering growth afterwards despite very benign global conditions. Britain is highly likely to be in an analogous position.

Unemployment, as we show in this paper, represents not just foregone economic opportunity; it has a desperate psychological and health impact on the individuals concerned. Full employment is one of the most important aims for any society. Work is of course a means of paying the bills, but it is also where we act on the world, structure our lives and give meaning to them. The government and opposition parties are correctly concerned to do all they can – within the constraints of particular philosophies and budgets – to alleviate the recession and mitigate the rise in unemployment with all its attendant distress.

The policy response must be multi-faceted and this paper looks at a range of potential interventions in the labour market and in increased spending and lowered taxation. We are keenly aware that this crisis originated in the financial system and any package that does not find a way to stimulate depressed bank lending would be incomplete. Recapitalisation of the banking system has provided a breathing space, but the banks are far from lending normally. One of the important reasons is that the government, anxious to be seen to protect taxpayer interests, has designed a bank rescue package that is too restrictive so taxpayers are paying in a sharper fall in output than would otherwise be the case.

There are a number of areas where the government needs to act fast. Although the Bank of England was right to cut interest rates to 3 per cent and is promising more the reduction has not been passed on to borrowers. The government needs to act both to unfreeze the flows of interbank finance and to lower risk premiums. First, it should lower the 12 per cent interest rate on the coupon it is charging when it invests in banks via preference shares. This makes the cost of capital high and incentivises the banks to charge high margins to deliver the profit to pay off the government loan fast. The dynamic is self-defeating and intensifies the lending crisis. A coupon of 7 per cent would strike a balance between cheapening the cost of capital and securing the taxpayer interest. The running cost of this would approach £1.5 billion in a full year.

Second, the insurance premium for guaranteeing £250 billion of unsecured debt (mainly interbank lending) is based on credit default swap rates in the 12 months up to this October – a period when the credit default swap market was imploding and the insurance cost racing up.

The failure of the scheme is reflected in LIBOR being locked at a costly 150 basis points above bank rate. The insurance premium needs to be radically lowered, costing the government up to £1.25 billion. In addition the government should expand and relax the current small business loan guarantee scheme; the insurance premium should be halved and it should be extended to all small businesses.

We propose two more schemes that should be self-financing although they expose the Treasury potentially to claims for loss. The terms of the Bank of England's special liquidity scheme must be relaxed so that banks can more easily swap commercial paper for cash and Treasury bills. In addition, the Crosby scheme for insuring the nominal value of residential mortgage-backed securities should be introduced. Between 25 to 50 basis points would be deducted from the interest payments on new securitised assets and the scheme should be billed initially as running for a time-limited 3 years. Without insurance this market will remain shut and foreign money will continue to exit the country. This is a cheap way of getting some mortgage finance into the housing market, stabilising sterling and providing the banks with much needed funds in the wholesale markets.

UK banks are now extremely risk-averse; vital funds for private finance initiatives and infrastructure spending all over the country are not forthcoming. We believe that there is a strong case for the UK reproducing Barack Obama's campaign pledge to establish a US Infrastructure bank.

The government, complying with the G20 final communiqué, will need to address the bonus reward system and culture that encourage excessive risk taking. The communiqué permits governments to choose regulation or voluntary code or whatever mix they deem appropriate. We believe that given London's role as a leading financial centre the UK government has an obligation to establish a leadership role. It should introduce a financial services bonus tax taper, with a higher marginal rate – say 75 per cent – for annual bonuses, progressively tapering to the normal income tax regime for bonuses paid over 5 years.

Alongside these measures there is a clear case for a fiscal stimulus as the G20 and IMF have mandated. Given the low stock of public debt to GDP, as we detail later, the UK can be relatively relaxed about increasing that ratio towards the international average of some 60 to 70 per cent providing a) it can sell the bonds and b) it has a credible plan for returning to budget balance over the economic cycle once the recession is over. We believe that a stimulus of 1 per cent of GDP, or some £15 billion, is financeable, justified by the depth of the recession and should be fundable. The government should say that it wishes to retain fiscal discretion until it is clear that the recession has bottomed, but it will then reintroduce the golden rule to balance the

current deficit over the economic cycle. In addition, the measures listed above should help to attract holders and investors in sterling assets.

The UK has enjoyed an unparalleled period of economic growth. Many view a correction as long overdue. But what we are experiencing goes well beyond a correction. Lives and businesses solid in even normally poor trading conditions are being blighted. We must do all we can to limit the damage. The measures we examine here and from which we distil our favoured priorities are technical. They will be vital in limiting the downturn. But we have also prioritised them because we believe they will be of continuing usefulness in the subsequent upturn. There will be economic life after 2009. It is imperative that we remain confident about the medium-term prospects for our country. The government needs to develop a narrative about how tomorrow will be better than today. Part of the authenticity and effectiveness of that message will be how obvious it is that solid building blocks are being laid that will not just mitigate recession but will entrench the upturn.

## 2. Why does full employment matter?

### Introduction

The pursuit of full employment as a public policy goal is, in the UK at least, generally dated from the 1944 White Paper on employment policy. This is one of the two great wartime documents that, along with the Beveridge Report, wove the fabric of the post-war welfare state. As Gordon Brown explained in 1999, the present government's objective has been to achieve the White Paper's ambition in an integrated global economy with a very different industrial structure and very different labour markets. In other words, the aim is to secure high and stable levels of growth and employment together.

Some readers might believe that this is little more than wishful thinking at a time of recession when by definition the economy is shrinking rather than growing. Our case on the other hand is that the pursuit of full employment should not be abandoned in the downturn. Every effort should be made to minimise job losses and encourage the creation of sustainable work as the economy recovers. That this is more than a worthy aspiration is proved by the economic record of the period from 1945–1979, when employment was maintained at a relatively high level and unemployment was low (certainly by the standards of the 1980s and the 1990s).

Far from being facts of nature, high levels of unemployment are often the consequence of conscious policy choices. For example, Geoffrey Howe's "austere" budget of 1981 almost certainly pushed up unemployment significantly (exacerbated by an overvalued pound) and Norman Lamont in the early 1990s was quite explicit that unemployment was "a price worth paying" to squeeze inflation out of the economy.

Today all political parties would find such views somewhat callous and all politicians are claiming that their policy prescriptions are likely to be the most successful in minimising the adverse consequences of a recession. Whether this is the case or not will be explored in the next section, but one can only welcome the fact that no political party is willing to accept that nothing can be done.

Nonetheless, it is also important to understand the severity of the current crisis. The recessions of the 80s and 90s are closer to a mild shower of rain than the raging hurricane of today's banking collapses. There can be little doubt that the world economy faces the biggest financial challenge since the early 1930s.

Yet even at such a turbulent time it is essential to remember that policy matters and successful intervention is possible. The reaction from the Hoover administration in the USA from 1929–1932 and the National Government in the UK after 1931 almost certainly exacerbated the problems of the Great Depression – and Roosevelt's New Deal almost certainly improved the economic prospects of ordinary Americans and avoided a descent into fascism.

For our purposes the lesson is clear: a limited and gradual response is insufficient to the task. What we need is bold and decisive leadership that can relate the construction of global solutions (a new financial and regulatory architecture) to the practical difficulties that people face in their daily lives – the risk of unemployment, falling property prices and a lack of access to finance.

Moreover, government must use all the instruments at its disposal – monetary policy, fiscal policy, public procurement and regulatory interventions – to sustain a high level of employment. Some commentators and the Conservative party have suggested that monetary policy alone should do most of the work. We believe that this is misconceived not least because we have already seen that banks do not necessarily pass on all interest rate cuts to their customers. The case for significant fiscal stimulus is compelling.

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### Unemployment, capabilities and freedom

The principal factor motivating policymakers in the 1940s was the belief that the misery of the Depression could have been avoided by intelligent early intervention. There was a determination to ensure that the social dislocation, poverty and inequality that followed the Great Crash in 1929 were prevented in the future. Part of the argument was prudential – a failure to sustain high levels of employment could encourage political extremism and a possible return to fascism – but much of the argument was principled: that unemployment had a corrosive effect on individual opportunity, wasted human potential and left the poor with cramped, narrow and unhealthy lives. For far too many people unemployment had the effect of making their existence nasty, brutish and shorter than might otherwise have been the case.

Rising poverty, reduced spending power and the corresponding reduction in demand all do profound harm to nations, communities, industries and individuals – although the UK has a fairly high level of “in-work poverty” too.<sup>1</sup> But while the first three tend to bounce back relatively quickly as the economy returns to a growth path, for individuals the effect of a lack of regular income is greatly amplified by the distinctive psychological burden that prolonged joblessness causes. This can be much harder to recover from. The damage done can be serious and leave lasting effects – which is what we mean by the “scar” of unemployment.

In more philosophical language we might say that unemployment diminishes life chances and deprives us of the capabilities we need to choose lives that we value – most obviously the need for a decent regular income.<sup>2</sup> Moreover, we place a high value on purposive action, on the ability to contribute to society, on independence, on self-respect and the ability to carve our own paths through life. All these valuable dimensions of what it means to be human are undermined by unemployment. Richard Layard makes the argument as follows:

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1       Cooke and Lawton, *Working Out of Poverty: A study of the low paid and the “working poor”*, IPPR (2008)  
2       Sen, *Inequality Re-examined*, Harvard (1995)

*When a person becomes unemployed his welfare falls for two reasons – first the loss of income, and second the loss of self-respect and sense of significance (the psychic loss). The pain caused by the loss of self-respect is (we find) at least as great as the pain which a person would feel if he lost half his income. So unemployment hits with a double whammy – the loss of the income hurts, but so does the loss of self-respect. That is why it is so devastating and we would much prefer it if people were in work.<sup>3</sup>*

What we also know is that unemployment has a clear and damaging effect on both physical and mental health.<sup>4</sup> Being unemployed is strongly associated with mild to moderate mental illness, especially anxiety and depression, as well as a higher risk of coronary heart disease and a range of other physical conditions. In other words, the unemployed die younger and have poorer health than those in work (more detail can be found in Box 1 on page 15). Possessing good health is an important capability if we are to be able to choose lives that we value. Whichever way we look at the question, joblessness can only be viewed as a serious constraint on an individual's freedom. And there are other adverse consequences too for families and society more generally.

### **Adverse social consequences**

Self-evidently a family with no adult in work is a family under pressure. It is entirely reasonable to conclude that rising unemployment is associated with rising tension within families and a much higher risk of relationship breakdown. If this leads to an increase in lone parenthood then we might also anticipate a rise in child poverty since child poverty and lone parenthood are so closely correlated. Indeed, according to the OECD, lone parents returning to work can explain much of the reduction in child poverty in the UK over the last decade.<sup>5</sup> The same is equally true of the recent improvement in social mobility. These gains will be lost if unemployment rises rapidly and remains at a high level for a prolonged period.

We might also anticipate an increase in the crime rate. This was identified in a confidential Home Office briefing earlier this year, which was subsequently leaked to the media and became a cause of great controversy. The relationship between crime and unemployment is not entirely linear and, as the American labour economist Richard Freeman has observed, we do not always understand why crime rises or why it falls.<sup>6</sup> On the other hand there does seem to be some relationship and, as Freeman has also observed, in certain circumstances (high unemployment, limited life chances) crime can be an economically rational choice for an individual.

3 Layard, *Good Jobs and Bad Jobs*, CEP Occasional Paper No.19 (2004)

4 Marmot, *Status Syndrome*, Bloomsbury (2004); Waddell and Burton, *Is Work Good for Your Health and Well-being?*, TSO (2006)

5 OECD, *Growing Unequal? Income Distribution and Poverty in OECD Countries* (2008)

6 Marris et al, *Modelling Crime and Offending*, Home Office Occasional Paper no 80 (2003)

There is a famous study of what happened in the village of Marienthal, not far from Vienna, when the main factory shut its gates in the depression of the early 1930s.<sup>7</sup> Isolating the effect of increased poverty from the effect of unemployment is a significant research challenge but this is nevertheless what researchers attempted to do. As had long been noted unemployed people do not tend to take up the violin, read more books, or enjoy quality time with their families. Indeed, researchers found that although people had enough to eat, use of the library dropped by a third, clubs closed down and wives complained that formerly energetic men took extraordinary amounts of time to accomplish simple tasks. People stood on street corners, waiting. Time weighed heavy but people talked to each other less. What little money around was spent not on necessities but on trinkets. And by the end of the decade, Marienthal, which had voted Social Democratic by more than 80 per cent in the elections of 1929 and 1932, had succumbed to the seductions of fascism.

The reason, argued the psychologist Marie Jahoda, was that work provided people with a fundamental “sense of reality”, which could not be obtained through any other activity or institution. Employment of any kind made five consequences inevitable. It:

- gave time structure to the day
- compelled contact and shared experience with others
- demonstrated goals and purpose beyond the individual
- imposed status and social identity through the division of labour
- enforced activity.

In the absence of these, the normal functioning of people within social contexts and communities began to erode, with little solace drawn from others being in a similar position.

Jahoda returned to her theme in the very different period of high unemployment in the UK during the 1980s. The poverty in question was now relative rather than absolute but she argued the central feature of purposelessness remained. The phrases were the same: on the scrapheap, useless, not needed by anybody. The loss of work followed by prolonged joblessness entailed a sequence of psychological states – fear and distress, resignation, adaptation, and finally, if unsuccessful in the search for work, blank apathy and withdrawal. Unemployment demonstrated the limits of individualism, she argued, because self-respect needed to be embedded in a social context, offered primarily by work, to be valued at all. “*These categories [time structures, social contact etc] of experience are not at the whim of a good or bad employer, but flow necessarily from the structural forms of modern unemployment.*”<sup>8</sup> The psychological need for work goes deep – much deeper, in fact, than is indicated by the favourite economists’ dismissal of the psychological benefits of working as “externalities”.

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7 Jahoda, *Employment and Unemployment: A social-psychological analysis*, Cambridge University Press (1982)

8 *Ibid*, p.59

**Box 1: The health effects of unemployment**

**Physical health**

- There is a positive association between mortality and unemployment for all age groups, with suicide increasing within a year of job loss.
- Cardiovascular mortality accelerates after 2 or 3 years, continuing for the next 10–15 years.
- There is an estimated 20 per cent excess risk of death for both men actively seeking work and their wives, with the possibility that this may be higher still in areas of higher unemployment.
- Studies illustrate that during the anticipation and termination phase of factory closure, illness and health service use increase, the rate of hospital admissions doubles and conditions such as heart disease and higher blood pressure increase.
- Upon re-employment there appears to be a reversal of these effects. While the direction of causality is difficult to determine unemployment is considered to be a significant cause of psychological distress in itself.

**Mental health**

- Studies indicated a positive association between unemployed people and a higher prevalence of common mental disorders.
- The literature describes a stabilisation of unemployed people's mental health levels once they have undergone a period of adjustment to their new circumstances.
- Factory closure studies indicate that job insecurity itself was found to bring higher levels of psychiatric morbidity among those anticipating the threat of redundancy compared to those anticipating no change.
- Those with a more negative outlook on life tend to be more damaged by unemployment while those who are unemployed but have more positive and goal-oriented outlooks fare better.
- Being married has been understood as a "protective agent" against psychological distress.
- There is an assumption that women do not show psychological distress to the same degree as men because of lower levels of attachment and identification with work. Though some studies have found no association between unemployment and psychological distress others have found that for single women the relationship between mental health and unemployment is similar to that for men.

These comparisons may seem extreme or excessively gloomy. Our view is that a peak of 2.5 million remains a far more likely outcome of the current downturn than labour market crises of 1930s or 1980s proportions; it all depends on how intelligently policymakers decide to intervene. However, the reference points are useful in helping reinforce one of the key messages of this report: no economic goal is as humanly important as full employment (however defined). Having any work matters to life chances – and having decent work matters even more.

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**Not any jobs, but decent jobs** Of course it is easy during a recession to argue that almost all jobs, whether good or bad, are worth having simply because the personal, social and economic consequences of unemployment are so devastating. For some commentators worrying about job quality is a luxury that we can ill-afford when the priority is getting people back to work. This standpoint is not just a mistake, but also a strategic error. It fails to understand that while work has value in itself, workers legitimately expect their workplaces to be fair, decent and well managed. Our argument therefore is that rising unemployment does not mean that we have to abandon the notion of work as a fully human activity that engages all our skills, capabilities and emotions.<sup>9</sup> Nor should we reject the evidence that job quality affects health, life expectancy and life chances. Work may be better than unemployment, but it is only really good for us if it is good work.

At the heart of our argument is the notion of full and fulfilling employment, of decent work for all those who wish to work, of jobs that offer people interest, challenge and the opportunity for progression. As Juan Somavia, Director-General of the International Labour Organisation, has pointed out if we do otherwise we will be abandoning the commitment to “promote opportunities for women and men to obtain decent and productive work, in conditions of freedom, equity, security and human dignity.” Such principles are even more important in times of economic turbulence than in times of prosperity; they offer us an accurate compass to plot a course towards full employment and “good work”.

This very simple principle has been understood by earlier generations of policymakers. President Roosevelt’s New Deal was predicated on the recapitalisation of the banks, price stability, job growth and rising labour standards – including rights to trade union recognition, working time regulation and the introduction of a minimum wage.

The implications for the UK should be clear. There is no case for weakening employment rights, for exempting small and medium-sized firms from labour market regulation or for dropping the commitment to expand the right to request flexible working. All the measures we propose in Section 4 are reinforced by a floor of minimum labour standards and will be undermined if essential protections are removed.

<sup>9</sup> Coats, “*Good Work: Job quality in a changing economy*”, The Work Foundation (2008)

### 3. Labour market trends

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We are still in the early stages of the downturn but already some familiar patterns are asserting themselves. The disproportionate job losses so far have been among full-time workers, among male workers, among the young and among those in less secure employment. This closely mirrors the experience of the 1990–1992 recession.

Employment has fallen by about 100,000 comparing the 3 months to September 2008 with the previous 3 months. Men account for about 80 per cent of this fall and the entire decline is in full-time work. In contrast, part-time work has grown. These figures include both self-employed and employees. For employees almost the entire decline in employment is accounted for by men working full time.

Employment has also fallen disproportionately for the young. The fall in employment among the under-25s represented 40 per cent of the overall fall in employment, although such workers account for only 14 per cent of employment. As well as job losses among those already in work, the fall will also reflect employers hiring fewer young people than they otherwise would do. In contrast, employment levels among the over 50s have so far held up.

The latest statistics show sharp falls in forms of employment usually thought to be less secure – self-employment accounts for 44 per cent of the decline although self-employment only accounts for 13 per cent of total employment. Similarly, temporary employees account for about 36 per cent of the fall in total employment and for all of the fall in employee employment, even though temporary workers account for only 5 per cent of all people at work.<sup>10</sup>

Figure 1 overleaf shows some of these changes. These are just for one quarter so the picture may change as the recession deepens and widens. Moreover, some changes were underway before the recession began, such as the decline in temporary work.

There has been much speculation that this will be a “middle class” recession with the financial services sector suffering disproportionately. In the recession of 1990–1992 over 80 per cent of job loss came from manufacturing, construction, and distribution and hospitality, and just 11 per cent from “knowledge-based services”<sup>11</sup> (business and financial services, education and health). This is shown in Figure 2 on page 19, which covers the period 1990Q2 to 1992Q4. Some argue that this time high value-added services, especially in the private sector, will suffer more.

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<sup>10</sup> Temporary work as defined by the Labour Force Survey includes people on fixed-term contracts, agency workers, casual and seasonal workers, and other forms of non-permanent employment. Although the market as a whole has been contracting, agency work has been increasing. Agencies also place permanent employees. So these figures may not be a reliable guide to the role of agencies in the labour market.

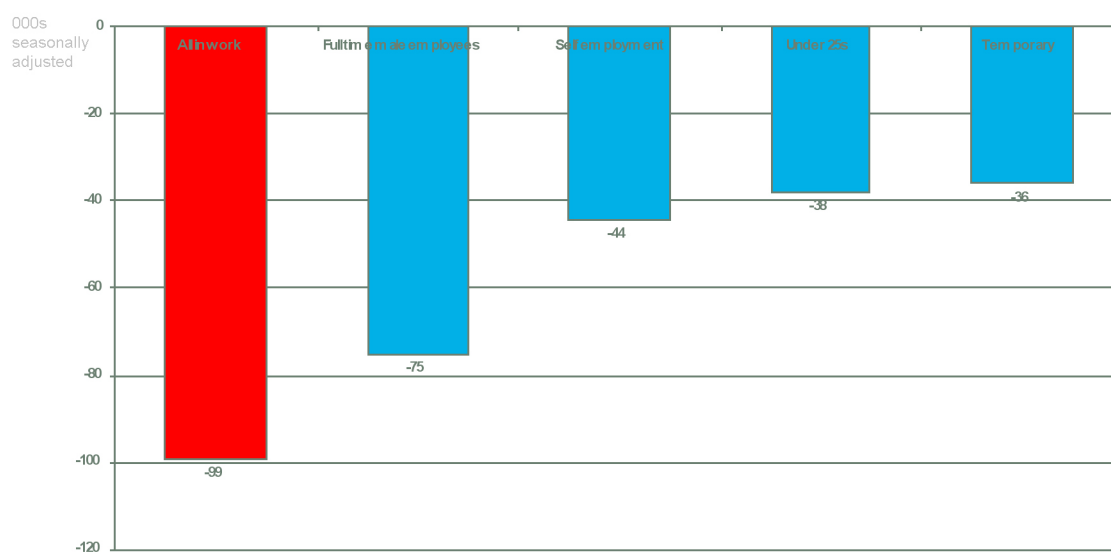
<sup>11</sup> OECD definition

Unfortunately, at the time of writing, the statistics on job loss by industry only cover the period up to June 2008. These show that between March and June employment went down in distribution, manufacturing and construction and increased slightly in business and financial services and in health, education and public administration. We can make no firm predictions on the basis of these figures but so far we have no hard evidence of a collapse in “middle class” employment.

One reason for being cautious is that while the financial sector was a big generator of value added, it has generated few jobs over the past decade. Much of the pressure has been on investment banking, which employs relatively few people, rather than on retail banking where the majority of the workforce is employed.<sup>12</sup> There will undoubtedly be redundancies in the sector following the forced mergers of some major banks but as a share of total job loss they may be relatively small.

**Figure 1: Job loss in Q3 2008**

All figures UK, July–September compared with April–June, seasonally adjusted. All in work includes employees, self-employed, government employment programmes, unpaid family workers. All 16 and older.

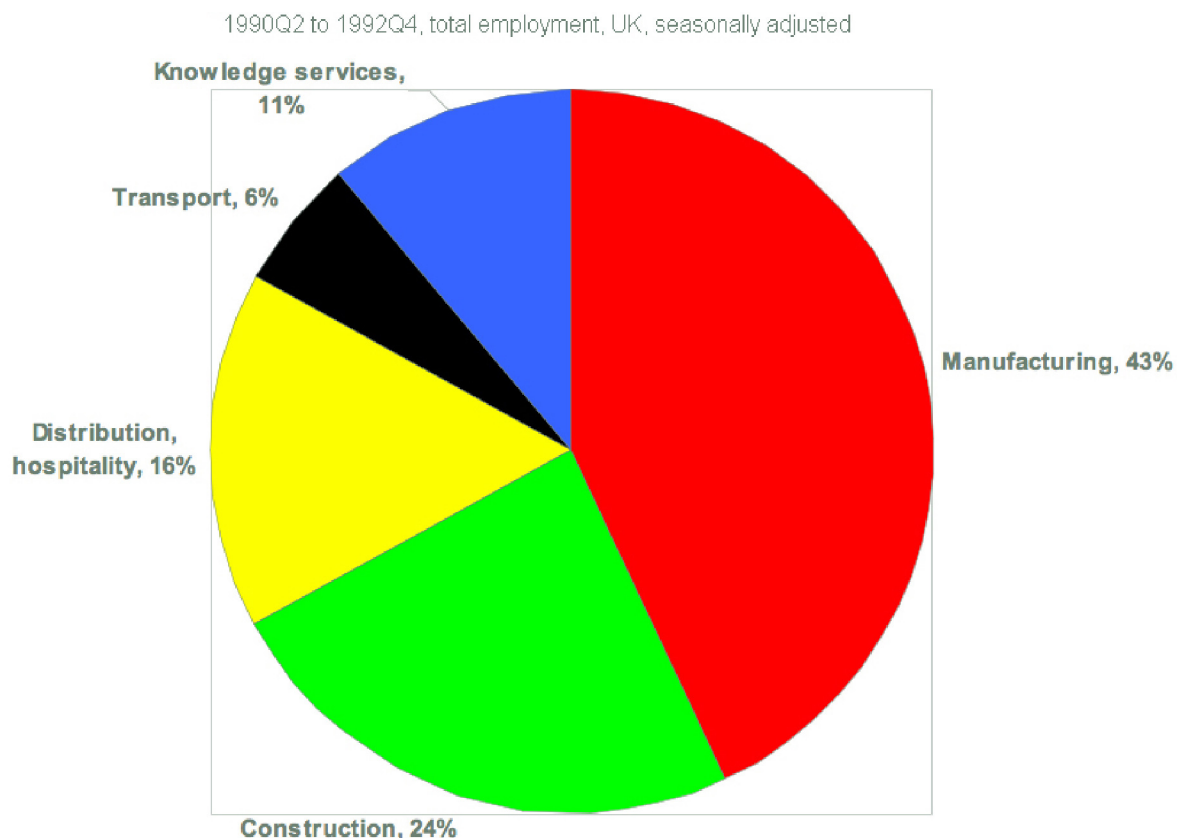


<sup>12</sup> Major redundancies reported in the national media are unrepresentative of total hiring and firing in the labour market and can be misleading. For example, much was made of the RBS announcement of 3,000 job losses. However, these are worldwide and affect only the investment banking arm. RBS retail banking is unaffected and employs 170,000 people in the UK.

What may be more plausible is that we see a bigger decline across the service sector as a whole than in the early 1990s. Manufacturing is significantly smaller than a decade ago and some of the most vulnerable industries such as textiles and clothing have shrunk even more. Manufacturing also has the benefit of a much more competitive exchange rate. Finally, as a forthcoming report from The Work Foundation argues, modern manufacturing may be less vulnerable because of the development of new business models that integrate services with manufacturing and invest heavily in “intangible” knowledge-based assets.

We have more up-to-date employment figures for manufacturing and these show that manufacturing employment fell by 22,000 comparing the 3 months to June 2008 with the 3 months to September 2008. This figure cannot be directly compared with the figures shown in the chart above because it comes from a different source, but it suggests a substantial share of full-time employee job losses have been from manufacturing.

**Figure 2: Job loss in the 1990s recession**



We are cautious about making too much of this. We still expect more jobs to be lost from services than in previous downturns, but it would be a mistake to think that manufacturing will not experience significant job losses. It is important therefore to look at wider measures to support the manufacturing sector, including strengthening some of the measures set out in the BERR Review of Manufacturing Strategy. We also think it is vital to apply the lessons learnt from dealing with the effects of industrial job loss from the closure of MG Rover. This is discussed later in this report.

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### Unemployment

We expect unemployment to peak at around 2.5 million using the ILO measure. Economic forecasters have struggled to keep up with the rapid change in the economic situation but the consensus view is now consistent with our estimate. Some of the more recent predictions are even more pessimistic, suggesting a peak of close to 3 million. This would imply an even bigger rise in ILO unemployment than in the recession of the early 1990s.

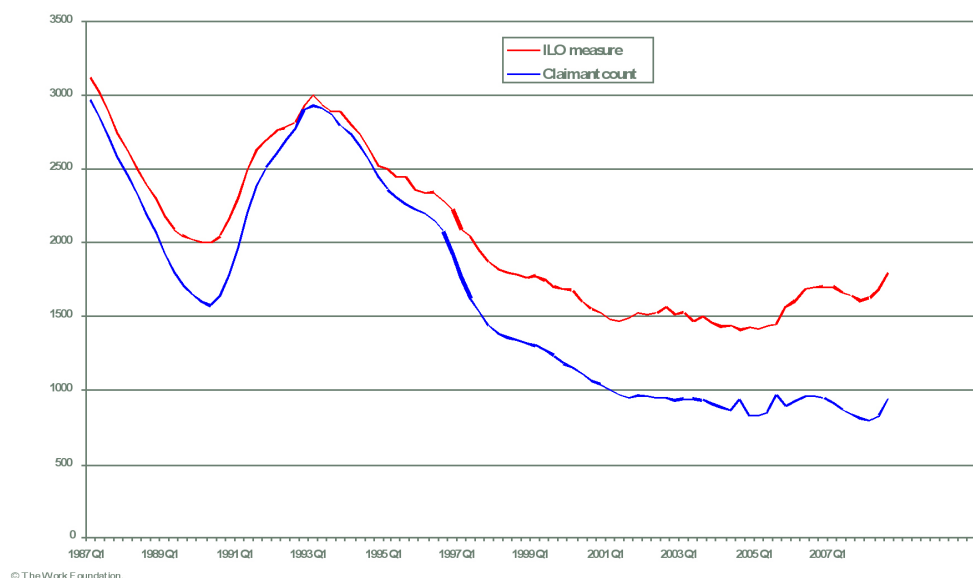
However, there are two official measures of unemployment. The more representative is derived from the sample household Labour Force Survey using International Labour Organisation (ILO) definitions. The ILO defines unemployment as all those who looked for work in the 4 weeks before the survey and who were also able to start work in 2 weeks' time. The second measure is the claimant count, which measures the number of people registered with the employment services in order to claim unemployment-related benefits.

Although the gap has widened (see Figure 3 overleaf), the two measures still tend to move in the same broad direction. In the last recession the claimant count increased even faster than the broader ILO unemployment measure, so that at the peak in early 1993 the ILO unemployment measure was just over 3 million and the claimant count measure was just under 3 million.

The two measures have moved together in the past because previous recessions – including the 1990s' recession – have primarily affected men working full-time in manual jobs in sectors such as construction and manufacturing. These individuals are the most likely to be able to make a claim for unemployment-related benefits. In addition, some people who by ILO definitions are unemployed but who are not claiming benefits decide to withdraw from the labour market altogether. So the impact of the recession also shows up as increasing numbers of working age people classified as inactive by ILO definitions (not in work or unemployed) as well as open unemployment.

**Figure 3: Unemployment 1987–2008**

ILO measure: all those who looked for work in the 4 weeks prior to the survey and able to start a job in 2 weeks' time.  
 Claimant count: all those on the unemployment register in receipt of unemployment benefit.  
 Source: Labour Force Survey, Office for National Statistics



We expect history to repeat itself and for claimant count unemployment to increase even faster than ILO unemployment. The current low level of claimant count unemployment is therefore misleading. The implication is that the employment services will have to cope with a massive increase in claimant caseload over the next 18 months. However, effective and large-scale labour market interventions could reduce the claimant count peak so the gap does not close as much as it did in the previous recession and speed up the fall when the economy begins to recover.

### The impact of migration

One recent complicating factor is the increase in migration from within the European Union. If migrants from Eastern Europe decide to return home either because of actual or feared job loss then this will dampen the rise in unemployment.

As a recent Work Foundation report on migration and the labour market shows, migrant movements are influenced by economic conditions in both the country receiving migrants and the country from which they come.<sup>13</sup> Most of Eastern Europe is set to experience robust growth, having been insulated from the worst excesses of the banking crisis. Investment is also growing in industries like construction. For example, in 2009 Poland is expected to grow

13 Coats, *Migration Myths*, The Work Foundation (2008)

by 4 per cent with a 10 per cent increase in construction investment according to the latest EU Commission economic forecasts.

However, migration statistics are poor and charting these movements with any degree of accuracy is problematic, especially at sectoral level. Moreover, if we have struggled to fully understand how migration has changed the dynamics of the UK labour market in periods of expansion, we know virtually nothing about how migration will alter those dynamics in a recession. Our guess is that while reverse migration may limit the rise in UK unemployment somewhat, it will not be a major influence on unemployment levels.

## 4. The need for a national policy response

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### **The case for monetary and fiscal intervention**

Our analysis so far shows that the banking crisis has the potential to precipitate a recession worse than that experienced in the early 1980s or 90s. Indeed, the developed world has not witnessed a financial calamity on this scale since the Great Crash of 1929. Nonetheless, as we have already observed, policymakers have learned something from history and it is our expectation that intelligent intervention can minimise the risk of a severe depression and ensure that unemployment peaks at 2.5 million in 2009.

The orthodox or pre-Keynesian response in today's circumstances would be to reduce public spending, increase taxes (to reduce the scale of the budget deficit) and cut benefits to the unemployed. Governments in the USA and the UK applied elements of this approach in the early 1930s. To replicate those huge policy errors would lead to economic disaster and the certainty of a prolonged slump. No respectable economist may advocate a return to Depression-era economics today but there are some commentators and politicians who find it difficult to accept that the orthodoxy of the last 30 years has been overturned. They still hanker after the certainties of sound money, unfettered markets, weak labour market regulation and the conviction that there is no distinction between the public interest and the interests of business.

Yet even though the UK and other developed economies face a serious crisis, policymakers need to be careful in their deployment of the full range of policy instruments. The 1990s' experiences of Sweden and Japan offer two lively examples of how to deal with a banking crisis, with Sweden eventually benefiting from rising world demand over the last decade and Japan languishing in a recessionary trough for most of the period.

An important preliminary conclusion is that expecting monetary policy to shoulder the whole of the burden is a false prospectus. Of course, it is right for the Monetary Policy Committee (MPC) to cut interest rates aggressively, but their focus is on hitting the inflation target 12 to 18 months in the future rather than on boosting employment (or minimising the risk of unemployment) tomorrow. Indeed, given the MPC's terms of reference it can do nothing else. Moreover, monetary policy works more slowly than fiscal policy in stimulating demand. A tax cut or a change in tax credits will put additional purchasing power into household budgets immediately and should be rapidly reflected in higher effective demand. In the USA, Elmendorf and Furman have estimated that a 1 percentage point cut in the federal interest rate would add nothing to growth in the current quarter, 0.1 per cent in the following quarter, 0.2 per cent in the third quarter and 0.4 per cent in the fourth quarter. And as we have already seen, a cut in interest rates by the MPC is not necessarily transmitted into real interest rate reductions for lenders. The monetary policy transmission mechanism seems to be blocked. If banks are unwilling to lend to each other, then they may be equally reluctant to lend to the rest of us.

It is quite wrong, therefore, to suggest that monetary policy alone is fit to do the heavy lifting needed as the economy falls into recession. A fiscal stimulus is needed to reduce the severity and impact of the economic slowdown.

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### Principles of effective fiscal stimulus

Of course, some critics argue that fiscal measures are irrelevant because they evoke a monetary policy response (higher interest rates as a reaction to higher government spending and borrowing), which negates the impact of the policy. Yet what these critics have missed is that the real risk in the immediate future is deflation, not inflation. The Governor of the Bank of England admitted as much in his comments on the most recent Inflation Report. Nonetheless, this does not mean that any fiscal stimulus will do the trick. There are good policies and bad policies. Experience tells us that to be successful fiscal intervention must be timely, targeted (putting money into the pockets of those who are more likely to spend than save) and temporary (to avoid any long-term deterioration in the public finances).<sup>14</sup>

**Timely:** If a fiscal stimulus is administered at the wrong time in the economic cycle then it could cause inflation. The challenge is to intervene at the right time, which in this case means after the economy has begun to slow but before recession begins to bite hard. We already know that the economy has experienced one quarter of negative growth and that the position may deteriorate. Most forecasters are projecting a year of recession and the CBI has announced that it expects unemployment to reach 3 million by the end of 2009. It is hard to argue that now would be the wrong time for a fiscal stimulus.

**Targeted:** Some commentators have argued for across-the-board cuts in direct or indirect taxes. Income tax cuts would be very visible and could be quickly implemented. However, the problem is that consumers in a downturn are just as likely to use the additional income to pay off debts and increase savings as to increase spending. Households faced with greater economic and job security are more likely to postpone the purchase of “big ticket” items such as cars and electronic goods. Indirect tax cuts, such as VAT, would face the same advantages and the same problems. Although the cut in VAT would reduce the cost of a wide range of goods and services it would do nothing to overcome consumer reluctance to increase spending. Moreover, it is not certain that the cuts in VAT would be fully passed on, especially for goods and services where prices are already falling or where demand is thought to be inelastic (not very responsive to price changes). The UK might also be constrained by EU-wide agreements that set a minimum level of VAT rates so that any cut in VAT within the limit would not be big enough to make much difference. Our assessment is that VAT cuts could be a very expensive way of not doing much to stimulate the economy. We therefore favour increasing the incomes of those most likely to spend the additional spending power – the poor. The tax system is a blunt instrument to do this as it is hard to devise a tax measure that puts most purchasing power

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<sup>14</sup> In this section we follow the arguments of Douglas Elmendorf and Jason Furman in their paper *If, When, How: A primer on fiscal stimulus*, Hamilton Project Strategy Paper (2008)

in the hands of less well-off households unless some of the gains for well-off households are clawed back through tax rises for the rich. Moreover, tax cuts are of no benefit to the non-working population or those who pay little or no tax. Instead, a more effective instrument would be to increase means-tested benefits such as tax credits or unemployment-related benefits.

**Temporary:** By definition, a fiscal stimulus is supposed to end once the economy has begun to respond. This means that any tax changes should be temporary and that tax cuts or increased borrowing during recession should be offset once the economy has recovered by higher taxes and the repayment of debt. This is the essence of Keynesian deficit financing. It is not a matter of accepting a long-term and systemic rise in public indebtedness as the cost for some temporary relief from recession; the long-term costs would then more than outweigh the short-term advantages. As Elmendorf and Furman have argued, long-run economic growth is driven by higher saving and investment to increase the capital stock of the economy. If the government has a high level of borrowing when the economy is growing strongly then long-term interest rates will be higher and this will also restrain investment, reducing effective demand and economic activity. The fiscal rules may have been abandoned for the duration of the current crisis, but this does not prevent the Chancellor from applying a commonsense notion of prudence – or returning to the application of the “golden rule” when the recession is over (only borrowing to invest rather than fund current spending over the course of the economic cycle).

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### Is the stimulus affordable?

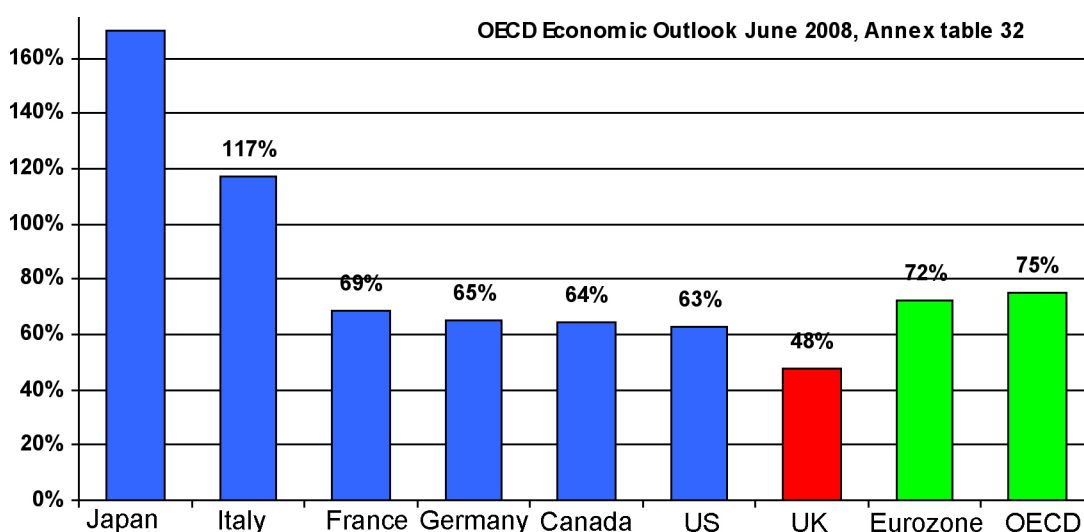
We are then left with the question of whether a fiscal stimulus is affordable. It appears to be a matter of political consensus that the “automatic stabilisers” should be allowed to operate – other things being equal, a decline in economic activity means that tax receipts will fall, public borrowing will increase and government expenditure will rise, largely as a consequence of the rising benefits bill. For most politicians this is entirely as it should be. To do otherwise (cutting spending, increasing taxes, cutting benefits) would reinforce the downturn and make the situation worse. We would be witnessing a very unwelcome return to the economic orthodoxy that deepened the Great Depression.

One might argue that it is tautologous to say that a fiscal stimulus should be a genuine stimulus, but some commentators and politicians have seemed to attack the notion of increased borrowing and increased spending. The point here is that the “stimulus” cannot be effective unless it is designed to boost the level of aggregate demand in the economy. The Chancellor will be wasting his time if he gives with one hand through tax cuts and takes with the other through reductions in public spending. In the current economic environment all tax cuts will be unfunded – indeed stimulatory tax cuts by definition cannot be fiscally neutral. The objective must be to maintain current spending plans, put more money in the pockets of those citizens with the highest propensity to spend rather than save and, in the medium term, embark on an expansionary programme of targeted public works.

It has also been suggested that the UK government is so indebted that a stimulus package is unaffordable even if it is desirable. In essence this is a counsel of despair: “The situation is bad but there is nothing that policymakers can do because there is no money in the bank and borrowing would be imprudent.”

What is most surprising about this view perhaps is that the UK has a relatively low level of overall public indebtedness (Figure 4). This suggests in turn that the UK has slightly more fiscal room for manoeuvre than most other OECD countries. Certainly there is an issue about the volume of bonds that the government will need to sell over the next year, not least to fund the recapitalisation of the UK’s failing banking system (an issue that we discussed in Section 1). But there is no irresistible argument that says that increased borrowing is unaffordable or that tax cuts should be “funded”. If John Maynard Keynes is to be our guide in these dark times then it is the case for deficit financing that is irresistible, just so long of course as policymakers understand that increased borrowing in recession must lead to the repayment of debt once the economy has recovered.

**Figure 4: Public borrowing across the OECD, 2007 (general government gross financial liabilities)**



This approach was accepted in principle by John Major’s Conservative government during the 1990s recession. Fiscal strategy over this period was to announce a path for public borrowing and more or less stick to that path regardless of variations in economic activity. However, according to the Institute for Fiscal Studies (IFS) 1992 Green Budget the government not only allowed the automatic stabilisers to work through fully in 1991–1992, but also provided for a

discretionary fiscal boost through higher spending. None of this was explicitly spelt out by the Treasury, but observing the changes in public borrowing the IFS commented:

*The Government has so far allowed the automatic effects of economic activity on the PSBR [Public Sector Borrowing Requirement] to come through in full.*

The IFS also noted that the public borrowing targets announced in the 1991 Autumn Statement were consistent with some discretionary action, primarily through higher spending.<sup>15</sup> The IFS said:

*The PSBR will increase in 1992–1993 by about 1 per cent of GDP more than can be explained simply by the automatic impact of the decline in activity. This is one very rough measure of the extent of exogenous fiscal easing now in the system.*

The difference between that period and the present day is that we are now having a transparent national conversation about the government's approach to fiscal policy. There will be no hidden fiscal boost behind a veil of economic orthodoxy. This is probably both better politics and better for public understanding of the challenges facing the nation.

So if the stimulus is affordable and the case for intervention compelling then how large should the stimulus be? Once again this is a matter of judgment that does not admit of only one answer. The rule of thumb to be applied is that the stimulus should be large enough to make a difference but not so large that it runs the risk of reigniting inflation. On one view this latter concern may be a little misplaced, not least because all the risks now appear to be on the deflation downside. Our assessment is that a boost of up to 1 per cent of GDP would be appropriate, although some economists – most notably Paul Krugman in the USA – have been bolder, with Krugman suggesting that policymakers should be crafting a big stimulus package in all developed world economies (although he has noted too that the severity of the position in the USA demands a bigger stimulus than in the UK):

*When depression economics prevails, the usual rules of economic policy no longer apply: virtue becomes vice, caution is risky and prudence is folly.<sup>16</sup>*

If no action is taken then it would be right to accuse policymakers of negligence given what we have already said about the imperative to maintain the highest possible level of employment. There is no excuse for delay.

<sup>15</sup> IFS 1992 Budget Strategy, p.19

<sup>16</sup> Krugman, "Depression Economics Returns", *New York Times* (14/11/08)

**Which policy instruments?** We now turn to the policy instruments at the government's disposal that might either generate a direct fiscal boost or create the conditions that will ensure that fiscal policy achieves maximum effectiveness. In other words, some of these policies act on the supply side and others on the demand side. For convenience we have used this as the frame of reference for our analysis. There is a wealth of international research evaluating the effectiveness of these policies and we consider each in turn:

### **Supply-side interventions**

- Active labour market programmes – like the New Deal in the UK
- Training programmes for the unemployed

### **Demand-side interventions**

- Public job creation for the unemployed
- Reductions in payroll taxes
- Wage subsidies
- Higher out-of-work benefits
- Tax cuts and tax credits
- Short-time working and labour hoarding interventions
- Public works

The important point of principle perhaps is that these policies can be designed badly or well. The government has an obligation to learn from what has worked in the past and “what works” elsewhere, which is what evidence-based policy is all about.

We suggest the following principles should underpin the government's response in the radically changed economic circumstances. These include:

- working within the existing framework rather than developing new schemes from scratch
- no dilution of quality in job search and support services, training and job experience
- removing or suspending remaining inflexibilities in the benefit system.

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### **Supply-side interventions** *Employment programmes*

Governments can and do intervene directly in the labour market through “active labour market policies” (ALMPs). These measures typically fall under four headings:

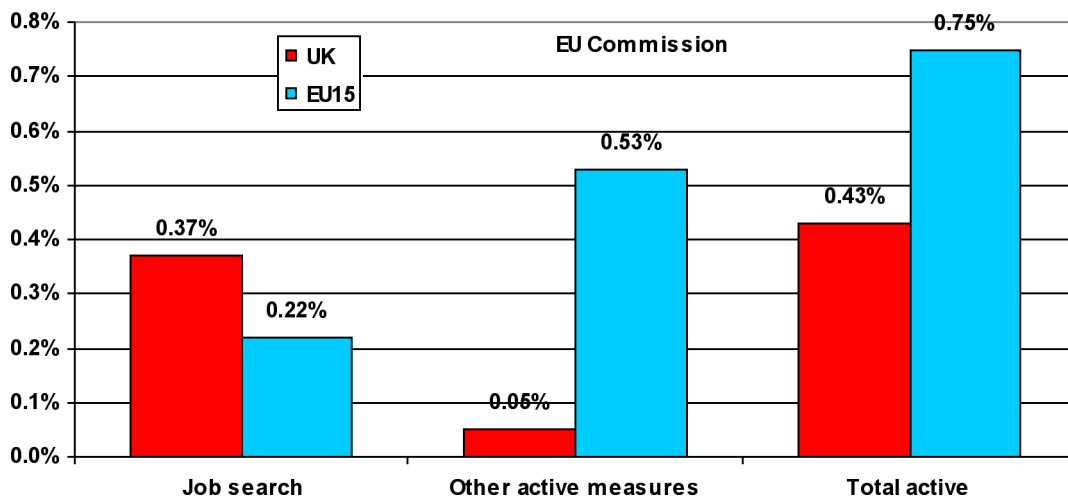
- Employment services to support job search for the unemployed
- Training measures to increase the skills of the unemployed
- Wage subsidies for employers to increase the demand for labour from employers, either to save existing jobs or create new jobs
- Temporary jobs (usually in the public sector).

Over the past decade most OECD economies have reduced spending on active measures as unemployment has fallen and also in some cases because the effectiveness of some programmes has been re-assessed. We discuss some of these evaluations below and consider the implications for the UK.

The UK starts from a position of relatively low investment in active labour market measures compared with most other EU economies. In 2006 the UK had the second lowest investment rate of the EU15 at just over half the EU average, lagging far behind the higher investment economies of the Nordics and the Netherlands. UK active labour market measures rely very heavily on spending to help the unemployed look for work where we outspend every other EU economy except the Netherlands. In contrast, the UK spends very little on training, employment support or incentives to set up businesses for the unemployed (Figure 5).

The UK's heavy reliance on job search reflects in part the view that the UK's labour market is more flexible than many of those in the rest of Europe and therefore the main focus of policy should be on helping match workers to jobs, especially when job generation was strong and levels of unfilled vacancies historically at high levels. The heavy investment in labour market programmes in other economies could therefore be seen as a necessary counter-weight to greater inflexibilities, for example stronger employment protection legislation, that slow down the workings of the market.

**Figure 5: Investment in active labour market measures, 2007**



In addition, UK policy has given higher priority to quantity over quality. So getting the unemployed into any job has been given higher priority than more intensive improvement of their skills while unemployed so that they can take better jobs. Moreover, there has been considerable scepticism about the effectiveness of large-scale general training and other support schemes for the unemployed based on the UK and other economies' past experience.

Assessing what might work and what should be avoided is not straightforward. A recent review of EU active labour market measures by Jochen Kluge looked at around 100 evaluation studies of schemes running in the 1970s and 1990s but found it hard to detect consistent patterns of results. He concluded, albeit tentatively, that:

*Rather than contextual factors such as labour market institutions or the business cycle, it is almost exclusively the programme type that matters for programme effectiveness.<sup>17</sup>*

In other words, programmes that worked well in upturns should also work well in downturns and factors such as the dismissal protection legislation and the regulation of fixed-termed contracts and temporary work have little or no effect. However, both Kluge and a more recent assessment of German training programmes<sup>18</sup> suggest that well-designed programmes do even better when unemployment is high (perhaps because more employable people enter them than when unemployment is low).

Kluge looked at the effectiveness of different programmes in getting the unemployed into sustainable employment against the “base programme” of training. He suggested that private sector incentives and the active job search programmes favoured in the Netherlands and the UK were more effective than training, while creating jobs in the public sector and programmes targeted specifically at young workers were less successful than training.

Whatever option is chosen the problems of “deadweight” and “substitution” are significant. In a review of programmes across the OECD, Martin and Grubb found that private sector employment incentives can carry deadweight of up to 90 per cent – in other words, firms would have taken on workers anyway without an incentive or replaced existing workers with subsidised workers. Effective targeting or monitoring can reduce these problems, but the more conditions that are imposed the greater the reluctance of employers to participate. However, Martin and Grubb<sup>19</sup> argue that even when displacement is high initially, the programmes may be worth pursuing because “*insofar as active labour market policies increase effective labour supply, their displacement effects fade way over the medium term*”.

17 Kluge, *The Effectiveness of European Active Labour Market Policy*, RWI Essen and IZA Boon (2006)

18 Lechner and Wunsch, *Are Training Programmes More Effective When Unemployment is High?*, SIAW (2006)

19 Martin and Grubb, *What Works and For Whom: A review of OECD countries' experiences with labour market policies*, IFAU Working Paper (2001)

**Policy  
recommendations**

**Welfare to work – revisit the scale of ambition**

The government has recently indicated that it intends to press ahead with the intensification of job search and support measures for some groups of claimants on long-term benefits despite the worsening employment position. While we support the goal of getting more lone parents and more Employment Support Allowance recipients into work we question whether the full scale of the government's ambition (the 80 per cent employment rate) is achievable in the short term. Typically such workers are less attractive to employers than other job applicants even when vacancies are high, and they are likely to be pushed to the back of the queue even more firmly when vacancies are low and the competition for jobs from those already on the claimant count is intense. Moreover, careful consideration must be given to the resourcing of the "core" functions of JobCentre Plus given that today's jobseekers will soon be joined by many more unemployed people with good employment records and up-to-date skills.

**Sustain high-quality job search and support services**

The UK has put a lot of reliance on job search and support policies. These work best when times are good and the evidence suggests that they still have a useful role in recessions. Recessions tend to be selective so some sectors will continue to grow and firms and organisations will continue to hire even when overall employment is falling. This is because firms need to recruit to fill vacancies created by people retiring or moving to other industries. More vacancies are created through this process than through the expansion and contraction of industries.<sup>20</sup> Even in recessions job search support programmes through the New Deal and other programmes can still help move claimants into new jobs.

The key priority will be to ensure that the quality of job search support is not diluted by the sheer number of claimants flowing through the employment services. The employment service is undoubtedly too small at present to provide the same level of individual attention that is a key feature of the New Deal. The government will have to expand capacity rapidly, either by expanding JobcentrePlus or by accelerating the involvement of private sector and voluntary providers, or through some combination of the two.

*Training programmes for the unemployed*

The Kluge review found results for training were also positive. Of the 70 evaluations, 38 were positive, 14 found they made little difference and 18 found negative effects. These mixed effects may reflect differences in programme design. For example, an evaluation of Swedish training programmes<sup>21</sup> found that they were ineffectual because they were primarily designed as a way of extending entitlement to unemployment benefit, while another suggested that

<sup>20</sup> SSSA, *Working Futures* (2004)

<sup>21</sup> Siansei, *Differential Effects of Swedish Active Labour Market Programmes for Unemployed Adults in the 1990s*, IFS (2002)

heavy reliance on classroom-based training gave worse results than vocational training located within the workplace.<sup>22</sup>

Another evaluation of training schemes for the unemployed in East Germany found they worked well for women but not for men because many unemployed men were given construction-related skills but entered the labour market just when the German post-reunification construction boom came to an end.<sup>23</sup> The authors have more recently evaluated West German training programmes using the same methodologies following the 1998 labour market reforms and found them generally ineffectual except for the very low skilled. They conclude that:

*[E]ither the quality of the programmes, the participants or the assignment process or certain characteristics of the labour market, which make programme participation less rewarding have changed since the early 1990s.<sup>24</sup>*

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### Policy recommendations

#### Investing in skills

Recessions can be an opportunity to invest in human capital for the upturn. There is a case to expand the training elements within the New Deal for those claimants who might benefit. However, if training is provided it should be high quality, tailored to individual needs and if necessary long term, and vocational courses should wherever possible be workplace based. This option has to be used with care. The danger is that skills will be wasted if no jobs are available at the end of the training and there is a risk that people are trained in the “wrong” skills for the upturn. It also may be difficult to expand capacity rapidly while ensuring quality.

Drawing on the experience of the MG Rover closure where training and education played an important role, the provision of training and further education as an option may be especially suitable for dealing with the immediate consequences of industrial closures. Recent research<sup>25</sup> on what happened to the workers made redundant found that some 60 per cent had undergone training and education. Two-thirds took up the offer of free training places offered by local agencies and many others underwent training by their new employers. The types of assistance and support that people found most helpful were free travel to a training course or job interview; a free place on a training course; being sent on a training course by a new employer; and help with setting up a business.

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22 Carling and Richardson, *The Relative Efficiency of Labour Market Programs: Swedish experience from the 1990s*, IFAU Working Paper (2001)

23 Lechner, Miquel, and Wunsch, *The Curse and Blessing of Training the Unemployed in a Changing Economy: The case of East Germany after unification*, SIAW (2005)

24 Wunsch and Lechner, *What Did All the Money Do? On the general ineffectiveness of recent West German labour market programmes*, SIWA (2007)

25 Bailey, Chaplain, Mahdon and Fauth, *Life After Longbridge: Three years on – pathways to re-employment in a restructuring economy*, The Work Foundation and Birmingham Business School (2008)

**Demand-side interventions**

*Public job creation for the unemployed*

The impact of public sector job creation programmes needs a little commentary. Clearly they “work” in the short term in the sense that people are moved from unemployment to doing something and Kluge suggests that they still have value for equity reasons. In their review of OECD policies Martin and Grubb suggest that public job creation can be valuable as a strictly temporary measure “as a means of helping the most disadvantaged maintain contact with the labour market, particularly in a recession when aggregate demand is depressed and jobs are scarce”. The same point is made in an earlier paper by Peter Jackman where he argues:

*Even where schemes do not have much of a return to those on them, as much of the microeconomic evidence suggests, they may still have a substantial social return in preventing the emergence of long-term unemployment.<sup>26</sup>*

**Policy recommendations**

**Expand provision for employer placements, including in the public sector**

The latest DWP figures show that about 240,000 people are currently participating in New Deal and Employment Zone programmes.<sup>27</sup> Some of the New Deal programmes include elements that allow subsidised employment together with short-duration training courses primarily for claimants under 25. These elements could be expanded and extended to other claimant groups. The problem of low employer take-up might be addressed by increasing the generosity of the subsidy.

However, it might be more effective in the short term to expand capacity through extra places within the public sector linked to training where appropriate for the individual. These jobs should however be strictly time-limited and run down as and when the claimant count starts to decline. Their primary purpose is to keep the more disadvantaged in contact with the labour market rather than as a route to permanent employment.

The disadvantage of such schemes is that they could easily turn into the low-quality make schemes of the 1980s and be seen as primarily concerned with masking the rise in unemployment. We think the benefits still outweigh the costs but one implication is that investment per person will have to be significantly higher than in the past.

*Payroll taxes*

There has been some suggestion that payroll taxes such as national insurance should be cut to encourage employers to keep existing staff or hire new ones. Economic theory suggests that

<sup>26</sup> Jackman, *What Can Active Labour Market Policy Do?*, CEP Discussion Paper (1995)

<sup>27</sup> DWP Quarterly Statistical Summary. Current participants at May 2008. Figures do not include participants on New Deal for the over 50s and New Deal for the Disabled because of DWP concerns with statistical quality.

such taxes although paid by employers in fact fall on employees so that a cut will ultimately be reflected in higher wages and leave overall labour costs unchanged.

Past studies have concluded that payroll taxes such as employer national insurance contribution levels have little impact on unemployment rates. Steve Nickell has concluded “*payroll taxes, per se, can be expected to have little impact on unemployment...*”<sup>28</sup> If there is a labour market effect it is through the impact on work incentives for individuals. This said, there could be a temporary short-term effect as adjustment in the labour market takes time and the feed through to higher wages is likely to be dampened in a recession.

Payroll tax cuts have not featured very much in active labour market evaluations although they work in a rather similar way to employer wage subsidies by reducing the cost of labour to the firm. In the UK the 1994 Budget introduced as an experiment a national insurance holiday to employers who took on the long-term unemployed. However, it was not until April 1996 that the measure was implemented, which might suggest some difficulties in introducing the measure quickly. A government assessment subsequently noted “*for employers, the NIC Holiday appeared to be a bonus for recruiting a long-term unemployed person, rather than an incentive for so doing*”.<sup>29</sup> One evaluation in Finland looked at an experimental programme that cut payroll taxes in high unemployment regions of Finland.<sup>30</sup> The conclusion was somewhat discouraging, with little impact other than it saved some mainly small firms from closure.

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### Policy recommendations

Based on the evidence available, we do not believe that a reduction in payroll taxes will in itself boost job creation since it does nothing to raise employers’ demand for labour or, more accurately, does nothing directly to raise the level of effective demand in the economy. It may be the case that a reduction in payroll taxes if combined with other elements in a fiscal package could encourage employers to recruit employees, which in turn would raise the level of purchasing power in the economy. But these are indirect effects and there may be other policy instruments available to secure a more rapid fiscal boost. We do not see reductions in payroll taxes as an immediate priority, although they should not be entirely ruled out as a policy option in the future.

#### *Wage subsidies*

Wage subsidies were tested in the UK in the mid-1990s and were either given to individuals (Jobstart) or employers (Workstart). In a review of the evidence, Van Reenen commented that “none of these schemes were very well funded and all have suffered from low take up”.<sup>31</sup> For

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28 Nickell, “Unemployment and Labour Market Rigidities”, *Journal of Economic Perspectives* 11(3) (1997)

29 Government Social Research Unit (2003)

30 Korkeamaki and Uusitalo, *Employment Effects of a Payroll Tax Cut* (2005)

31 Van Reenen, Institute for Fiscal Studies (2001)

example, Workstart was thought to have “deadweight” of over 80 per cent with many of the remaining jobs filled at the expense of short-term unemployed. Similar schemes in the US were equally unsuccessful. New Deal also includes an element of wage subsidy, but rather more generously funded, and this seems to have somewhat more success. There may be scope for looking at a more specific subsidy linked to avoiding redundancies.

### *Higher out-of-work benefits*

We have already noted that an effective stimulus package has to be targeted. In other words, money must reach those citizens who are most likely to spend it. One possibility would be for the government to raise the level of out-of-work benefits simply because the unemployed have a high propensity to spend any income that they receive. The argument may not be popular, but it is undeniable that the UK has generally lower benefits than other major OECD economies (see Figure 6 overleaf). A conventional objection to higher benefits is that “if you pay people for doing nothing that is precisely what they will do”. But international experience suggests that time limits and job search conditions can compensate for the supposed disincentive effects of high replacement rates. These findings have been recognised by HM Treasury:

*Empirical evidence suggests that the way in which the benefit system is administered is just as important as the level of financial support; most notably the eligibility period and the eligibility requirements.<sup>32</sup>*

Were this not the case it would be impossible to explain why economies with much higher replacement rates (the Netherlands, Sweden, Denmark) all have employment records that, over the last decade, can withstand a rigorous comparison with the UK.

Some commentators have gone even further, with Dean Baker and his colleagues observing that:

*A higher replacement ratio is associated with lower unemployment unless benefit duration is extremely high; conversely, longer duration of benefits reduces unemployment unless benefits are at very high levels.<sup>33</sup>*

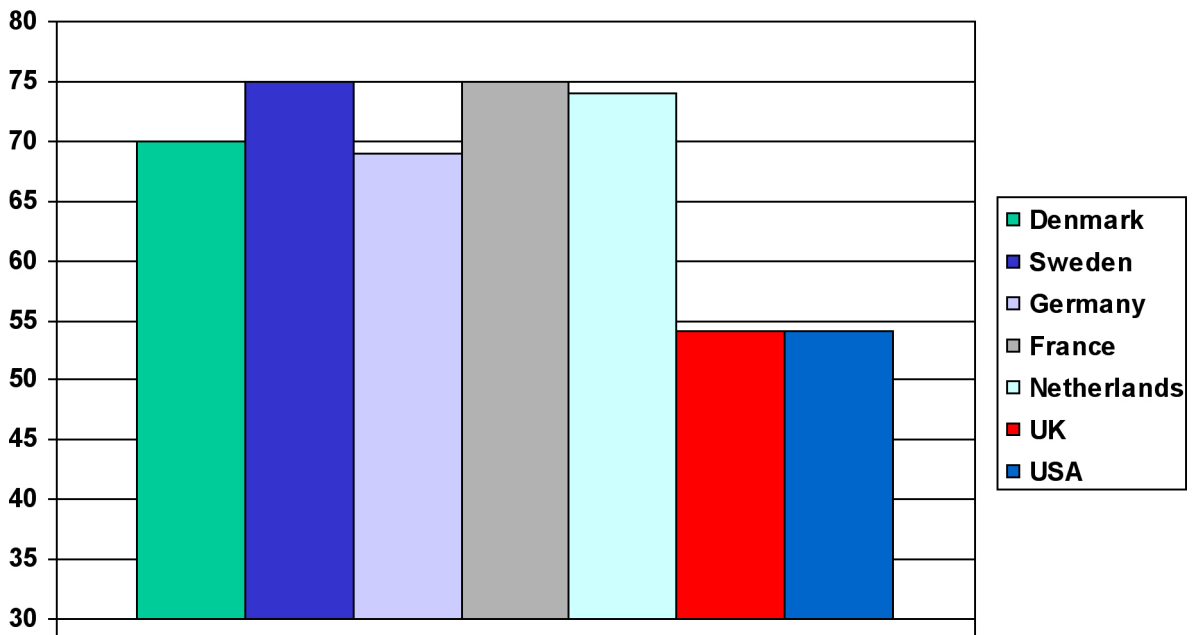
In other words, policymakers have a choice between high benefits with short durations or lower benefits with long durations. The important point here is to ensure that unemployment is not a financially catastrophic experience. Job search is more likely to be successful if job seekers

<sup>32</sup> HM Treasury, *EMU and Labour Market Flexibility* (2003) para 4.19

<sup>33</sup> Baker et al, “Labour Market Institutions and Unemployment”, in Howell (ed), *Fighting Unemployment*, OUP (2005) p.106

can give the exercise their full attention safe in the knowledge that the bills will be paid and that they do not run the risk of accumulating personal debt. Higher benefits are consistent with the “something for something” principle if they are matched by tough and enforced job search conditions as well as limits on benefit durations.

Figure 6: Initial net replacement rate (% of earnings in work), OECD 2004



**Policy recommendations**

The government should consider whether benefits for the unemployed can be raised to levels that bear comparison with other major EU member states. It may not be possible to achieve a 70 per cent replacement ratio in the short term even if this were adopted as a long-term ambition. Whatever choices are made about benefit levels in the future, there is a compelling case for some increase today, perhaps moving to 60 per cent of net earnings in work.

*Income tax cuts and tax credits*

A reduction in income taxes obviously constitutes a significant fiscal boost to the economy as long as there is no reduction in public spending to compensate for the fall in tax receipts. Nonetheless, we should recall the principles of successful fiscal stimulus (timely, targeted and temporary) and note that a general reduction in taxation almost certainly fails to meet the second and third of these objectives. Offering a tax reduction to all income groups almost certainly means that not all these resources will be immediately spent simply because the more affluent may choose to save some of their additional income, repay debt or smooth their

expenditure over a longer period. Moreover, high-income households are least likely to be under pressure in an economic downturn and, as Elmendorf and Furman argue, a permanent tax reduction could lead to higher interest rates and thereby limit the effectiveness of the supposed stimulus. On the other hand some of these risks might be managed by government making it clear that tax reductions in the recession will have to be matched by potentially higher taxes as the economy recovers, unless of course tax receipts are especially robust anyway because the economy is growing strongly.

Another route to achieving a targeted and temporary tax reduction would be to offer a one-off tax credit to those on lower incomes. This has the advantages of simplicity, could be limited to a single fiscal year and would immediately put money into the pockets of households under pressure. The size of the tax credit would be influenced by the overall construction of the fiscal package, but in our view it would be sensible to focus resources here as well as on the targeted programme of public works discussed below.

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### Policy recommendations

Some idea of the package possible was shown in a simulation undertaken by the Institute for Fiscal Studies for Barnados in July 2008 that focused on increasing the child tax credit by between 14 and 26 per cent.<sup>34</sup> The gross cost was £4 billion per year. The IFS simulations included other changes that clawed back some of the increase for better-off families, reducing the net cost to £2.7 billion. Such measures would help offset the impact of higher unemployment on child poverty and make the government's child poverty target for 2010 more achievable. Initially, we would suggest that this should be a temporary measure for a year only (to meet the principles of a responsible fiscal stimulus). This does not mean of course that it would not be desirable to have a permanent improvement in the incomes of the working poor, but consistent with the approach we have outlined here the government would need to consider how such an initiative could be funded in the long term.

#### *Short-time working and labour hoarding*

Human capital is now said to be where many businesses locate their comparative advantage. But in a downturn businesses run the risk of shedding skilled employees and then experiencing skills shortages and bottlenecks as the economy recovers. It is worth considering therefore whether instruments might be developed that allow employers to hoard valuable labour even though they may not need all their staff to work a standard 35–40 hour week at a time of reduced demand for goods and services.

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34 Brewer, Browne and Phillips, *Options for Tax Credit Reform*, IFS (July 2008)

Other countries have managed this process through a range of short-time working schemes that enable employers to reduce hours and earnings at the same time as the state replaces some or most of the net income that has been lost by employees. For example, during the 1990s recession, German manufacturers made fairly extensive use of the short-time working provisions of the Employment Promotion Act, which entitled employees to up to 67 per cent of their net loss of earnings. The objective was to reduce the risk of redundancy by giving employers more flexibility to manage their labour costs while giving employees the security that most of their net loss of earnings would be compensated. When recovery came, employers still had access to a valuable pool of human capital, were able to anticipate the upturn and could rapidly respond to increased demand for their products with no time lag or loss of productivity associated with the need to recruit new and less experienced employees.

Evaluation of these programmes suggests that they can be effective in overcoming a temporary decline in the demand for labour.<sup>35</sup> On the other hand, an attempt to use such instruments to manage structural change can be self-defeating since they delay necessary change and can encourage workers to accept the status quo rather than acquire new skills that will boost employability in growing sectors of the economy. It would be better in these circumstances to invest public resources in training programmes rather than short-time working schemes.

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### Policy recommendations

The UK's most recent short-time working scheme was abolished by the Thatcher government in 1984. We believe that the government should consider introducing a temporary scheme today, which would be available to employers only during the downturn. In other words, the scheme should be suspended once the economy returns to a stable growth path, although it might be reactivated at some point in the future during an economic slowdown. Applying this approach will ensure that the scheme does not become a device for the preservation of an unsustainable status quo.

#### *Public works*

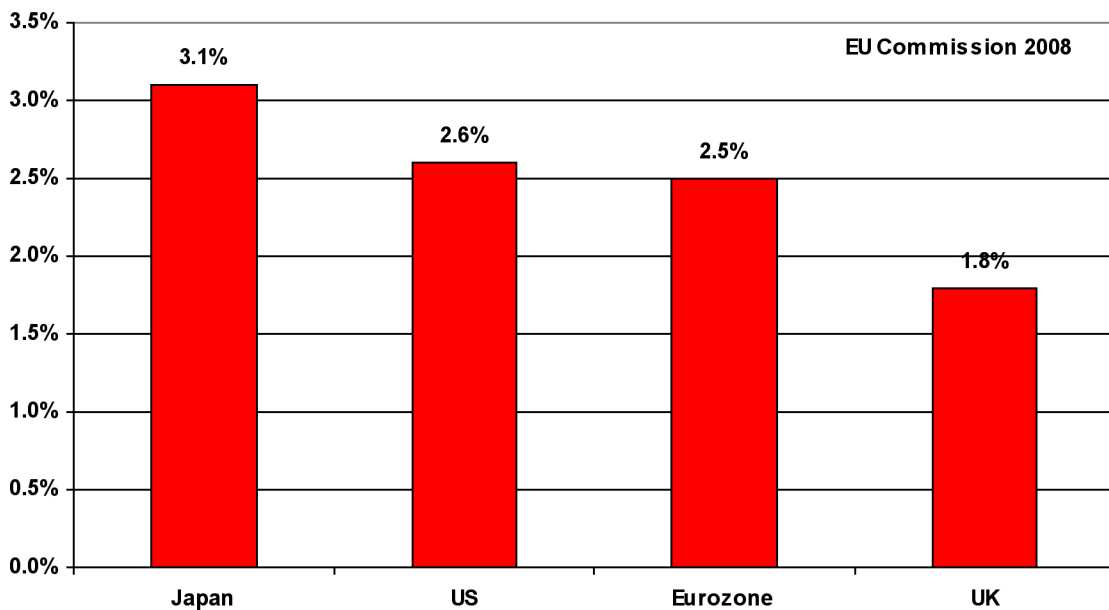
Governments can directly boost the economy through public works – extra spending on schools, hospitals, roads and housing. UK public investment has been increasing and is already acting as a stabiliser for both construction and the economy as a whole. In principle there is more scope to bring work forward and build additional projects. Moreover, public investment in the UK is lower than in the US and across the EU measured as a share of GDP (see Figure 7 overleaf), so counter-cyclical additional spending will not lead to “over-investment” in infrastructure.

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<sup>35</sup> Mosley and Kruppe, “Short-Time Work in Structural Adjustment: European experience”, *European Journal of Industrial Relations*, Volume 2, Number 2, pp 131-151 (1996)

The primary argument against infrastructure projects is the delay before they act; by the time they feed through into extra jobs and growth the economy and the sector is already recovering. There is still uncertainty about whether the downturn will be a “V” – sharp downturn but strong recovery – or a more drawn-out affair with several years of anaemic growth.

**Figure 7: Public investment in 2007 compared by country**



However, even in a “V”-type recession the delayed impact of large construction projects is less of a worry when the downturn is severe and the recovery in new orders is likely to be delayed. For example, in the downturn of 1990–1992 construction new orders began to fall in mid-1989 and did not begin to recover until mid-1993.

Even so, we would give particular priority to smaller scale and more labour-intensive projects as these can be brought forward relatively quickly provided financial and non-financial barriers can be removed. About 50 per cent of all construction orders (public and private) consists of projects involving less than £2 million spending according to the Office for National Statistics. An obvious area is social house-building by the public sector and housing associations, largely because house-building is the most badly affected by the slump in orders. Between 2008Q1 and 2008Q3 new orders for private house-building fell by 42 per cent in real terms (see Figure 8 on page 41).

Unfortunately, investment in social housing is small (albeit higher than at the start of the 1990s recession). Social housing investment accounts for about 6 per cent of all construction new orders. New orders for social housing were worth just over £400 million in the third quarter of 2008 compared with pre-slump private sector house-building orders of £1,500 million in the first quarter of 2008 (both figures 2000 prices, seasonally adjusted).

Even if new orders for social housing doubled from their current level they would not make up for the fall in private sector house-building orders over the past 9 months; far less the further declines likely over the next 12 months or expected falls in orders in other much larger sources of new orders for the construction industry, such as commercial property. The latter accounted for 34 per cent of all construction orders at the start of 2008 and since then orders have already fallen 22 per cent in real terms.

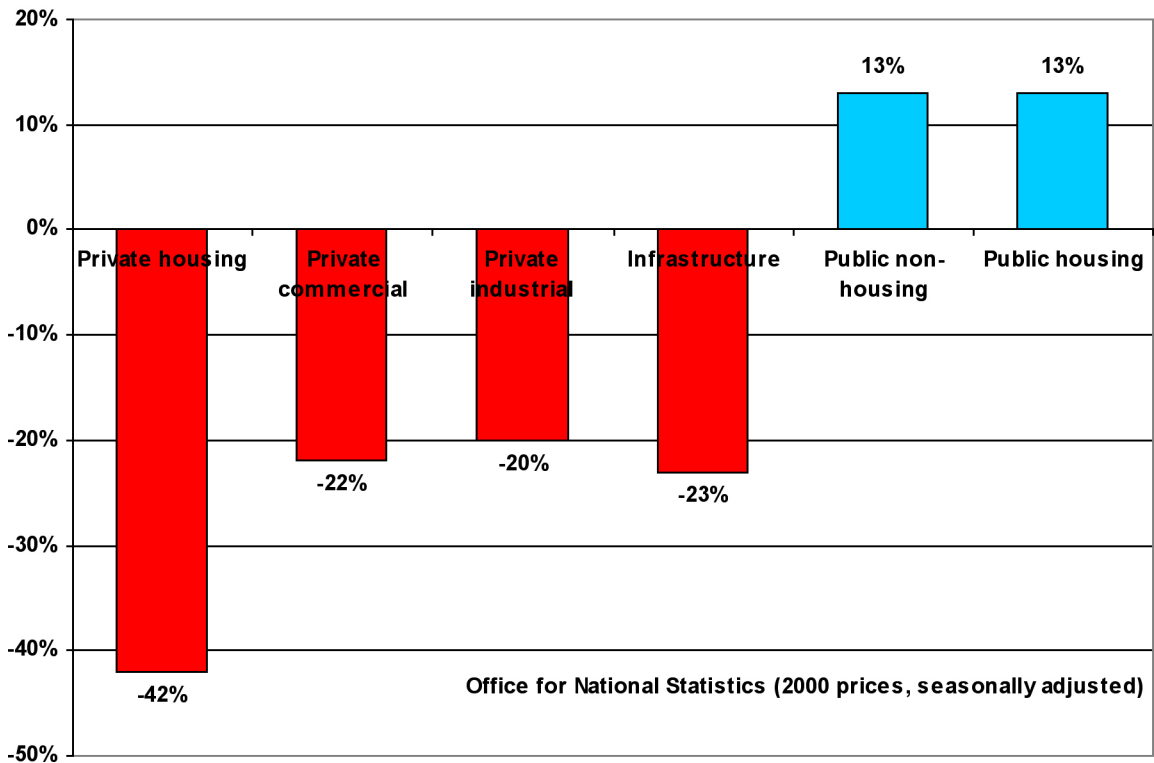
We cannot realistically expect increased social house-building alone to counteract the fall in private construction orders, especially if we want to sustain existing quality standards. Additional investment in schools, hospitals and roads will also be required. It is particularly important to identify areas where additional investment will help free up projects, for example if new development is being held up because budgets for investment in local roads and other infrastructure have been exhausted. As we show later in this report, there is considerable scope to bring forward and free up projects at local and regional levels.

The government should also look at other ways of stabilising the housing construction market, for example expanding the resources available to the Housing Corporation and housing associations to buy housing that at the moment is unsellable and renting it as social housing either on a permanent or temporary basis. Housing acquired in this way could be sold back into private ownership in the upturn.

The government may also need to act if the supply of capital for private finance initiatives (PFI) is in danger of drying up or is holding up the start of construction projects. Where PFI is the problem the government should replace private capital with public capital and finance the project in the conventional manner.

The government should also look for ways of reducing non-financial barriers to action, in particular the planning system. There cannot be a free-for-all, otherwise projects of dubious value and low quality that otherwise would not be approved could be forced through. However, if opportunities to fast-track viable projects exist it is essential that the government takes the lead in helping speed up the system.

Figure 8: New construction orders Q1 2008 to Q3 2008



**Policy recommendations**

The government should help bring forward as many construction projects as possible and authorise new projects able to start quickly. Institutions such as the Housing Corporation and housing associations together with local authorities and regional agencies should be given increased funding if necessary. Where access to private finance is holding projects back it should be replaced with public finance. There should be particular attention given to smaller scale and more labour-intensive projects in areas such as social housing, hospitals, schools and transport. The government should ensure resources and authority to act is devolved as fast as possible to regional and local authorities and agencies.

*Other regulatory interventions*

Before concluding this discussion of national policy options, a word needs to be said about the likely impact of regulatory interventions on the level of employment. Some business

representatives talk about such matters using the language of “burdens” that either inhibit entrepreneurial dynamism or hold back job creation. The rather conventional argument is that light-touch labour market regulation generates the strongest employment performance and that excessive regulation can explain why countries like France and Germany have had such a poor jobs record over the last decade or more. Furthermore, it is said that regulation in the UK is already reaching dangerous levels and that every effort should be made to retain a high level of labour market flexibility.

Unfortunately the evidence tends to contradict rather than reinforce this analysis. In a comprehensive review the OECD found that there was no systematic relationship between the strictness of employment protection legislation and employment performance over the course of the economic cycle.<sup>36</sup> Moreover, the UK has the second most liberal labour market in the OECD (only the USA is more flexible on the employment protection measure), product market regulation is permissive and competition policy is robust. A simple inspection of the UK’s relative performance shows that the scope for deregulation is limited.

Some suggestions have been made that small firms should be exempted from the rigorous application of employment law for the duration of the recession and perhaps beyond. We believe this to be a mistake. It would create a two-tier labour market, exacerbate the problem of employment insecurity and encourage bad employment practice – leaving aside the perverse incentive it might create for small firms to stay small simply to avoid “burdensome” regulation.

Others have called on the government to delay the implementation of the extended right to request reduced hours of work. We believe this to be a mistake too. The right to request could be a valuable form of flexibility for employers during the recession. It is employees here who are offering to reduce their hours – and accept reduced earnings too. Far from being a “burden” at a time of falling demand, the application of the right to request could be seen as a form of short-time working with no wage compensation. One additional possibility worth considering is that employers and employees should be able to place a time limit on the duration of the new flexible arrangement, which under current regulations is seen as a permanent change to the contract of employment. This will allow both employers and employees to consider a return to “normal” working hours as the economy recovers.

Finally, government might consider whether this is an opportune moment to make progress with the working time agenda and move towards the implementation of the 48-hour limit on the maximum average working week (measured over a 12-month reference period). The level of overtime being worked will fall as the economy slows down and this might be the best possible

<sup>36</sup> OECD, *Employment Outlook 2004*, Chapter 2, “Employment Protection Legislation and Labour Market Performance” (2004)

moment to inspire a national debate about how, by improving productivity and performance, organisations can respond to the upturn when it comes without relying on a pattern of excessive hours.

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**Linking  
national policy  
with regional  
and local  
delivery**

This section has focused on what government can do nationally, but it is inevitable that delivery will take place at regional and sub-regional level. Public works programmes are most effective if they reflect local needs and priorities, and active labour market interventions will be better targeted if they reflect the industrial structure and skills base of the local economy. Government policy already envisages devolution of delivery to RDAs and a plethora of local partnerships. Furthermore, a degree of flexibility is needed because a decline in economic activity may affect different regions differently. It is to these issues that we now turn.

## 5. Cities, regions and partnerships

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**Introduction** Just as 10 years of unprecedented growth in the UK economy has played out across the UK's cities and regions with varying consequences, so the economic downturn will have different implications for the UK's cities and regions, which are principally influenced by local factors and conditions including the skills base, industrial structure, occupational structure, infrastructure and location.

Responses to labour market adjustments that happen at the local level need to be driven by local actors with in-depth local knowledge and understanding of the challenges unique to a particular place. We argue that the necessary powers and resources to take these detailed decisions should be devolved to a more local level. The economic assessment duty and the strategic role of regional development agencies (RDAs) will become more important in a recession, particularly given the expansion of regional funding allocations.

Local authorities and regional development agencies should not reinvent the wheel but should learn from each other. Moreover, they should consider a range of potential initiatives, including active labour market policies – for example investing in skills, working with employers to minimise redundancies through innovative use of benefits – and also public works and infrastructure investment.

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**City labour markets and the recession** Examining the impact of the 1990–1992 recession at a local level can be indicative of the potential spatial impact of the current economic downturn. Whilst past recessions cannot serve as perfect predictors of the socio-economic outcomes of the current downturn, the preceding conditions, sectoral and spatial implications can be illustrative of how this recession might affect different areas.

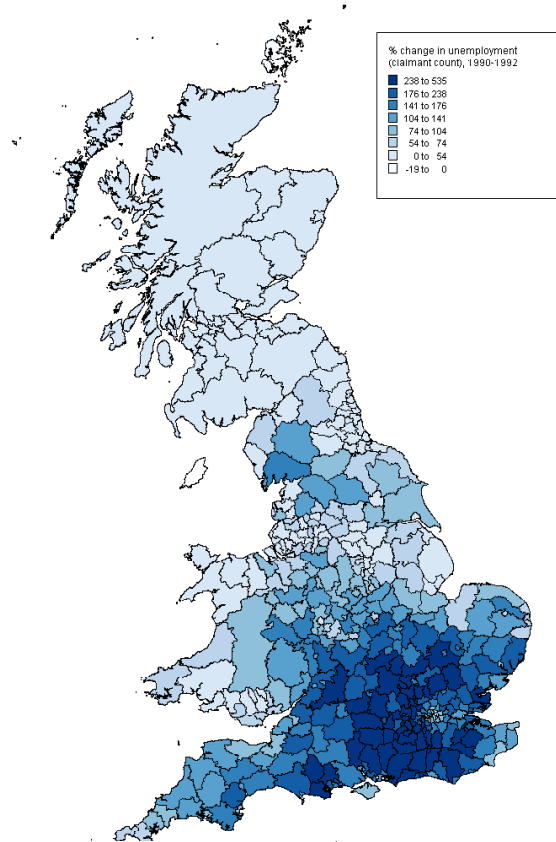
The last recession was born in southern England, principally because the property bubble that burst in the early 1990s was located there. An inevitable consequence was that parts of the south of England appeared to suffer earlier and more severely than other parts of the UK.<sup>37</sup> Economic restructuring in the last recession disproportionately affected the UK's industrial base, with large job losses in the manufacturing and construction sectors as a result of high interest rates and the collapse of the housing market. This led to higher percentage change in unemployment (claimant counts) in the south east and the Midlands (Figure 9a).

Examination of the impact of the last recession on absolute growth in unemployment exposes an alternative geography (Figure 9b). Whilst there were still significant numbers of jobs lost in the south east of England, the largest increases in the absolute number of claimants were to be

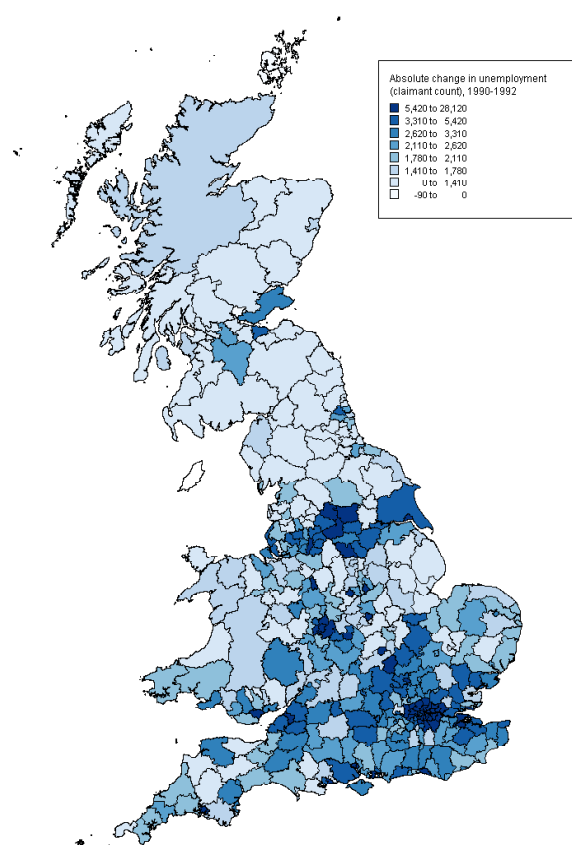
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<sup>37</sup> Green et al, "The Changing Geography of Recession: Analyses of local unemployment time series", *Transactions of the Institute of British Geographers*, Volume 19, Number 2, 1 June 1994, pp.142-162(21)

**Figure 9a: Relative change in unemployment in the last recession (claimant count), 1990 to 1992**



**Figure 9b: Absolute change in unemployment in the last recession (claimant count), 1990 to 1992**



found in parts of the North and the Midlands. These areas had barely started to recover from the previous 1980s recession and so the relative change in unemployment was not as marked as in the south. Birmingham for example saw an increase of over 28,000 claimants between 1990 and 1992, although existing high unemployment meant that in relative terms the claimant count increased by just over 60 per cent. Within the south east, the actual number of jobs lost in London – a polarised city with high unemployment rates prior to the recession – was also large, mostly accounted for by a reduction in the number of jobs in the construction industry.

In contrast, the impact of the current recession is likely to be much more universal, both in terms of the sectors and places affected. On the one hand, while there is still likely to be substantial job losses in manufacturing, there is likely to be more jobs lost in services than in previous recessions. On the other, regional differences in industrial structure are less acute, as regional economies have diversified since the last recession. Consequently the impact of the current recession is likely to be less geographically specific. Over recent years the North East economic base, for example, has transformed from one based primarily on traditional industries – shipbuilding, engineering and steel – into new areas such as microelectronics, the oil and gas sector, process industries and automotives.<sup>38</sup> The impact of these sectoral and spatial changes helps us to predict the likely differences between this recession and the previous one.

Consistent with the last recession, to date we have seen substantial losses in the manufacturing sector as demands for goods falls and companies find it increasingly difficult to obtain finance. Yet job losses are not likely to be as high as in the 1990s for two reasons. First, the exchange rate has been free to depreciate, stabilising the level of exports and reducing the impact on value added from the sector. Second, the manufacturing sector now accounts for a far smaller proportion of employment across the UK. This latter point has important implications for the potential spatial impact of the recession. The growth of services across the UK has meant that all regions and cities are less reliant on manufacturing for employment. The highest proportion of manufacturing employment is found in the East Midlands where the sector accounts for 17 per cent of employment: this compares to 35 per cent in 1991.<sup>39</sup> Although the regional differences are not as acute, however, manufacturing is still disproportionately concentrated in parts of the North and there are areas such as Copeland, Flintshire, Corby and Sedgefield where manufacturing accounts for around a third of total employment. The

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38 Government Office for the North East, *Our Region* (2008)

Available at: <http://www.gos.gov.uk/gone/ourregion/>

39 Figures derived from the *Annual Employment Survey* (1991) and *Annual Business Inquiry* (2006)

automotive industry, which is concentrated in areas of the Midlands, is currently making redundancies, cutting hours and reducing output.<sup>40</sup>

There are likely to be higher job losses in the service industry than in previous recessions, which is a consequence of the move away from traditional industries, and will impact on all regions. The service sector accounts for nearly 80 per cent of employment across all regions and as a whole is less geographically concentrated than the manufacturing sector was in the 1990s.

Within the financial sector, although the job losses are predicted to be relatively small, the sector – most identified with clustering – tends to be highly concentrated in particular areas. Employment in the financial sector is concentrated around London. In the City of London, at the heart of the financial capital, the sector accounts for well over 40 per cent of employment. Clusters of financial services can also be found elsewhere in the UK in Manchester, Leeds, Edinburgh and Norwich. These areas are more likely to be affected by job losses in the sector. Decline in the financial sector is also likely to have knock-on effects for the sector's supply chains – IT, legal and business services, which often surround financial clusters. In Leeds, the financial sector and associated business services have acted as a catalyst for growth in the wider city region. In other parts of Yorkshire, Halifax and Skipton's economies have been dominated by the finance institutions that bear their name. For some areas the impact on the financial sector may mean the loss of "anchor institutions" that have long provided not only employment in the area but played a substantial leadership role in the economic regeneration of local areas, contributing intellectual property, skilled jobs, stimulating the clustering of related industries and changing the look and feel of the cities.

The collapse of the housing market has meant that, as in the 1990s, the construction sector has been one of the hardest hit to date. Many firms, particularly those in London, have already been affected by the fall in the property market and subsequent decline in construction. New developments are declining and cities most in need of physical regeneration may also be the least attractive to developers who need to ensure a financial return. While cities such as Plymouth are predicted to fare better in terms of job losses – largely due to the dependence on the public sector, which should be more stable in the downturn – much needed regeneration programmes designed to increase inward investment and employment in the city are likely to be hampered. Housing market decline will also affect professional services such as real estate and property services.

<sup>40</sup> FT Reporters, *Recession Britain: Grim down south* (2008)  
Available at: [http://us.ft.com/ftgateway/superpage.ft?news\\_id=fto111220081527091807](http://us.ft.com/ftgateway/superpage.ft?news_id=fto111220081527091807)

The last decade of regeneration saw the resurgence of cities such as Manchester, Leeds and Glasgow, fuelled by rising consumption and booming property prices. These economies may be disproportionately affected as they are driven not only by finance and business services, but also by consumer spending on retail and property. The impact on these cities is already apparent as many city centre and canal-side developments lie empty.

Some of the cities most at risk from the downturn may, paradoxically, also be best positioned to meet the challenges that they face; experience during the previous recession suggests that this could prove to be the case.<sup>41</sup> For example, the south east is most vulnerable to rising unemployment with predicted jobs losses in the finance and construction sector, but may also be best placed to respond. As our analysis of changes in unemployment in the last recession has shown, predicted job losses do not necessarily mean high increases in unemployment in absolute terms. Resurgent cities that have improved their economic performance over the last decade and reduced unemployment, such as Manchester and Leeds, may also be better positioned to minimise the risks. In other words, their experience in the immediate future may look more like the experience of southern England in 1990–1992, with large percentage rises in unemployment but smaller increases in absolute numbers than in harder hit areas.

While this may offer cause for optimism, the downturn may exacerbate problems in less economically successful cities – those that have struggled to build their economies over the past decade and that have benefited less from rising prosperity. These cities may not have so many jobs at risk in financial services and construction, but they will already be struggling to reduce worklessness and to increase inward investment. While they may not lose as many jobs as some of the other cities, they are already in a worse position and this may be reinforced by the recession.

We are still in the early stages of the current downturn, making it difficult to gauge its severity and to assess the impact at a local and regional level. The most recent available regional figures (claimant count) show an increase in unemployment across all regions, with a slightly higher proportional increase in the South West and South East. These figures cannot be used to assess the impact of the recession across the regions over the longer term, however, partly because of the lag in data but more crucially because we have not yet seen mass redundancies in the sectors not directly affected by the economic downturn. In addition, claimant count figures provide a slightly distorted view as the propensity of those made unemployed to claim benefit will vary according to occupation and industry, and therefore by region. Some people may

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41 Local Government Association, *From Recession to Recovery: The local dimension*, LGA (2008)

choose to exit the labour market altogether and may not even show up on the ILO measure of unemployment.

Not only can we not see the impact of the recession in the figures at the moment but it is impossible to predict the spatial impact of the recession by sectoral composition alone. The impact on cities and regions is less predictable as it will be influenced by a range of local factors including demographic structure, migration, the characteristics of the local labour markets, the skills base, local housing markets, business support mechanisms and education institutions. These factors affect the resilience of local economies in both the short and medium term and can produce highly differentiated effects found in parts of the North and the Midlands.

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**Policy  
response**

The spatial variation in economic outcomes and the critical influence of local factors on the impact of the downturn, coupled with the fact that we can not fully predict the future, means that it is difficult to ascertain what national policy measures will be most effective at the sub-national level. Rather, the necessary powers and resources should be devolved to a more local level to enable decision making on the ground and should be underpinned by in-depth local understanding of the specific issues and challenges an area faces. Solutions to the detailed problems that individual neighbourhoods and cities face are best identified at the local level. Restrictions on the mechanisms and policy levers that local stakeholders can pull to militate against the challenges of the downturn need to be lifted to enable them to make the most appropriate response. The government should also ensure that there is no delay in implementing the recommendations from the Sub National Review. The economic assessment duty and the strategic role for RDAs with the expansion of regional funding allocations will prove pivotal in ensuring that cities and regions respond effectively to the challenges they face.

**Labour market initiatives**

It is crucial that this local dimension is applied to active labour market policies built on local knowledge and local relationships. Travel-to-work patterns in the UK demonstrate the limited distances travelled by individuals to work. Any labour market adjustments provoked by the economic downturn will take place at the local level and employment opportunities are likely to be dependent on the state of local labour markets. The DWP has in recent years re-directed emphasis on national employment initiatives towards initiatives with a greater local dimension, most notably through Employment Zones and City Strategy Pathfinders. Local flexibilities should be extended so that initiatives can be tailored to the needs of the local economy to take full account of local labour market demand and supply-side issues.

Successful labour market initiatives will depend on demand-supply matching at the local level. Job matching will be, in the majority of cases, dictated by local market conditions. Skills and training provision is most effective when specific and relevant to the needs of local employers, as well as tailored to the individual. Short-term placements – work experience and temporary employment – that offer development opportunities to individuals provide an opportunity for cities to manage the impact of a downturn as well as requiring the engagement of local employers, best done at a local or sub-regional level. This is an important issue: nationally the government states that there are 600,000 vacancies in the labour market and in some cities, including Manchester, vacancies have actually risen recently. Skills and spatial mismatches may be preventing employers from recruiting in the areas of highest unemployment. Of course, part of the remedy lies in better skills and training provision (as we argued in Section 4), but improving transport infrastructure at city and regional level to enable individuals with the appropriate skills to travel to vacant jobs is another essential ingredient in the policy mix.

Multi-area agreements provide another pre-existing opportunity for central government to devolve funding to the city-region level by bringing together partners to tackle skills and employment issues on the ground. The Manchester Multi-Area Agreement proposes a “Greater Manchester Flexible New Deal” that is jointly funded and managed by the DWP, but brings in other local service providers to tackle local skills and employment issues.<sup>42</sup> Implementing such an initiative is particularly timely when unemployment levels are already rising across the UK’s cities and predicted to increase substantially.

It is also important to bear in mind that the focus on active labour market policies in light of the economic downturn and rising unemployment should not deter efforts to increase the prospects of the long-term unemployed who may well be further away from the labour market. For some areas levels of worklessness will be more acute. However, priorities will need to be adjusted as it is likely that there will be a need to help those closer to the labour market move back into employment as well as the longer-term unemployed and those in the “hard-to-reach” groups identified in the government’s welfare reform programme. Understanding the subtleties of local labour markets is a prerequisite for the effective delivery of national policy.

### **Access to capital and business support**

These labour market initiatives need to be coupled with policies and initiatives to prevent rising unemployment across cities and regions through job cuts and firm closures. The impact of the recession is likely to be sharper for those companies with limited access to capital – particularly SMEs. The RDAs, with greater capacity to steer funding towards finance for businesses, need

<sup>42</sup> Bolton Council, *The Manchester Multi-Area Agreement* (2008)  
Available at: <http://democracy.bolton.gov.uk/CMISWebPublic/Binary.ashx?Document=5544>

to prioritise investments and channel funding to meet the needs of smaller businesses that cannot be met elsewhere. Several RDAs have already announced extended financial support, including Advantage West Midlands, which recently put a £4 million Transitional Loan Fund into place.<sup>43</sup>

Alongside access to finance, RDAs should continue to work with companies to increase business efficiencies and continue to support and promote innovation within firms. Local authorities and other business support agencies need to focus on business support that is locally sensitive and addresses the issues that are specific to the individual firm, the sector it sits in and the location. Part of this work will be about creating coherent and accessible support for local businesses. For example, greater use may be made of local library facilities in providing business support.

### **The stabilising role of the public sector**

The public sector is predicted to act as a stabilising force in the economic downturn. The sector employs around 8.5 million people across the UK and in many cities – Liverpool, Newcastle, Hull and Brighton – the public sector provides over a third of employment. In cities such as Cambridge and Oxford the higher education sector has driven economic success. As expenditure in health and education is set to continue, employment in the two sectors is likely to remain relatively stable. For all cities, and particularly those with large public sectors, the challenge is to maximise existing resources. As the private sector is likely to reduce expenditure on training and development, a greater dependency will be placed on the public sector to support local workforce development. As we have already observed, there is the potential for individuals to be placed on short-term contracts within local government to provide opportunities in the local labour market for work experience and development.

Another important conclusion is that reductions in public expenditure to compensate for tax cuts would undermine the stabilising role of the public sector. Sustaining economic activity in city regions under pressure depends on a fiscal framework that embraces an increase in public borrowing beyond the operation of the automatic stabilisers.

### **Using public procurement to support the local economy**

There is also potential to maximise the impact of public sector procurement at the local level. A total of £125 billion is spent annually by the public sector on purchasing goods and services.<sup>44</sup> Local and regional government procurement professionals should examine the local multiplier

<sup>43</sup> See: <http://www.advantagem.co.uk/news-media-events/news/2008/11/loan-fund-for-business-announced-at-west-midlands-economic-summit.aspx>

<sup>44</sup> Office of Government Commerce, *Transforming Public Procurement*, OCG (2008)

effects to assess how support for local businesses might be increased through the public sector supply chain without compromising quality.

### **Public works programmes**

Initiating, bringing forward and expanding current public works programmes is an additional preventative measure that may help to counteract losses in employment in other parts of the economy, particularly in the construction industry. London is still committed to large public works programmes including the modernisation of the London Underground, Crossrail and the 2012 Olympics, although the recession is already having a visible effect on development in the Olympic Park.<sup>45</sup> Sustaining these projects is important in providing employment through contract opportunities in the long term. They also have the potential to lead significant regeneration of local areas for some time into the future. In the downturn local authorities and RDAs in particular with funding for major infrastructure developments should focus on developments that are labour-intensive to encourage buoyancy among local labour markets. Unlocking investment in schools, hospitals and roads may also achieve the same objective. The public sector should work with the private sector to identify what developments can proceed and consider innovative ways of raising investment. In general at the city level there is an *“appetite for greater use of public-private partnerships and innovative local funding schemes to secure additional investment, especially in enabling infrastructure.”*<sup>46</sup>

The collapse of the housing market and falling confidence among property developers will lead to increased demand for rented accommodation and more affordable housing, and put increased pressure on social housing. Social housing provides a valuable safety net for those not able to secure housing through other channels and in times of economic hardship not only will the supply of social housing be affected but demand for social housing is likely to increase. Social housing, in terms of terms of construction jobs, only accounts for a small percentage of house building and in many areas the quality of social housing is in question. The public sector can no longer rely on developers to fulfil the Section 106 obligations for social housing and affordable housing provision is also likely to be less of a priority for developers.<sup>47</sup> There are ways that local authorities can respond, however. In response to the oversupply of apartments and offices and increased demand for social housing Edinburgh City Council is buying homes that developers are unable to sell and offering their own mortgage scheme. Council plans could

45 HM Treasury and Department for Business, Enterprise and Regulatory Reform, *The London Economy: Responding to changing economic circumstances* (September 2008)

46 Core Cities Group and PWC LLP, *Unlocking City Growth Interim Findings on New Funding Mechanisms* (2008)

Available at: <http://www.corecities.com/dev07/Publications/PWC%20Finance%20Summary%20Final%20160708.pdf>

47 Poynter, *The Credit Crunch and London's Economy* (2008)

Available at: <http://www.uel.ac.uk/risingeast/currentissue/academic/poynter.htm>

see investment of up to £507 million in 6,700 new homes over the next 5 years to increase the availability of affordable housing.<sup>48</sup> Local and regional authorities must continue to look for innovative ways to secure private investment and replace private capital with public funding where necessary.

Transport investment needs to remain a priority as it provides both employment opportunities in infrastructure development and widens individuals' access to work. Access to transport – car ownership and public transport – improves individuals' job opportunities, allowing them to travel across wider geographical areas. Improved transport would also help link rural economies and smaller towns to the large cities that have been the drivers of the economy in the last decade. The Leeds City Region transport vision sets out plans to maximise the potential impact of Leeds at the core of the city region by increasing connectivity within the city region and to other core cities, such as Manchester, Sheffield and London.<sup>49</sup> Despite collaborative efforts at the local level to improve transport infrastructure, in reality the authorities at this level have little discretionary power and little access to sustainable funding for projects.<sup>50</sup> Funding needs to be raised for such projects that are able to demonstrate – with detailed assessments of the costs, benefits and risks associated – the potential local economic impact in both the short and medium term.

### **Partnerships and collaboration**

Crucial to the success of all policy responses at the local level is effective collaboration between local stakeholders. Effective partnership working at the neighbourhood, city or region level will be key to delivering a sufficiently targeted but wide range of support to people, businesses and the wider community. There are examples of best practice in joint working on labour market initiatives and responding to the challenges of large-scale redundancies at the local level. One such example is MG Rover, although it is worth noting that not all interventions and mechanisms used will be applicable in the current climate as the number of whole large-firm closures is not predicted to be high and they will not be confined to the manufacturing sector. The coordinated effort on the ground in response to the 6,000 redundancies from the closure of MG Rover in Longbridge and the effect on the wider community does provide, nonetheless, a particularly relevant example. The support package for former employees brought together a range of local organisations including Birmingham City Council, JobCentrePlus, the Learning and Skills Council, local colleges and other training providers. Specifically in the provision of training and development the council was successful in mobilising local providers to develop

48 See: [http://www.edinburgh.gov.uk/CEC/Corporate\\_Services/Corporate\\_Communications/Press\\_Releases/NewsRelease.jsp?ID=4000](http://www.edinburgh.gov.uk/CEC/Corporate_Services/Corporate_Communications/Press_Releases/NewsRelease.jsp?ID=4000)

49 See: <http://www.leedsinitiative.org/transport/page.aspx?id=2410>

50 Core Cities Group and PWC LLP (2008)

and deliver individual training plans that provided pathways back into employment and higher job satisfaction among those made redundant.<sup>51</sup>

The response from local authorities and RDAs, as it applies at the national level, needs to be timely, targeted and temporary. Leaders at the local and regional level need to prioritise investments that are likely to have the greatest impact in the short term (the next 12 to 18 months) but with an eye to how their region is placed to respond to the upturn when it happens. Investment needs to be targeted, for example in areas that are likely to have the greatest spillover effect. Some measures will need to be temporary, for example provision of access to funds will not necessarily be needed at such a scale when the economy picks up again. Policymakers should seek to focus on initiatives that respond to the needs of their particular region, learning lessons from the past and from each other rather than “reinventing the wheel”, but also ensuring that the strategies are bespoke to the needs of their region. Greater innovation is likely to be required to enable authorities to secure finance to move projects forward, for example considering “Accelerated Development Zones”, as suggested by the Core Cities and PWC<sup>52</sup>, as well as measures such as Community Infrastructure Levies, Supplementary Business Rates, JESSICA and Local Asset Backed Vehicles.

Responding to short-term economic uncertainty is important, but policymakers should continue with longer-term regeneration and local economic development programmes. This will ensure that local economic actors are prepared for the recovery when it materialises and that regeneration projects are linked to strategies to stimulate the economy. Priorities identified before the recession are still as relevant as they were before the start of the economic downturn. Cities should continue to diversify their areas of specialisation, invest in skills for the long term, create better socio-economic outcomes at the local level and develop a workforce that is fit to meet the challenges of economic restructuring.

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51 Bailey, *Life After Longbridge: Three Years On*, The Work Foundation (2008)

52 Ibid

## 6. Conclusion

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The purpose of this document has been to set out a positive prospectus for policymakers. It offers a menu of options for recapitalising the financial sector, giving the economy a fiscal boost, improving the supply side and adapting national policies to local needs. None of these activities is likely to prove easy and there is still a great deal of uncertainty about the scale of the economic challenge facing the world. Inevitably this means that policies will be revised in the execution and that what seems ambitious today may well look too cautious tomorrow.

In particular, we do not fully understand the severity of the banking crisis. We do not know whether further public action will be needed to offer the banks extra liquidity and we do not know what this might mean for government borrowing – even if we assume that the banks will repay the money that they have been loaned in the long term. Nor is there any certainty about the impact that the turbulence in the banking sector will have on the real economy. That growth has slowed, that recession is a near certainty and that unemployment will continue to rise can all be taken as axiomatic. But we do not know whether the recession will be short and sharp with a rapid recovery or whether a prolonged slump is in prospect. We have tried to be measured in our own forecasts (unemployment at 2.5 million by the end of 2009) but note that others, including the CBI and the Bank of England) now appear to be more pessimistic. Yet none of these predictions should be taken as the final word. Yesterday's optimists are today's pessimists. The CBI was predicting a short, shallow recession in September and now purports to foresee something far worse. Perhaps the best conclusion is that policymakers should not panic but should recognise the imperative for a bold and co-ordinated reflation across the developed world. Any lack of co-ordination will expose those countries that decide to implement a reflationary package alone. In this case collaboration between nation states trumps narrow nationalism. There is too much at stake for policymakers to behave otherwise.

A fiscal boost of £15 billion or 1 per cent of GDP seems prudent to us in the current environment. We hold fast to the view that such a stimulus must be timely, targeted and temporary. The first criterion is certainly met with the economy set to fall into recession. We have argued strongly that targeted measures are those that improve the purchasing power of the poor – most obviously through the temporary expansion of tax credits for those with low to modest incomes. We reject the view that such a fiscal boost must be “fully funded” since by definition if it is fully funded (if tax cuts are offset immediately by reductions in public expenditure) then it will not prove to be a fiscal boost at all but nothing more than some administrative tampering with the tax system.

Perhaps our most controversial proposal is that the level of unemployment benefits should be raised. There is no doubt that this meets the principle of targeting – the unemployed will spend

the extra money – and we believe that with good policy design the supposed disincentive effects of higher benefits can be eliminated. International experience is compelling on this point – what matters to work incentives is whether high benefits are matched by tight job search conditions and limits on benefit durations. The “something for something” principle, endorsed by public opinion and commonsense, is supported by empirical research too – reciprocity and mutuality are clearly identified as the corner stones of an effective welfare system.

Public works also have an important role to play in boosting economic activity and minimising the impact of recession. The government should help bring forward as many construction projects as possible and authorise new projects able to start quickly. Institutions, such as the Housing Corporation and housing associations, together with local authorities and regional agencies should be given increased funding if necessary. Where access to private finance is holding projects back it should be replaced with public finance. There should be particular attention given to smaller scale and more labour-intensive projects in areas such as social housing, hospitals, schools and transport. The government should ensure resources and authority to act is devolved as fast as possible to regional and local authorities and agencies.

We have emphasised the importance of the city-region dimension simply because policy implementation is likely to be most effective where it is devolved to those with a sophisticated understanding of city-region economies and their labour markets. It simply is not possible to dictate the detail of policy design from the centre and expect this to work in an undifferentiated way across the UK. Responding to the recession is an opportunity for RDAs, local authorities and other city-region stakeholders to re-assert their role and demonstrate their resilience and flexibility in responding to economic challenges. Most importantly perhaps, none of these objectives will be secured unless public institutions and the private sector are able to collaborate across boundaries. Effective active labour market programmes, support for SMEs under pressure, the delivery of business support activities and investment in skills and physical infrastructure are all rooted in the principles of partnership. Developing such relationships must be a priority in the period ahead.

While the developed world may be about to enter the territory of Donald Rumsfeld’s “unknown, unknowns”, what we know now is that there can be no excuse for quietism or inactivity. Nor should we succumb to a bleak pessimism. Intelligent intervention of the kind we recommend in this paper can minimise the worst consequences of recession, reduce the risk of large-scale job losses and position businesses so that they are ready to respond to the recovery when it comes. This is an age when cautious optimism, deployed through the creative use of public action, can ensure that developed countries weather the storm. If policymakers have a clear-

sighted view of the problems and a willingness to think innovatively about the solutions, then they are most likely to save the banking system and minimise the adverse consequences for the real economy. Franklin Delano Roosevelt was right: in today's conditions, the only thing we have to fear is fear itself.

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