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Speech

Has UK Labour Market Performance Changed?

Speech given by

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1. Introduction

In the late 1980s, unemployment (ILO measure) fell from 11.2% in 1986 to 7.2% in 1989. Over the same years, inflation (GDP deflator) rose from 3.5% to 7.1%. In the late 1990s, unemployment fell from 10.3% in 1993 to 5.5% in 2000. However, inflation, also fell from 2.7% to 1.7% over the same period.

In 1998, around 2.3 million men of working age (excluding students) were classified as economically inactive. That is, neither employed nor looking for work. Twenty years previously, this number was only 400 thousand.

In 1979, the proportion of employees who were trade union members was over 50 percent. Today this number is below 30 percent and, in the private sector, below 20 percent.

In 1975, earnings at the 90th percentile of the pay distribution were less than three times earnings at the 10th percentile. By 1996 this multiple had risen to nearly four times.

All these facts are indicative of big changes in the UK labour market in the last quarter of the 20th Century. In what follows, we look at some of the forces underlying these changes and briefly touch on their implications for policy. In the next section we look more closely at the interaction between monetary policy and the labour market. Then in Sections 3 and 4, we analyse the recent history of UK unemployment and the forces underlying its substantial decline over the last decade. In Section 5 we focus on inactivity rates and then in Section 6 we consider the growth of some significant imbalances in the UK labour market. We conclude with a summary and some final remarks.

2. The Labour Market and Monetary Policy

One way of looking at the setting of monetary policy is by noting that to stabilise inflation, it helps if real demand is kept in line with potential output. Given the lags in the system, this must be done in a forward looking manner. In order to do this, it is vital to keep track of potential output. For example, a ceteris paribus increase in the growth rate of potential output will typically require a temporary loosening of monetary policy. The growth rate of potential output may be split up into four parts as follows¹:

Potential output growth = trend labour productivity growth +
growth of the working age population

- the trend rate of change of the inactivity rate
- the rate of change of the equilibrium unemployment rate.

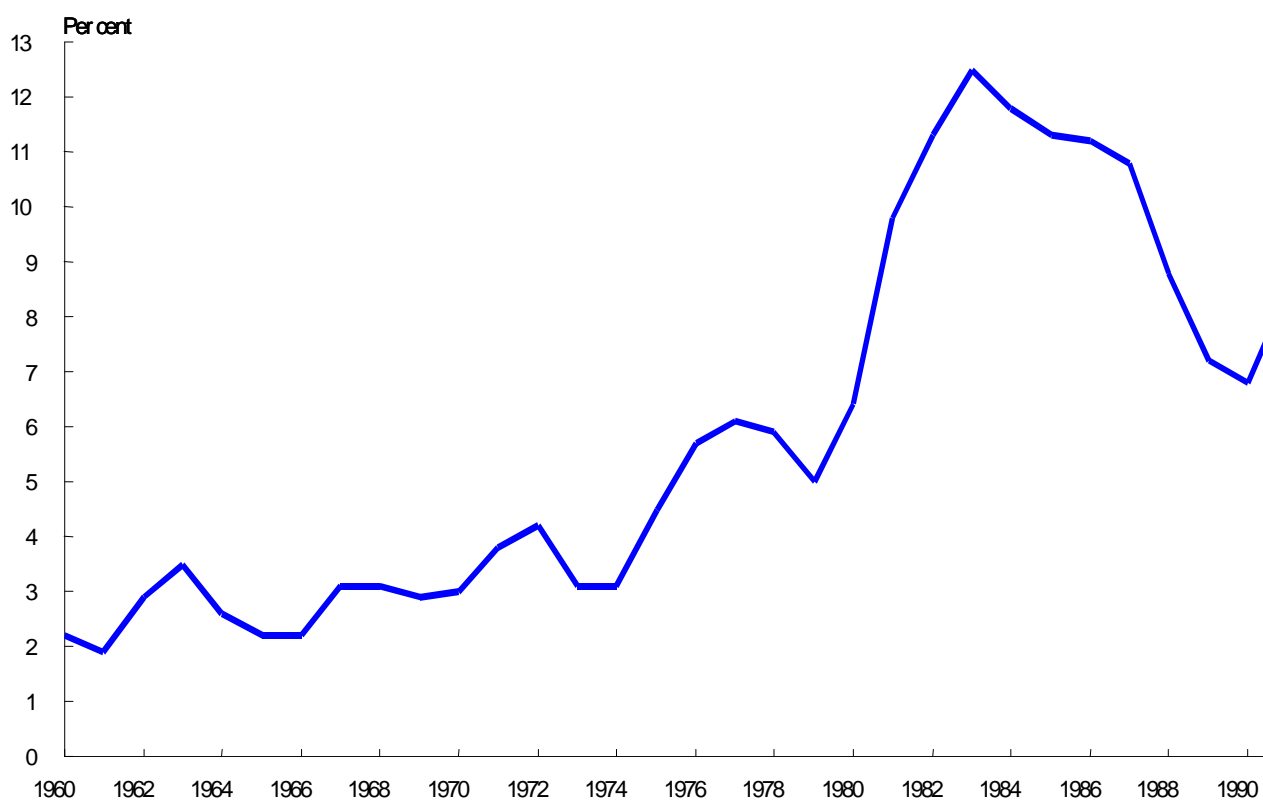
Trend labour productivity growth is the trend rate of growth of output per employee, the inactivity rate is the proportion of the population of working age neither working nor looking for a job and the equilibrium unemployment rate is the rate consistent with stable inflation, sometimes termed the NAIRU.

The operation of the labour market impacts on all four of the elements of potential output growth. The first, namely trend productivity growth, depends crucially on the rate at which skills are accumulated. The growth of the population of working age is mainly determined by demographic changes but it is also influenced by net migration. Both equilibrium unemployment and the extent of inactivity directly reflect the performance of the labour market. In what follows, we focus on these last two factors, although we may occasionally comment on some implications for productivity growth. We begin by looking at the recent history of equilibrium unemployment.

3. The Recent History of Unemployment in the UK

Before going into detail about recent shifts in equilibrium unemployment, it helps to set the scene if we have some idea of the history of unemployment in post-war Britain. In Figure 1, we show the path of unemployment since 1960, using the standard ILO definition (that is, an unemployed person is someone without work who is actively searching for work and is available to take up a job)². We can see that unemployment started to move gradually upwards in the late 60s and early 70s, surging upwards rapidly after the first oil shock in 1974, again after the second oil shock in 1979, came down rapidly in the Lawson boom of the late 1980s and rose equally rapidly after 1990. Since 1993 it has gradually subsided so that by 2000 it reached its lowest level since the 1970s.

Figure 1
Unemployment in Britain, 1960 – 2000



Note: These data refer to the ILO rate back to 1984. Prior to that, the data are based on OECD standard registered unemployment rate (see Layard et al., 1994, Annex 6, Table A3 for details).

To get some understanding of these fluctuations, let us consider the period since the mid-1980s. In 1986, unemployment had been in excess of 11 percent since 1982. By the Spring of 1990, it had fallen below 7 percent. This dramatic fall was produced in part by expansionary fiscal and monetary policy, in part by an international boom and in part by a large fall in commodity prices in the mid-1980s. So why did the fall in unemployment come to an end? Basically because inflation, as measured by the rise in the price of UK output (GDP deflator), rose from 2.5 percent per annum in 1986 to 7.6 percent in 1990. Indeed during one month in 1990, the headline RPI rate reached double figures. Furthermore, by 1990, the trade balance was in deficit to the tune of 4 percent of GDP.

Anxiety about these trends had set in by 1988 and the short term interest rate rose from around 8 percent in the Spring of 1988 to 15 percent by the Winter of 1989. This tightening of monetary policy had its effect on inflation and unemployment after 1990 and by 1993, unemployment had risen to over 10 percent with GDP price inflation falling to 2.7 percent. Again by 1992, the government was getting anxious about rapidly rising unemployment and once the UK had left the European Exchange Rate Mechanism, monetary policy loosened with short rates falling from over 10 to around 6.5 percent during 1992. Unemployment then started to fall and from 1994, GDP inflation started to rise, peaking in 1996. Since 1996, we have been in the benign state of falling unemployment and stable or gradually falling inflation. However, the balance of payments deficit has been gradually worsening since 1997.

What does this story reveal? Basically it is consistent with a standard open economy natural rate view of the world. Thus, if economic activity gets too high and unemployment gets too low, inflation starts to rise. If unemployment gets too high, inflation starts to fall. So we define equilibrium unemployment as that level which is neither too high nor too low and which is thus consistent with stable inflation. This equilibrium level is sometimes called the 'natural rate' or the NAIRU³. In practice, things are a bit more complicated because a high exchange rate can act to suppress inflationary pressure essentially by enhancing the effective level of foreign competition facing UK firms as well as by making imports cheaper. So, if the exchange rate is high, which usually shows up in the form of a larger trade deficit, this

may prevent inflation rising even if unemployment is below the equilibrium rate. Formally, what this means is that there is a three way trade off between unemployment, changes in inflation and the balance of payments. If unemployment is below the equilibrium rate, either inflation rises and there is no balance of payments deficit or inflation is stable and there is a payments deficit or there is some combination of the two (see Layard et al., 1991, Chapter 8 or Nickell, 1990). So here we define the equilibrium rate as that consistent with stable inflation and a zero balance of payments deficit.

Despite its name, the equilibrium unemployment rate may change quite significantly from one decade to the next. How and why it might have changed we shall discuss below. What is important to understand here is that, broadly speaking, it cannot be changed by monetary policy. This simply influences the way in which actual unemployment fluctuates around the equilibrium rate.

Finally, although it is easy enough to talk about equilibrium unemployment, pinning down the number is less straightforward. Basically, it is influenced by any factor which systematically influences inflationary pressure in the labour market at a given level of unemployment. For example, changes in the power of trade unions, the operation of the benefit system, the match between the skill requirements of job vacancies and the available skills of unemployed job searchers, labour taxes, product market competition, minimum wages can all change the equilibrium rate.

Furthermore, changes such as these do not act on the equilibrium rate instantaneously. Individual behaviour takes time to adjust to changes in the economic environment, so that the impact of changes of the type listed above on the equilibrium rate will tend to emerge gradually over a number of years.

4. Recent Changes in the Equilibrium Unemployment Rate

The easiest way of estimating the equilibrium unemployment rate is to take the actual rate and make a downward (upward) adjustment if inflation is falling (rising) or if the balance of payments is in surplus (deficit). The calibration of the size of the adjustment must be generated by some estimated model. In Table 1 we present some estimates of the equilibrium rate based on this method for various periods since 1969.

We use periods of at least four years in order to smooth out year to year fluctuations. As we can see, for the most recent four year period, equilibrium unemployment is estimated to be 5.7 percent. Although it should be recognised that there are considerable uncertainties surrounding this number. Over the period 1997-2000, the average level of actual unemployment is above this and the balance of payments is in deficit which is consistent with the falling rate of inflation. In fact, in the most recent year (2000), unemployment has fallen below 5.7 percent but this has not been associated with rising inflation because the high level of the exchange rate has helped to suppress inflationary pressure. In 2000, this was associated with a payments deficit of around 2 percent of GDP.

TABLE 1
Estimates of Equilibrium Unemployment

	1969-73	1974-81	1981-86	1986-90	1991-97	1994-98	1997-2000
Unemployment (%)	3.4	5.8	11.3	8.9	8.8	7.9	6.1
Change in inflation (% p.a.)	1.5	1.1	-1.2	0.5	-0.7	-0.04	-0.4
Balance of payments deficit (% of potential GDP)	-0.7	0.9	-1.3	0.8	0.7	-0.1	0.5
Equilibrium unemployment (%)	3.8	7.5	9.5	9.6	8.9	6.9	5.7

Sources: unemployment, inflation, balance of payments, GDP, Economic Trends.

Unemployment refers to the ILO rate, inflation to the GDP deflator. Potential GDP refers to actual GDP corrected for unemployment fluctuations. The equilibrium rate is calculated exactly as described in Layard et al. (1991), pp. 442-5 or Nickell (1990). As well as adjusting for inflation changes and the payments deficit, there is also an adjustment for unemployment dynamics.

Notes: Prior to 1990, the values of inflation changes and the trade balance are lagged one year and two years respectively to account for the time taken for these factors to feed into unemployment. After 1990, we use current values because the reaction of unemployment to economic conditions increased in rapidity.

For our purposes, the key feature of Table 1 is the steady decline in the equilibrium unemployment rate from its peak level of the 1980s, a decline which accelerated in the second half of the 1990s. The obvious question is what has brought this about. And the obvious place to look for an answer is at the workings of the labour market. Before going into detail, it is worth recalling that we should not expect shifts in the operation of the labour market to impact instantaneously on the equilibrium rate. As is well-known, it takes a considerable time for individual and organisational behaviour to respond fully to changes in the economic environment. That said, we shall now investigate successively changes in industrial relations, the benefit system, labour taxes, the introduction of a National Minimum Wage and the extent of competition in the product market.

Changes in the system wage determination

In most European countries, the majority of employees have their wages determined by Trade Union collective bargaining. In those countries where this bargaining operates in an uncoordinated and adversarial fashion, this tends to generate upward pressure on inflation at given levels of labour market slack leading to higher levels of equilibrium unemployment⁴. In the 1970s and early 1980s, Britain was one such country. For a variety of reasons, which include the Trade Union Legislation introduced in the 1980s, the structure of wage determination in Britain has changed dramatically over the last 20 years. This is reflected in the numbers presented in Tables 2 and 3.

These data reveal that the proportion of workers covered by Trade Union collective agreements has halved from its peak of 70 percent in 1980 and this decline has almost been matched by the fall in union membership. Looking at the private sector alone, which is the driving force behind wage inflation⁵, we see that by 1999 membership is down below 20 percent.

TABLE 2

The Spread of Trade Unionism in Britain 1970-99 (%)

	1970	1975	1980	1985	1990	1994	1996	1998	1999
Coverage	68	-	70	64	54	40	36.5	34.5	35.8*
Density	44	48	50	45	38	34	31.2	29.6	29.5

Note: Coverage refers to the proportion of civilian employees whose pay was covered by a trade union collective agreement. Density refers to the proportion of civilian employees who are members of a trade union.

Source: Coverage, 1970-94, estimates by W. Brown based on Milner (1995), Millward et al. (1992) and OECD (1997). 1996-99 based on Hicks (2000). Density, 1970-85 based on Visser (1996). 1990-1999, Labour Force Survey, see Hicks (2000), Table 2. Note, the coverage data in 1999 (marked with an asterisk) are based on a different question in the Labour Force Survey than that asked previously.

TABLE 3

Unions in Britain in 1999

	All	<u>Private Sector</u>		<u>Public Sector</u>	
		<25 emp.	≥ 25 emp.	<25 emp.	≥ 25 emp.
Coverage	36	10	31	62	75
Density	30	9	26	51	62
		(average = 19)			

Source: Hicks (2000) Tables 5 and 7, based on the Labour Force Survey.

with only a small minority of private sector workers being covered by collective agreements. During this process, wage bargaining, even in the unionised part of the private sector, has become far less adversarial. Indeed the number of strikes is currently minimal relative to the level of disputes two decades ago.

How has this change, which is almost unique in its scale among OECD countries, come about? Two factors are important. First, the Trade Union legislation of the 1980s moved the balance of power in disputes away from employees and made it harder for unions to organise. This made it less easy and attractive to join a union. Second, the heavily unionised sectors of the economy have been in relative decline over the whole period (except for the public sector). This process is exemplified by the numbers presented in Table 4. These show clearly how, in the private sector, newer establishments set up after 1980 are far less likely to be unionised than those set up before 1980.

TABLE 4

Union Recognition in Establishments
Percent Unionised

	All	<u>Private Sector</u>		Public Sector
		Manu.	Serv	
1980	64	66	40	94
1998				
Set up before 1980	54	50	28	88
Set up after 1980	29	14	18	85

Source: Machin (2000) Table 3. Based on Workplace Employee Relations Surveys.

So as old establishments are replaced by new establishments, unionisation inescapably diminishes. This is almost the whole story. Derecognition in continuing

plants is very rare (see Machin 2000, Table 2). So whatever these changes have meant for the working conditions of the average employee, there seems no question that they have contributed to the decline in inflationary pressure at given levels of labour market slack and hence to the fall in equilibrium unemployment⁶.

Changes in the benefit system

There are four aspects of the benefit system which influence equilibrium unemployment. These are, in turn, the level of benefit, the duration of entitlement, the coverage of the system and the strictness with which the system is operated. In Tables 5, 6, 7 we present a partial picture of how the system has changed over the years. In Table 5, we see that the actual level of benefit relative to earnings has declined quite rapidly since the late 1970s, basically because of the abolition of earnings related supplement and the switch of indexation from an earnings basis to a price basis introduced by the first Thatcher administration.

TABLE 5
Benefit Replacement Ratio (%)

	1961-65	1966-70	1971-75	1976-80	1981-85	1986-90	1991-95	1997
OECD Measure	25	27	24	24	22	18	18	18
B. of E. Measure	53	60	57	56	52	44	43	42

Note: The OECD measure is an average of unemployment benefit entitlement relative to average gross wages for three different family types (single, with dependent spouse, with non-working spouse) over the first five years of an unemployment spell. The Bank of England measures refers to the ratio of the total income while unemployed relative to the total, post-tax income while employed. It includes taxes and subsidies although it excludes housing benefit.

TABLE 6
Some Important Changes in Unemployment Insurance and Unemployment Assistance, 1983-98

Unemployment Insurance	
Indexation	Up-rating reverted to historical rather than forecast inflation 1983. Suspension of Statutory Indexation, 1986.
Child Dependent Allowances	Abolished 1984.
Occupational Pensions	UI reduction if in receipt of pension extended to over 55's.
Disqualification Period	Extended from 6 to 13 weeks, 1986 and 26 weeks 1988. Voluntary redundancies excluded from this category, 1985.
Contribution Conditions	Entitlement to depend on paid (not credited) N.I. contributions in past two (not one) years before claim, 1988.
Unemployment Assistance	
Equal Treatment	Couple free to choose who should be claimant, 1983.
Income Support	Replaced Supplementary Benefit with series of allowances based on age and marital status. Capital limit raised from £3000 to £6000. Rates assistance limited to 80%. Additional housing cost assistance abolished. Help denied to people whose partner working more than 24 hours a week, 1988.
Disqualification	40% reduction if disqualified from U.I., 1986.
16-17 year olds	General entitlement removed, 1988.
Mortgage interest	Under 60s to receive only 50% of interest during first 16 weeks on benefit, 1987.
Restart	Compulsory counselling and referral for unemployed workers with duration excess of six months, 1986. Interviewed every 6 months from 1988.
	Actively Seeking Work Rule introduced 1989. Show good cause for refusing jobs. New claimants required to complete Back to Work Plan and attend a review after 13 weeks.
Job Seekers Allowance	Unemployment Insurance reduced from 12 to 6 months, 1996.
New Deal	New Deal for young people, 1998

Source: Schmitt and Wadsworth (1999), Atkinson and Micklewright (1988).

Underlying these broad brush changes have been numerous detailed shifts set out in Table 6 which have reduced the coverage of the system and increased its operational strictness. The former effect is made clear in Table 7. All these changes have made unemployment a less attractive state than work, which will have had a gradual impact on equilibrium unemployment.

TABLE 7

Proportion of Male Unemployed Receiving Benefit by Characteristics

	1983	1990	1993	1997
All	.907	.694	.797	.691
Duration <12 mths	.882	.651	.809	.654
Duration >=12 mths.	.931	.787	.785	.730
married, working spouse	.857	.563	.706	.604
married, non-working spouse	.942	.774	.828	.740

Source: Schmitt and Wadsworth (1999), Table 2

A small digression is in order here to point out that simply because a change in the benefit system reduces equilibrium unemployment, it does not necessarily imply that it is a good thing. It is arguable, for example, that the current system is simply too mean. In fact, to have a system which operates well, it is not necessary to plunge households into poverty should the sole breadwinner lose his or her job.

The system as operated in Denmark, for example, was substantially reformed in the early to mid 1990s, not by reducing the generous level of benefit (replacement rates close to 70 percent of gross earnings) but by providing a system of job search assistance allied to a set of sanctions to be applied if individuals do not fulfil their responsibilities to look for and accept work. These reforms have underpinned the excellent performance of the Danish labour market in recent years (current unemployment around 5 percent).

In any event, desirable or otherwise, the overall thrust of changes in the benefit system in the UK have undoubtedly contributed to the fall in equilibrium unemployment reported in Table 1. Indeed, all the evidence suggests that this and the changes in trade unionism are the most significant factors.

The role of employment taxes

The taxes that are important in the labour market are those which form part of the wedge between the real cost of labour per employee facing firms and the real post-tax consumption wage facing workers. This is important because if any tax which is part of this wedge rises, then either workers get poorer or labour costs go up and employment falls. So, to the extent that workers resist falls in their living standards, employment will fall. The taxes which contribute to this wedge are payroll taxes, income taxes and consumption taxes. There is considerable debate on the extent to which changes in these taxes are absorbed by wage changes or end up impacting on employment (see Nickell and Layard, 1999, for a summary and evidence). The overall conclusion is that a small part of the tax change may impact on employment and this might have helped reduce equilibrium unemployment since the early 1980s because the tax wedge has fallen slightly since that time. The contribution reported in Nickell and Van Ours (2000) is just over ½ percentage point.

The National Minimum Wage (NMW)

While the introduction of the NMW in April 1999 was obviously irrelevant for the reduction in equilibrium unemployment since the 1980s, looking forward it could play a role. The evidence from other countries is that for minimum wages set at relatively

low levels (such as the UK level), the employment effects are minimal except perhaps for young people in those countries which do not have a special low rate for the under 21s. (See Dolado et al. 1996 for a good summary). The evidence we have so far in the UK confirms this (see Machin et al. 2001, for a particularly reliable analysis). So while the existing NMW strategy continues, we should not expect significant effects on equilibrium unemployment from this direction.

Product Market Competition

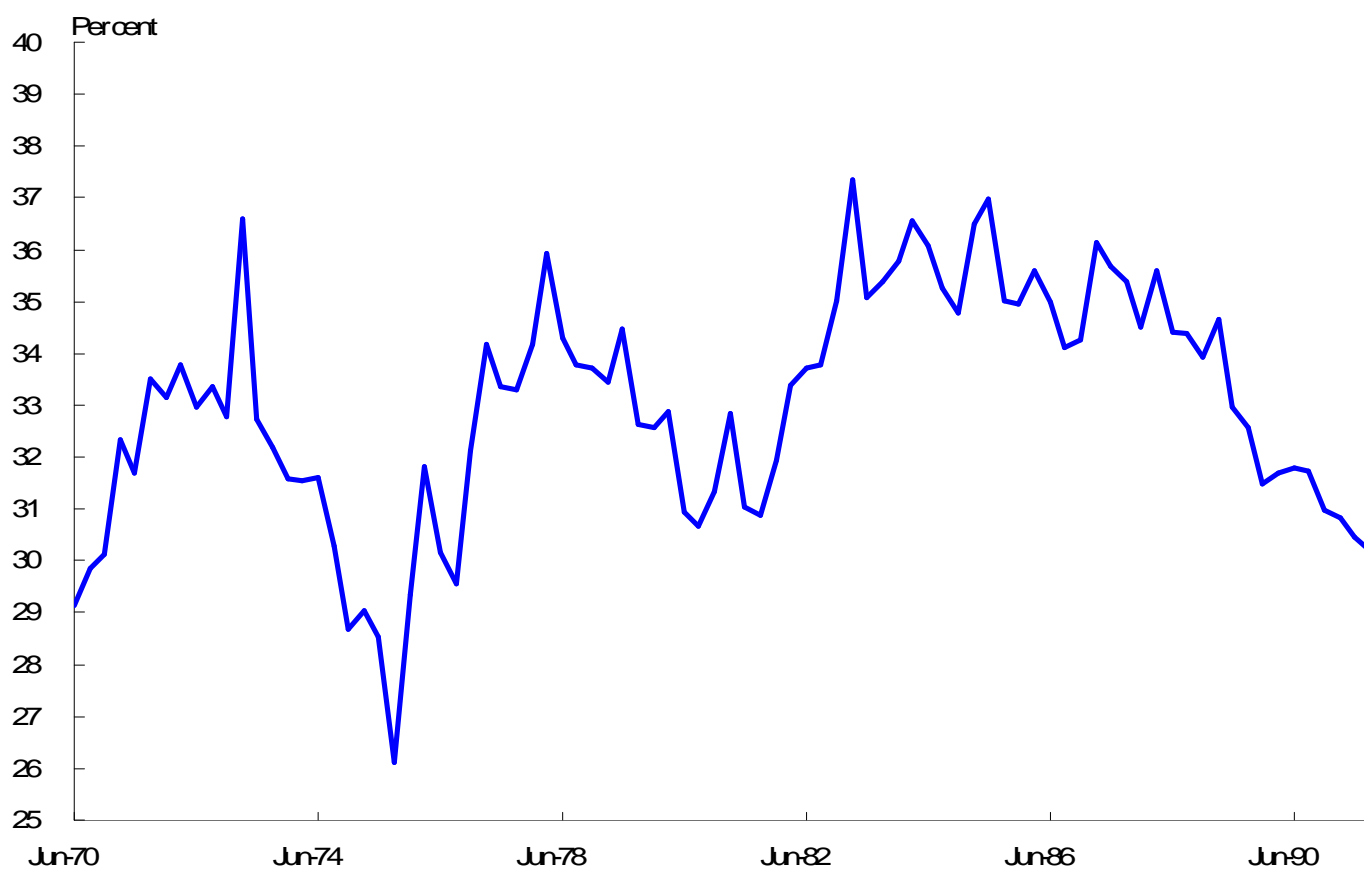
In a world where wages are determined by bargaining, increases in produce market competition will tend to reduce equilibrium unemployment and raise the share of labour in total output. Many have argued that there has been a significant rise on competition in the UK over the last 20 years and most businessmen would agree. Forces pushing in this direction include privatisation, deregulation and declining trade barriers both within Europe and in the World at large. On the other hand, these same forces have also generated a great deal of “restructuring” in many of the affected sectors which has, in many cases, had the effect of sustaining and even concentrating market power. Until the strengthening of the UK anti-trust system on 1st March 2000, when the 1998 Competition Act came into force, competition law was quite feeble, particularly relative to that ruling in the US. This perhaps explains why the share of profit in the business sector of the economy has not exhibited any significant trends in the UK over the last 30 years⁷ (see Figure 2) and why many internationally traded branded goods are so expensive in the UK despite the “high” exchange rate which makes imports cheaper.

It is worth noting that following the sharp rise in the exchange rate in 1996-98, UK firms operating in international markets have been under particular competitive pressure which has impacted on margins in recent years and helped suppress UK inflation. My previous remarks concern the longer term trends in market power and competition, not to short or medium-term fluctuations due to exchange rate shifts.

Inflationary expectations

Before moving on to discuss inactivity, it is worth remarking on a particularly important feature of the operation of the labour market which has been most helpful in recent years, namely the low level and stability of inflation expectations. In Figure 3, we present the RPI inflation expectations of trade unions since these will be particularly relevant to wage bargaining. As can be seen, since the introduction of inflation targeting after Britain's exit from the ERM in 1992, Trade Union inflation expectations have gradually subsided and are currently relatively stable. This stability is, in a sense, a public good because it enables the economy to operate in a more stable fashion. Thus if the economy is hit by a shock, its impact will be much greater if the shock influences inflation expectations. For example, in the period from the beginning of 1999 to the middle of 2000, the oil price rose from around \$10 to around \$30 a barrel. Had this been incorporated into inflationary expectations, the nominal and then the real macro economic consequences of the shock would have been far more significant. As it is, the macroeconomic consequences appear to have been minimal. This expectational stability is arguably a consequence of the structure of monetary policy determination and it has played a significant role in helping to suppress wage inflation despite the historically low levels of unemployment we are currently enjoying.

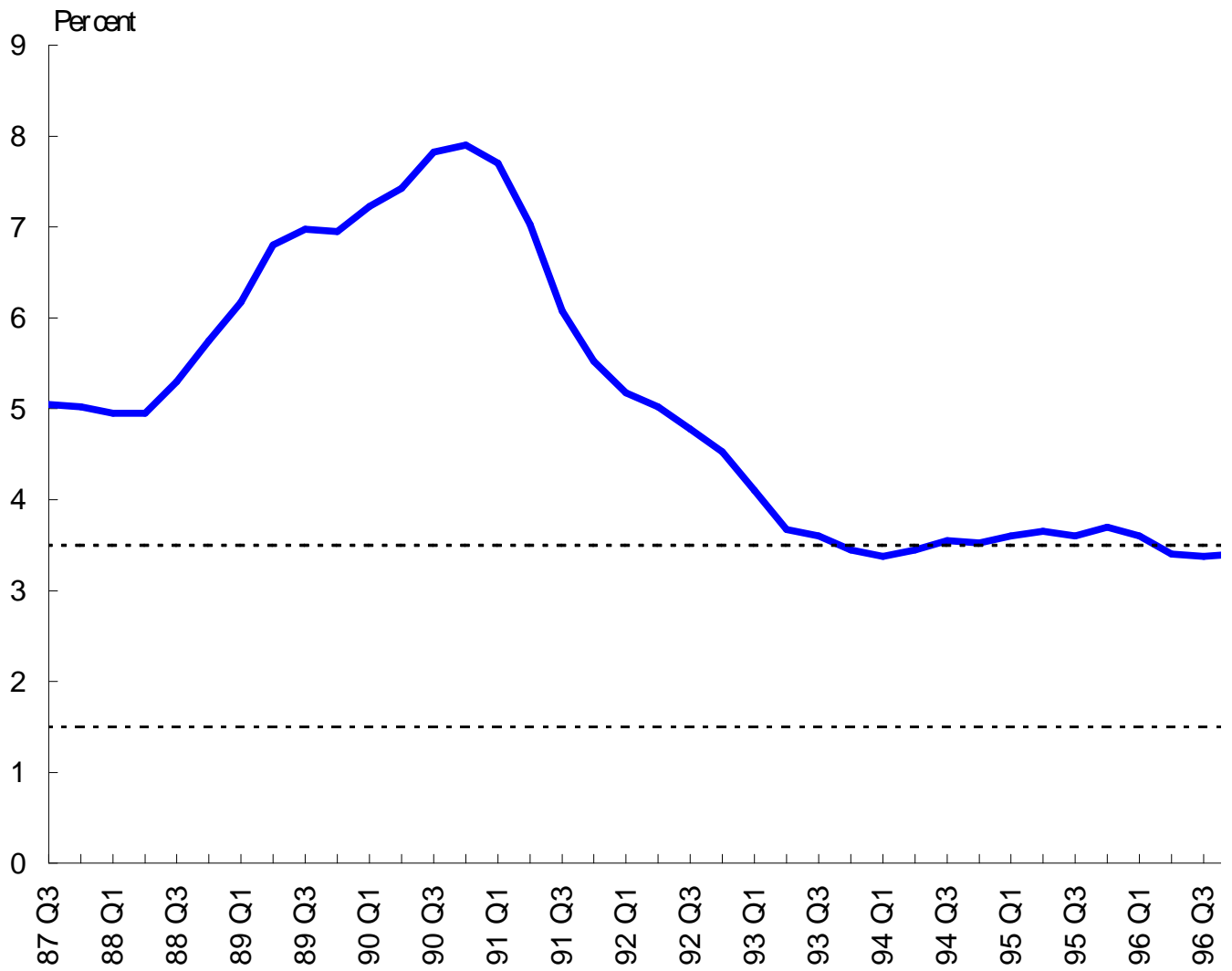
Figure 2
Adjusted profit share



Note: this is the profit share in the private sector.

Figure 3

Trade Union 12 month RPI expectations (4 qtr ma)



Source: Barclays Basix survey

5. Recent Changes in Inactivity Rates

The other key part of the impact of labour supply on potential output growth is the rate of change of the inactivity rate. Inactivity is, in some respects, more important than unemployment because there are vastly more people in this category. So the number of potential workers among the inactive is substantial and this could, therefore, have a potentially significant impact on potential output growth. In practice, however, the inactivity rate among non-students has remained remarkably stable over the last twenty-five years (see Table 8). It is important to recognise that the inactive are not as cut off from the labour market as the name suggests. Overall, some 4 percent of non-student inactive individuals actually get jobs every quarter⁸. This compares with around 23 percent of the unemployed (and 14.8 percent of inactive students). So the inactive are a source of potential labour supply but they are very different from the explicitly job-seeking unemployed.

TABLE 8

UK Inactivity Rate (%)

	All	Men	Women
1975	18.8	2.6	36.5
1979	19.0	4.7	34.6
1983	20.8	8.2	34.4
1987	19.2	9.6	29.8
1990	17.5	8.9	26.9
1993	19.2	11.3	27.9
1998	19.7	13.2	26.9

The inactivity rate refers here to the total number of individuals of working age who are not students and who are neither working nor unemployed, as a proportion of the non-student population of working age.

Source: Labour Force Survey, Spring Quarter, Gregg and Wadsworth (1999).

Underlying the stability of the inactivity rate among non-students is a dramatic contrast between men and women. Since 1975, the percentage of non-student men of working age who are inactive has risen by more than 5 times, around a 10 percentage point increase. By contrast, this is almost offset by a nearly 10 percentage point decline in the inactivity rate of women. These are dramatic changes indeed and reflect quite a number of such effects which underlie the calm macroeconomics of the UK labour market. These we pursue in the next Section.

6. Imbalances in the UK Labour Market

The most important changes in this context are the improving position of women relative to men and of the skilled relative to the unskilled. So let us start with the situation of women relative to men.

Imbalances between the sexes

The main point here is that women are catching up. In Table 9, we present information on employment rates and relative pay rates. The basic picture is of the employment rates of men and women coming together and the relative (hourly) pay of full-time women rising substantially. This has not happened for part-time women. The pay gap is closing in part because qualification rates have been rising faster from women than men and partly because women are improving their rewards relative to men for the same qualifications. For example, by the mid 1990s, the proportion of younger (25-34) full-time women with degrees was higher than for men, whereas the number of part-time women with degrees was only one-third as great. These changes have been driven partly by the impact of the anti-discrimination legislation of the early 1970s and partly as more and more employers recognised that it was silly to throw away profits by making it hard for women to enter and progress in their firms.

TABLE 9

Employment and Relative Pay Rates by Gender

	<u>Employment Rates (%)</u>		<u>Relative Pay (%)</u>	
	Men	Women	FT Women/Men	PT Women/Men
1975	92.3	59.4	63	66
1981	84.7	59.6	68	59
1984	80.6	60.1	68	59
1987	80.4	63.3	70	65
1990	84.4	68.1	71	58
1993	77.5	66.6	78	61
1998	81.0	69.3		

Source: Desai, Gregg, Steer and Wadsworth (1999), taken from the Labour Force Survey and the General Household Survey.

Given that women are improving their position relative to men, let us return to the changes in inactivity noted in Table 8 and see if we can shed some more light on the startling differences between men and women portrayed there. We can start by looking at the reasons for inactivity set out in Table 10. For men, the majority of inactivity is caused by sickness and disability, particularly among the prime age group. In this group, the majority of inactive women report themselves as looking after home and family. For older workers, sickness, disability and early retirement are very important for both men and women. This suggests that we should investigate further the role of sickness and disability, but before doing so, we should look at another major imbalance, that between low and high skill workers.

TABLE 10
Reasons for Inactivity in 1998 (%)

Age	Sickness/Disability		Home and Family		Early Retired		Discouraged		Other	
	M	W	M	W	M	W	M	W	M	W
25-49	71.6	20.6	15.3	70.6	0.5	0.2	1.2	0.5	11.6	8.2
50-64	59.7	41.7	4.5	31.2	25.2	12.7	2.6	0.9	8.1	13.5

Source: Gregg and Wadsworth (1999), Table 3.4 from Labour Force Survey, Spring Quarter. M= men, W= women.

Imbalances by skill

It is well known that over the last two decades, individuals with higher qualifications have improved their situation dramatically relative to those with low or no qualifications. This is partly because of the bias of technical change in favour of the skilled and partly because changes in the pattern of international trade has favoured skilled workers in the developed countries (see, for example, Berman et al. 1998 and Wood, 1994). Thus in Britain, the wage differentials between those with high qualifications and those with no qualifications rose substantially between the 1970s and the 1990s despite the significant increase in the numbers of the former relative to the latter (see, for example, Machin, 1999, Tables 11.4, 11.5). This suggests that, for the skilled versus the unskilled, there has been a significant increase in the relative demand relative to the relative supply. This may be expected to have an impact on both unemployment and inactivity rates which favours the skilled. This is indeed precisely what has happened as Tables 11 and 12 indicate.

In Table 11, we see how the unemployment rates for men have worsened dramatically for men with no qualifications (around one quarter of the population of working age). Interestingly, this has not happened for women, yet another example of the relative improvement of their labour market situation.

TABLE 11
Unemployment Rates by Qualifications (%)

	Degree	Higher Intermediate	Lower Intermediate	None
Men				
1979	1.5	2.4	3.3	7.0
1985	3.4	8.2	12.4	19.1
1990	2.2	5.5	7.3	13.6
1993	3.0	4.5	8.3	15.6
Women				
1979	3.4	4.2	5.3	7.2
1985	5.7	8.2	10.6	13.0
1990	4.2	5.7	6.6	9.2
1993	4.6	6.1	8.4	11.3
1998	2.9	3.8	5.9	8.4

Source: Nickell (1999), Table 1.3 from Labour Force Survey, Spring Quarter.

TABLE 12
Male Inactivity Rates by Qualifications (%)

	Degree	'A' level and equivalent	'O' level and equivalent	CSE and equivalent	None
1979	0.8	1.6	1.5	1.6	4.9
1981	1.2	1.1	1.9	2.2	6.0
1984	3.8	3.8	5.8	5.1	14.5
1987	5.2	5.5	6.2	7.4	17.0
1990	4.7	6.0	6.0	7.6	17.3
1993	7.1	9.2	9.5	10.5	22.1
1998	7.4	9.4	10.7	13.2	30.4

Source: Gregg and Wadsworth (1999), Table 3.3 from Labour Force Survey, Spring Quarter, These refer to the non-student population of working age.

In Table 12, we see that inactivity rates for men without qualifications have risen enormously so that by 1998, almost one-third are inactive. To obtain some idea of what is going on here, we look at the sub-group of the inactive men who are sick or disabled. In Table 13, we show the percentage of the population of working age who

are inactive because of sickness or disability. We divide both by age and educational qualification and we see some remarkable numbers. For those without qualifications, aged 25-54, the proportion of the male population who are inactive because of sickness or disability has increased from 3.1 percent in 1979 to 18 percent in 1998. Even more startling is the fact that this number has doubled since 1993 during a period when unemployment was falling and the overall economy was buoyant. This is one of the key factors underlying the rise in male inactivity over the last twenty years.

TABLE 13
Male Sickness Inactivity Rates by Sex, Age and Level of Qualification

	1979	1983	1985	1990	1991	1992	1993	1994	1995	1996	1997	1998	2000
Age 25-54													
Degree	0.2	0.3	0.4	0.5	0.4	0.8	1.1	1.0	0.9	1.0	1.3	1.1	1.0
Higher Intermediate	0.4	0.9	1.3	1.8	1.8	2.3	3.4	3.5	3.5	3.1	3.8	4.3	3.4
Lower Intermediate	0.8	1.2	1.1	1.6	1.4	2.4	2.7	3.3	3.7	4.9	5.4	5.2	5.2
None	3.1	4.4	4.9	6.9	7.4	7.4	8.7	10.1	14.0	14.8	17.0	18.0	17.2
Age 55-64													
Degree	1.8	2.1	3.3	3.8	4.0	-	8.5	7.1	6.8	6.1	6.7	6.7	4.8
Higher Intermediate	4.5	4.7	10.6	12.5	14.0	-	16.5	20.1	21.5	13.5	14.3	19.3	15.0
Lower Intermediate	4.2	9.1	7.3	11.0	10.2	-	15.1	15.7	15.9	20.1	19.4	17.6	20.8
None	8.6	14.7	17.3	22.1	21.0	-	24.9	27.9	31.2	31.9	33.6	34.6	33.8

Source: UK Labour Force Survey, Spring Quarter.

A further aspect of these dramatic changes is the difference across regions. As we can see from Table 14, inactivity rates are much higher in high unemployment regions than they are in low unemployment ones, indicating that this is a demand as well as a supply side phenomenon.

The implications of these imbalances

We started out this part of the paper by noting that overall inactivity rates had barely changed over 25 years. So, as far as aggregate potential output has been concerned, changes in inactivity have not been an issue. But underlying this picture of calm, there have been the most dramatic shifts.

TABLE 14
Male Unemployment and Inactivity across Regions

Area Male Unemployment Rate	<u>Inactivity Rate</u>		<u>Inactivity Rate (low skill, 25+)</u>	
	1990	1998	1990	1998
<5%	8.3	11.9	13.2	27.3
5-7%	11.1	13.9	18.3	32.6
7-9%	12.9	15.1	23.1	33.6
>9%	14.9	18.7	26.3	43.4

Source: Gregg and Wadsworth (1999), Table 3.5 from Labour Force Survey, Spring Quarter.

Women have been catching up with men and the demand for unskilled men has all but collapsed. In areas of high unemployment, less than half the men with no qualifications are working and a large proportion of these would be classified as sick or disabled. One of the lessons of all this is that the inadequate education and training received in the past by a significant part of the population has not only been disastrous for them personally but has meant that the UK economy has been made significantly poorer by not making use of their potential. The benefits to the economy overall as more women have chosen to work have been more or less cancelled out, at least in numerical terms, by the steady withdrawal of men from the labour force.

Summary and Conclusions

A key part of the process of making monetary policy is to understand the forces underlying the growth of potential output. This divides naturally into productivity growth and the potential growth of employment. Given that population growth is mainly a function of demographics, the potential growth of employment depends crucially on trends in unemployment and inactivity. The former are those non-workers looking for a job whereas the latter are the non-workers not looking for a job. Interestingly enough quite a number of this last group nevertheless end up in employment, although a lot fewer than from the unemployed.

In this paper we have analysed the forces underlying trends in unemployment and inactivity. Our main results are as follows:

- i) The main factors underlying the fall in equilibrium unemployment over the last twenty years have been the decline in Trade Unions, particularly in the private sector, and the fall in generosity and increase in strictness of the benefit system. The small fall in employment taxes, changes in product market competition and the introduction of the National Minimum Wage have had a minor impact.
- ii) The inactivity rate among the non-student population has barely changed since 1975. This stability, however, masks enormous changes, since the inactivity rate among men of working age has risen by around 10 percentage points over this period (a multiple of 5 times!) and this entirely offsets the large falls in inactivity among women.
- iii) Underlying the rise in inactivity among men have been dramatic increases among the unskilled so that by 1998, around 30 percent of non-student men of working age without qualifications were inactive. Even more dramatic is the fact that most of these are inactive because of sickness or disability, even those who are not elderly. For example, in 1979, around 3 percent of men aged 25-54 without qualifications were inactive because of sickness or disability. By

1998, this number had risen to 18 percent. The corresponding number for those with degrees is 1 percent.

- iv) The incidence of inactivity is much higher in high unemployment regions than in low unemployment regions. Thus, in the high unemployment regions of the North-East and North-West, more than half the men aged 25-64 without qualifications are not in employment. This indicates that this is not just a supply-side phenomenon.

Endnotes

1. More formally, if Y^* is potential output, POP is the population of working age, Π is the level of trend labour productivity (trend output per employee), ia is the inactivity rate, u^* is the equilibrium unemployment rate (NAIRU), then

$$Y^* = \Pi \times POP \times (1 - ia) \times (1 - u^*)$$

Taking log derivatives yields

$$\dot{y}^* = \dot{\Pi} + \dot{pop} - \dot{ia} - \dot{u}^*$$

where $y^* = \ln Y^*$, $pop = \ln POP$, $\Pi = \ln \Pi$

2. To be more precise, they must have searched actively for work within the last four weeks and must be able to start work within the next two or they must be waiting to take up a job already obtained.
3. I prefer the equilibrium rate. The natural rate is misnomer, since there is nothing natural about it and it can be systematically changed by some types of policy. NAIRU is a misnomer because it should be the constant inflation rate of unemployment, that is non-changing not non-accelerating.
4. For detailed evidence on this issue see, for example, Nickell, 1997. Many heavily unionised countries in Europe, such as the Netherlands, Denmark and Norway have systems of collective bargaining which enable the parties to the

bargain to take account of the macroeconomic consequences of the agreements they strike. This has helped them to achieve low levels of unemployment. Such co-ordination was attempted in Britain in the late 1970s with only limited success because the institutional framework was simply not up to the task.

5. Evidence suggests that most public sector wages follow the lead of the private sector, often with a considerable lag.
6. The rough and ready numbers reported in Nickell and Van Ours (2000) suggest that this factor has made the most important contribution to the decline in equilibrium unemployment.
7. This is also the case in the US. Interestingly enough, the share of profits has risen substantially in Continental Europe over the last 15 years, perhaps indicating a weakening of competition.
8. See Schweitzer (2001), Table 1. Figures refer to 1993-9.

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Summary

Has UK Labour Market Performance Changed

by Stephen Nickell

1. Why has wage inflation not taken off despite the fact that unemployment is at its lowest level for a generation?

The answer is that the level of unemployment consistent with stable inflation (the NAIRU) has fallen substantially since the 1980s.

2. Nickell's estimate of the level of unemployment consistent with stable inflation for the period 1997-2000 is 5.7 percent (on the ILO basis). The reason why inflation is not rising even though unemployment is currently below this level is the fact that the high level of the exchange rate is generating further downward pressure on inflation at the expense of a substantial trade deficit.
3. The main factors underlying the fall in the NAIRU over the last twenty years have been the decline in the role of Trade Unions and their more co-operative nature, particularly in the private sector, and the fall in generosity and increase in strictness of the benefit system. The small fall in unemployment taxes, changes in product market competition and the introduction of the National Minimum Wage have not played a serious role.
4. While the unemployed are a significant part of potential labour supply, a more important group in this regard are the inactive (those who are neither employed nor seeking work). The proportion of the non-Student population of working age who are inactive has barely changed over the last 25 years (around 19 percent).

5. Underlying this stability are some remarkable changes. The proportion of inactive men has risen by around 10 percentage points and this has been offset almost exactly by the 10 percentage point fall in inactive women.
6. The rise in inactivity among working age men is concentrated on the unskilled and those living in high unemployment regions. For example, 30 percent of working age men with no qualifications were inactive in 1998 compared with less than 5 percent in 1979. The majority of these are inactive because of long-term sickness or disability.
7. One of the lessons from these changes in inactivity is that the inadequate education and training received in the past by a significant part of the population has not only been disastrous for them personally but has meant that the UK economy has been significantly poorer by not making use of their potential. The benefits to the economy overall as more women have chosen to work have been more or less cancelled out, at least in numerical terms, by the steady withdrawal of men from the labour force.