



BANK OF ENGLAND

# Speech

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## **The Recent Performance of the UK Labour Market**

Speech given by

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## 1. Introduction

‘Employment opportunity for all is the modern definition of full employment’. So says the Chancellor of the Exchequer in Spending Review 2000, the Treasury’s public spending plans for the first four years of the 21<sup>st</sup> century. There is no question that one of the major challenges facing any industrialised country is to ensure that its labour market operates so as to enable people who want to work to do so at a reasonable rate of pay. So this will be our focus in what follows.

In fact we consider two major issues. The first refers to the performance of the labour market from the macroeconomic point of view, and this we cover in Section 2. Here we look at unemployment and inflation, explaining why recent history from this perspective looks relatively benign and asking about the future consequences of some of the significant policy changes since 1997. The second major issue, dealt with in Section 3, concerns the imbalances in the labour market across different skill groups, focusing particularly on the problem of worklessness facing the unskilled. Again, we attempt to analyse why this problem has arisen and the main thrust of recent policy in attempting to resolve it. We then conclude with a summary of what we have learned.

## 2. The Macroeconomics of the Labour Market

From the macroeconomic point of view, the UK labour market has looked remarkably healthy in recent years. Just to put the situation into a historical context, in Figure 1 we present the history of unemployment, inflation, inflation expectations and real wage growth. Since 1997, the following key factors stand out. Unemployment has continued to fall until the time of writing, reaching its lowest level for a generation. Inflation has remained remarkably low and inflation expectations among key wage bargainers have remained stable over the same period. Finally, real wage growth has been relatively healthy, so macroeconomic stability has not been purchased at the expense of cuts in average living standards. It is perhaps worth remarking that these trends since 1997 are essentially a continuation of what has been happening since 1993. However, the fact that unemployment on the ILO measure has fallen to 5 percent without any noticeable take-off in inflation is a fact of some significance.

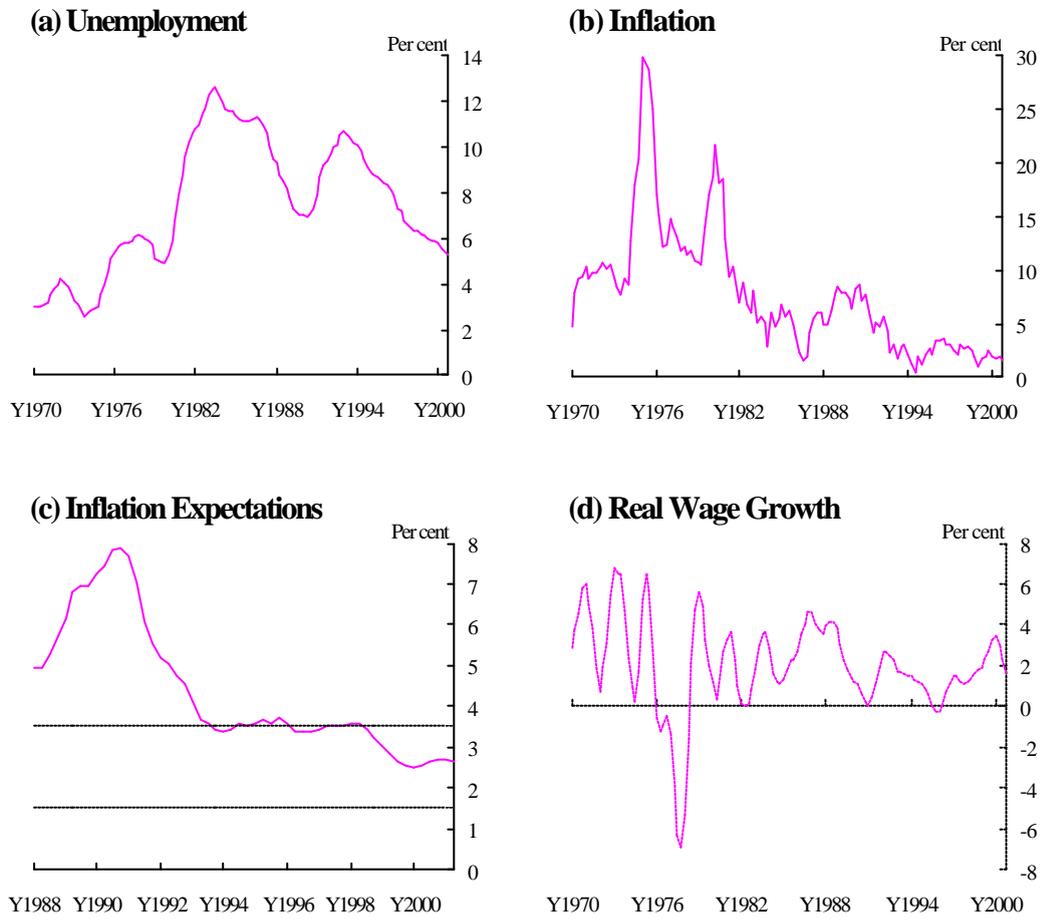
Part of this happy state of affairs is down to the monetary and fiscal policies which have been pursued and these we leave to others to discuss. The particular question we shall consider here is why unemployment has been able to fall to such a low level by the standards of recent history without any significant inflationary pressure. This suggests that the equilibrium unemployment rate, that is the level of unemployment consistent with the stable inflation<sup>1</sup>, has fallen since the 1980s. So we begin by looking at the recent history of the equilibrium rate.

### Recent Changes in UK Unemployment

Before going into detail about recent shifts in equilibrium unemployment, it helps to set the scene if we have some idea of the recent history of British unemployment. In Figure 1a, we showed the path of unemployment since 1970, 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). We can see that unemployment was moving gradually upwards in the 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**

**The Recent Macroeconomic Changes in the UK Labour Market**



Notes:

- (a) Unemployment rate is the ILO measure.
- (b) Inflation refers to the GDP deflator
- (c) Inflation expectations refers to those of Trade Union negotiators twelve months ahead.
- (d) Real wage growth refers to the Average Earnings Index relative to the RPI.

To gain 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. Then we define equilibrium unemployment as that level which is neither too high nor too low and which is thus consistent with stable inflation. 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 affects 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.

### Recent Movements in Equilibrium Unemployment

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.

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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.

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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 and labour taxes.

#### 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 unemployment<sup>2</sup>. 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 inflation<sup>3</sup>, we see that by 1999 membership is down below 20 percent with only a small minority of private sector workers being covered by collective agreements.

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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.

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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.

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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.

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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.

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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 unemployment<sup>4</sup>.

#### 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.

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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**

<b>Unemployment Insurance</b>	
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.
<b>Unemployment Assistance</b>	
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.
<b>Restart</b>	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.
<b>Job Seekers Allowance</b>	Unemployment Insurance reduced from 12 to 6 months, 1996.

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.

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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

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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 benefit 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.

### 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 three factors we have just discussed, wage bargaining, benefits and employment taxes are the main causes of the fall in the equilibrium unemployment rate which underpins the recent benign combination of relatively low unemployment and stable inflation. Furthermore all these changes have come about as a result of policy decisions made prior to 1997. So this naturally leads on to the question of what we might expect to happen to equilibrium unemployment in the future as a result of changes initiated by the Labour Government since 1997.

### Future Changes in Equilibrium Unemployment

A number of recent policy initiatives have potential implications for the future path of equilibrium unemployment. On wage determination, we have the National Minimum Wage and the new procedure for trade union recognition. On the tax, benefit front

there are the New Deals and other policies to improve labour supply as well as the 'tax' effects generated by the additional business costs imposed by new legislation. Finally there are the significant changes in competition policy.

### Wage determination policy

The National Minimum Wage (NMW) was introduced in April 1999. 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, unlike Britain, do not have a special low rate for the under 21s. (See Dolado et al. 1996 for a good summary). Despite this Minford and Haldenby (1999) suggest that the NMW will raise equilibrium unemployment by around 0.6 percentage point. However, the evidence we have so far in the UK confirms the international evidence (see Machin et al, 2001) and we should expect no significant impact on equilibrium unemployment from this direction.

Minford and Haldenby (1999) also predict a substantial rise in equilibrium unemployment (around 1.2 percentage points) as a result of increased union membership following the new procedure for Trade Union recognition introduced in the 1999 Employment Relation Act, which came into force in June 2000. However, given the structure of the recognition procedure, it seems likely that increased union membership from this source will be hardly enough to offset losses from closures, derecognitions and retirements (see Metcalf, 2001). So, despite the dire predictions of Minford and Haldenby, it is unlikely that this is going to have any important impact on equilibrium unemployment.

### Business Costs and New Deals

Since 1997, UK business has seen a number of new directives, for example, the working time directive, parental leave and part-timers rights. These, de facto, impose additional labour costs on firms. What typically happens is that, over the long-term, wages adjust to compensate and the employment effects are minimal. That is, the workings of the labour market ensure that the employees end up paying for their new benefits in the form of lower wages, a fact which is worth bearing in mind by those

press for further extensions of “employee rights”.<sup>5</sup> So while there are likely to be some negative employment effects as a result of these new employment rights in the short-run, over the longer term, the impact on equilibrium unemployment will probably be negligible.

The other important change introduced since 1997 in this context has been the New Deal policies, one of the implications of which is the enhancement of labour supply in the target groups. We shall look at the consequences of New Deal policies in more detail in what follows but, at this stage, all we need say is that, on the basis of the evidence so far, these policies have had a small positive impact on employment. So, over the longer term, we expect them to lead to a small reduction in equilibrium unemployment.

### Competition Policy

In a world where wages are determined by bargaining, increases in product 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 in 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 most cases, had the effect of sustaining and even concentrating market power.

This has been reinforced by the fact that, by comparison with the United States, UK competition law has been relatively feeble. However, the UK anti-trust system was significantly strengthened from 1<sup>st</sup> March 2000, when the 1998 Competition Act came into force. This, along with further prospective tightening as a result of future planned changes in competition law, should lead to some reduction in equilibrium unemployment in the longer term.

Overall, therefore, recent policy changes are likely to induce only small changes in equilibrium unemployment over the long run. On balance the sort of policy reforms

which would be most likely to induce significant reductions in equilibrium unemployment are further shifts in the benefit regime in the direction taken in Denmark which we described earlier. This completes our analysis of the macroeconomics of the labour market and we now turn to some of the important compositional changes which underlie the benign aggregate picture.

### 3. Important Imbalances in the Labour Market

As we have already noted, if we look at the traditional macroeconomic variables such as unemployment and inflation, the recent picture looks particularly cheerful. But the unemployed are not the only people not working. The other group of non-workers is the inactive who consist of those who are neither working nor looking for work. This is because they are either in full-time education or they are sick and disabled or they have retired early or they are looking after other family members. Before considering the inactive in more detail, it is important to recognise that they 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 quarter<sup>6</sup>. This compares with around 23 percent of the unemployed and 15 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.

The first important point to note is that while the unemployment rate has declined substantially since the mid 1980s, the (non-student) inactivity rate has barely changed for 25 years as we can see in Table 8. But underlying this extraordinary stability 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. This latter is simply part of the overall story of women improving their labour market position relative to men in terms of both employment and wages. This is a long process of catch-up which has been going on for over 25 years although it is by no means complete. Our focus here, however, is not on gender imbalances but on those by skill which have been worsening systematically over the last 20 years, particularly among men.

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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).

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Imbalances by skill: the relative decline of the unskilled

Since 1980, those with no qualifications, now around a quarter of the population of working age, have seen substantial falls in their pay relative to those who have obtained some educational qualification. For example, in 1980, men with degrees earned around 63 percent more than those without qualifications, ceteris paribus. By the mid 1990s this had risen to 93 percent. This, despite the fact that the percentage of employees with degrees had almost doubled over the same period (see Machin, 1999, Tables 11.4, 11.5). Despite the substantial falls in their relative pay, the employment position of the unskilled has seriously deteriorated as we can see in Tables 9 and 10. The startling feature of these data is that while the unemployment position of those with no qualifications has worsened somewhat, the inactivity rates of this group have risen dramatically, particularly for men. Most extraordinary is the fact that the inactivity rate among men of working age without qualifications was 30

percent in 2000 compared with less than 4 percent some 20 years before. This despite the fact that in 2000, the UK labour market was booming.

Overall, this dramatic shift in favour of skilled workers has come about because there has been a significant increase in the relative demand for skilled workers relative to the rise in their relative supply as educational standards improve. The relative demand increase has come about partly because of the bias of technical change in favour of the skilled and partly because changes in the pattern of international trade have favoured skilled workers in the developed countries (see, for example, Berman et al. 1998 and Wood, 1994). But the fundamental issue is the mechanism by which these shifts in supply and demand have generated such dramatic changes in the level of inactivity. In order to pursue this, we must investigate precisely why people are inactive.

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Table 9  
UK Unemployment Rates

Men	1979	1985	1990	1995	1998	2000
Education						
Higher	1.5	3.4	2.2	4.5	3.0	2.2
Intermediate	2.4	8.2	5.5	7.4	4.5	4.9
Lower	3.3	12.4	7.3	9.8	8.3	8.1
None	7.0	19.1	13.6	18.1	15.6	12.4
Women						
Education						
Higher	3.4	5.7	4.2	3.5	2.9	2.1
Intermediate	4.2	8.2	5.7	4.5	3.8	4.2
Lower	5.3	10.6	6.6	7.0	5.9	5.9
None	7.2	13.0	9.2	8.7	8.4	6.9

Source: UK Labour Force Survey

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Table 10  
UK Inactivity Rates

Men	1979	1985	1990	1995	1998	2000
Education						
Higher	0.9	4.2	4.6	6.9	7.2	6.3
Intermediate	1.2	6.2	6.6	10.5	11.6	9.5
Lower	1.4	5.4	5.5	9.7	10.6	13.3
None	3.8	12.3	17.0	25.3	30.5	30.0
Women						
Education						
Higher	21.5	19.6	14.3	13.4	12.4	10.3
Intermediate	26.7	24.7	19.6	21.1	20.3	17.6
Lower	28.9	25.2	22.9	25.5	24.7	27.5
None	40.3	42.5	38.7	45.0	48.9	45.7

Source: UK Labour Force Survey

Inactivity rates among the unskilled

In Table 11, we set out the reasons for inactivity in 1998. The key factor, perhaps surprisingly, is that the majority of inactive men are in this situation because of sickness and disability so we would expect to see significant increases in inactivity rates due to sickness and disability and this is confirmed<sup>7</sup> in Table 12. Indeed the numbers are remarkable. In 1979, only 3.1 percent of prime age (25-54) men with no qualifications were inactive because of sickness and disability. By 1990, this had risen to 6.9 percent, by 1996 to 14.8 percent and today it is over 17 percent. For older men, the numbers are, of course, significantly higher.

Table 11  
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,

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So how has this come about? There seems no question that some individuals who were hard to place in work were advised by the Employment Service to claim invalidity benefit. (See National Audit Office, 1989, for evidence). This is consistent with the fact that inactivity rates for men are significantly higher in high unemployment regions than in low unemployment regions, particularly for those with low skills (see Table 13). So with regard to unskilled men, the situation by the late 1990s may be summarised as follows. A huge decline in the relative demand for unskilled workers has outstripped the fall in their relative supply. This has led directly to significant falls in their relative pay and very large increases in their unemployment, inactivity, and sickness and disability rates. Furthermore, this has helped to create large differences between localities. Any area which has a high proportion of low skill workers can be expected to have high unemployment, high inactivity, high rates of disability and low average earnings for this reason alone. Of course, these disadvantages will then tend to interact with other local social and economic conditions to make the situation worse<sup>8</sup>. This, then, is the state of affairs. So what have been the recent policy responses?

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Table 12

Male Sickness Inactivity Rates by Age and Level of Qualification

	<b>1979</b>	<b>1985</b>	<b>1990</b>	<b>1994</b>	<b>1996</b>	<b>1998</b>	<b>2000</b>
<b>Age 25-54</b>							
Degree	0.2	0.4	0.5	1.0	1.0	1.1	1.0
Higher Intermediate	0.4	1.3	1.8	3.5	3.1	4.3	3.4
Lower Intermediate	0.8	1.1	1.6	3.3	4.9	5.2	5.2
None	3.1	4.9	6.9	10.1	14.8	18.0	17.2
<b>Age 55-64</b>							
Degree	1.8	3.3	3.8	7.1	6.1	6.7	4.8
Higher Intermediate	4.5	10.6	12.5	20.1	13.5	19.3	15.0
Lower Intermediate	4.2	7.3	11.0	15.7	20.1	17.6	20.8
None	8.6	17.3	22.1	27.9	31.9	34.6	33.8

Source: UK Labour Force Survey, Spring Quarter.

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TABLE 13

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.

## The Policy Response since 1997

The fundamental problem is that there is a large body of individuals of working age who, because of lack of skills, do not command a high enough wage in the labour market to provide a decent standard of living for themselves and their dependents. And this problem is particularly severe in Britain because the pool of very low skill workers is larger than in the typical European country<sup>9</sup>.

The obvious long-run policy is to provide every citizen with enough marketable skill to enable them to earn a decent wage in the labour market. There is, of course, a small group of individuals for whom this is not possible. For the remainder, however, it is possible and it is a matter of developing an education and training system that does it. This is a key part of the strategy of the present government and for an analysis of how it is getting on, see Glennerster (2001). Whatever the success in this area, however, this strategy is not going to resolve the problems posed in the foreseeable future.

In the meantime, the strategy since 1997 has been simultaneously to encourage work and to provide additional resources to low skill workers. The mechanism is two pronged – to provide assistance in getting into work (e.g. the New Deals) and to increase the rewards for working (e.g. the NMW, the Working Families Tax Credit (WFTC)). Overall, these policies have not, so far, had a big impact on labour supply and employment but they have had a significant impact in terms of providing extra resources to the low paid (essentially the unskilled). Furthermore, they have done this without encouraging them to withdraw from work. Let us consider these policies in more detail.

### Labour Supply Policies – the New Deal

The basic idea of the New Deal policies is to provide resources to assist members of a variety of targeted groups into work. These groups include young people (18-24) who have been out of work for 6 months, adults (25-59) who have been out of work for two years, over 50s who have been on any benefit for 6 months, the disabled and lone parents. The first two are compulsory and members of these groups must enter the

relevant programme. The detailed programmes are different for each group but there is typically an initial period where a personal strategy is worked out for each individual which leads on to some form of training, job search assistance, subsidised employment and so on. Most of the programmes have not been operating for very long and there are a variety of pilot schemes and experiments. So, at this stage, it is not possible to obtain a clear view of their consequences. However, the New Deal for young people was the first into operation, starting in January 1998 and here we are in a position to draw some conclusions.

The New Deal for young people is open to those aged 18-24 who have been claiming unemployment benefit continuously for 6 months. At this point participation is mandatory in the sense that benefit payments cease if the young person does not participate. Those joining first enter a Gateway period lasting up to four months, during which the Employment Service will work with them to improve their employability and to find unsubsidised jobs. Those who do not find a job will then move onto one of four options lasting for six months: (i) a period of subsidised employment (£60 p.w. subsidy), (ii) a course of education or training last, on average, 9 months, (iii) a six month Taskforce placement working on environmental projects or in the voluntary sector, (iv) a subsidised self-employment scheme.

Evaluations of this programme have been published by Anderton et al. (1999)(1999a) and Van Reenen (2000). First, of the four options, education/training is the most popular (47.1% up to end April 1999) with only 20.5% in subsidised employment and fewer in the others. Overall, the results indicate that the programme has generated around 20 thousand extra jobs each year and has significantly reduced unemployment rates among young persons. Furthermore, there is no evidence as yet of a significant adverse impact on the labour market prospects of groups outside the programme. Finally, Van Reenen calculates the social benefits to be in excess of the social costs without taking account of the fall in crime consequent on the reduction in the number of unemployed young people on the streets. Overall, the New Deal for young people bodes well for other New Deal Programmes. However, the difficulties involved in getting young people with weak skills into employment are relatively minor compared with the problems facing those with disabilities and their caseworkers and advisers. So far, the various pilot schemes for the New Deal for the Sick and Disabled have

attracted few participants and the many difficulties surrounding the work potential of those on incapacity benefit remain to be addressed.<sup>10</sup>

#### Increasing the rewards for working (i) The National Minimum Wage

The National Minimum Wage was introduced at £3.60 per hour for adults in April 1999 rising to £3.70 in October 2000 and £4.10 in October 2001. Young persons have a lower rate. The numbers affected by the minimum wage were up to 7 or 8 percent of the work-force of whom 70% were women and three-quarters of those were part-time. So the minimum wage is, in fact, too low to have had a significant impact on the pay prospects of low skill men most of whom are in work at pay rates above the statutory minimum. Recall that even after October 2001, 40 hours per week at the minimum rate will yield a mere £164, which is hardly a “decent” wage particularly for someone with dependents. Of course, the reason why the minimum wage is not higher is because of the real threat of serious employment consequences. At the current level, such consequences are minimal as we have seen. But should the minimum wage be moved up to a “decent” wage for a person with dependents, all the evidence suggests that the consequences for employment would be serious and the whole object of the exercise would be defeated. Even larger numbers of unskilled men would simply not be working. This leads naturally on to a policy of in-work benefits which we discuss next.

#### Increasing the rewards for working (ii) the Working Families Tax Credit

The Working Families Tax Credit (WFTC) was fully phased in from April 2000, replacing Family Credit (FC), a benefit paid to low earners with dependent children.<sup>11</sup> The WFTC is substantially more generous than FC, increasing both credits for younger children and the threshold, and reducing the benefit reduction rate. Furthermore, it also includes a new childcare credit. Analyses of the impact of these changes by Blundell and Hoynes (2000) and Gregg et al. (1999) suggest that the introduction of the WFTC will cause around 30,000 currently workless lone parents with children to enter work but it will probably drive some workers in married couples to move out of work. Overall, the positive labour supply effects are not great but it will generate a significant reduction in child poverty without negative labour

supply effects. This is probably the main achievement of the new system of in-work benefits. It is also worth mentioning that a related tax credit system has been introduced for disabled individuals, namely the Disabled Person's Tax Credit (DPTC). This replaced the previous in-work benefit for disabled persons, the Disability Working Allowance, in October 1999. From April 2000, it has been paid through the wage packet and represents a similar increase in generosity as the WFTC.

### The Outlook for Policy in the Future

Two important changes are particularly relevant in the current context. The first is the ONE system (now called ..... ) which is currently being piloted. This represents a significant change in the benefits system whereby the Employment Service, the Benefits Agency and local authorities come together at a single point of contact for benefit claimants. Each new claimant will be allocated a Personal Adviser who will deal with all work, benefit and related issues. Interestingly this reverses the change introduced in 1974 when Benefit Offices and Job Centres were split in order to encourage the Employment Service to compete effectively with private sector job placement agencies. The idea underlying ONE is to enhance the effectiveness of the system in getting people off benefit and into work. It will certainly have a greater potential for doing so than the more diffuse system which it replaces.

The other change in prospect is to extend the in-work benefit system to non-disabled individuals without children. This involves splitting off the child element of the WFTC and placing it into a "seamless" means-tested system of financial support for children with parents in and out of employment. What remains will be an 'Employment Tax Credit' which can then be extended to individuals or families without children. Eligibility for this new tax credit remains to be decided. For example, a restricted version would be one for adults aged over 25, working 30 hours or more per week and with a lower rate for single persons than for couples. The aim would, of course, be to raise the benefits of working for low skilled persons without dependent children.

Overall, the above changes will probably have some input in reducing both unemployment and inactivity among the low skilled but they are unlikely to make

much of a dent in the huge increase in inactivity among low skilled men which we have seen over the last twenty years. At the moment, this is fundamentally a disability issue and providing the kind of assistance which will enable a significant portion of this large group to re-enter the labour market is likely to remain an unresolved problem.

#### 4. Summary and Conclusions

In judging the recent performance of the UK labour market, we consider both the overall macroeconomic performance and some of the underlying micro problems, particularly those facing unskilled workers. On the macro front, the news is rather good. We have seen a continuing decline in unemployment down to its lowest level for a generation without excessive inflationary pressure. This suggests that equilibrium unemployment has been declining and, in fact, it has been doing so since the mid 1980s. The reasons why this has happened are first, because the balance of power in wage bargaining has shifted away from workers as union coverage has declined significantly over the last twenty years and unions have become far less adversarial. Second, unemployment benefits have also declined over the same period and the whole benefit system has become much more focused on getting the unemployed back into work. These are the most important factors with a small additional contribution from the decline in taxes on employment.

These changes were, of course, initiated long before the present government came to power in 1997. So what is the likely future impact on unemployment of the relevant changes instituted after 1997? Overall, we think these are likely to be small. For example, the introduction of the National Minimum Wage and the new procedure for union recognition are unlikely to generate any significant increases in unemployment and the same is true of the significant increases in the financial burdens on UK business because of new regulations on working time, part-time workers, parental leave and the like. Pointing the other way, the New Deals and the increasing rigour of competition policy will probably only have a small positive impact on employment over the medium term.

Turning now to the imbalances underlying the favourable macroeconomic labour market performance, the key problem is the rapid increase in the level of inactivity among men. This has been particularly dramatic among unskilled men, so that by the late 1990s, around 30 percent of working age men with no qualifications were inactive. Underlying this has been the rapid fall in demand for unskilled male labour which significantly outpaced the fall in supply as educational standards rose. The majority of inactive men of working age report themselves as sick or disabled, so there has been a spectacular rise in the number of working age men in receipt of incapacity benefit, concentrated among the unskilled.

The policy response to this situation since 1997 has been to focus on policies to encourage the unskilled into work while simultaneously raising the rewards for working. The main set of policies in the first category are the New Deal policies which are targeted on a variety of groups and provide systematic mechanisms aimed at getting participants into jobs. The second set of policies include the introduction of the National Minimum Wage and new forms of “in-work” benefits, notably the Working Families Tax Credit. Since these policies are all relatively new, their overall impact is hard to judge but the New Deal for young people has had considerable success in getting long-term unemployed young people into work. On the other hand, the Working Families Tax Credit has had only a small positive impact on labour supply although it has had a significant effect in terms of reducing child poverty. So far, however, the existing policies do not seem likely to help in significantly reducing the high levels of worklessness among unskilled men, particularly in the older age groups.

## End Notes

1. This level of unemployment is sometimes called the ‘non-accelerating inflation rate of unemployment’ (NAIRU) or the natural rate. Neither of these names is very appealing, the latter because there is nothing natural about it, the former because the inflation rate should be unchanging rather than non-accelerating.
2. 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.
3. Evidence suggests that most public sector wages follow the lead of the private sector, often with a considerable lag.
4. 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.
5. That is, they might consider asking employees whether they want to sacrifice wages in order to have new rights. Typically, however, employees and others usually have the impression that the costs of their new rights will be paid for out of profits, an impression reinforced because managers also like to claim this as well. In the longer run, however, this is not the case because market wages typically adjust to compensate.
6. See Schweitzer (2001), Table 1. Figures refer to 1993-9.
7. The overall picture of rapidly rising inactivity among men due to sickness and disability is consistent with the rapid rise in the number of claimants to Incapacity Benefit (previously Sickness and Invalidity Benefit). In 1985 there were 830

thousand male claimants. By 1996, this had doubled to 1.63 million. However, after this date the numbers declined to 1.46 million in 1999, basically because the system was tightened when Incapacity Benefit was introduced in 1995. (See UK Social Security Statistics, 2000). In Table 12, we can also see some flattening off in the numbers after 1996.

8. So the supply of housing, medical and banking services, for example, will all typically deteriorate as the relative economic position of the locality declines.
9. For example, the results of the OECD Literacy Survey (OECD, 1997a) indicate that some 22 percent of the population of working age in the UK is at the lowest level of literacy (close to illiteracy) compared with around 10 percent in the typical Northern European country (Germany, Netherlands, Sweden).
10. For example, Alistair Darling, the Secretary of State for Work and Pensions recently proposed that those on incapacity benefit might periodically have their capacity for undertaking employment reassessed. This was greeted by a high level of protest despite the fact that the number of persons drawing sickness and incapacity benefit has more or less doubled since 1985 while, at the same time, the overall health of the population improved.
11. It is also worth remarking that in 1998, the system of National Insurance payments by firms was changed so that when they paid workers above the lower tax threshold, they no longer had to pay tax on all earnings but instead they paid tax simply on the marginal earnings above the threshold. This eliminated the incentive for firms to pay wages just below the threshold which also helped increase the benefits of working for low paid workers.

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