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**Article**

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# UNEMPLOYMENT CRISIS

## THE UNEMPLOYMENT CHALLENGE IN EUROPE

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### Where are we now?

Europe, like much of the World economy, is in the middle of a serious recession with GDP in many countries having fallen significantly. Interestingly enough, looking across the OECD countries, there has not been a very strong correlation between the rise in unemployment and the fall in GDP. For example, in the last year (up to 2009 Q1), GDP in the United States has fallen by 2.5 percent and unemployment has risen by four percentage points. By contrast, German GDP has fallen by 6 percent but unemployment has risen by less than one percentage point. On the other hand, Spanish GDP has fallen by 3.1 percent whereas unemployment has risen by eight percentage points.

To some extent, these differences reflect the productivity levels in the hardest hit industries. For example, in Spain, there has been a huge contraction in the relatively low productivity construction sector generating large falls in employment relative to GDP. In Germany, on the other hand, the high productivity capital goods sector has been badly hit leading to much smaller falls in employment relative to GDP. The other major factors are labour market institutions and specific employee retention policies. For example, countries with a combination of very flexible short-term contracts and very inflexible permanent contracts will see large falls in employment. Indeed these falls may be exacerbated by the fact that those on permanent contracts will be less inclined to moderate their wage demands because their security of employment is much enhanced by the existence of a large cushion of short-term contract workers. Use of short-time working subsidies, by contrast, will tend to attenu-

ate employment losses. This has been a key factor in Germany.

Overall, however, prospects for unemployment look bad across the board. While GDP growth in Europe will probably be positive in 2010, it could well be below trend and this will not bring down unemployment. So what is to be done?

### How can we mitigate the rise in unemployment?

#### *Macroeconomic policy*

It goes without saying that we need, and by and large we have got, expansionary monetary and fiscal policy as befits a situation in which aggregate demand has fallen and there was little in the way of core inflationary pressure even before this fall. This was not a recession generated to squeeze inflation out of the system.

#### *Labour market policies*

The issue here is the extent to which the rise in unemployment can be attenuated relative to any given fall in GDP. Firms which are confident in their long-term prospects and employ a high proportion of workers with firm-specific skills may employ a variety of policies to retain employees at reduced costs such as hour reductions, compulsory vacations, pay cuts and so on. Subsidy policies can be used to encourage this, the justification being that this will sustain labour market attachment. Maintaining attachment to the labour market is one of the key ways of maintaining the health of the labour market in the long run and this is one method which has been employed effectively in some EU countries. The cost of this method is that it may impede the movement of workers towards more productive activities and prevent the contraction of less productive industries or industries where there is general overcapacity. For example, competitive protection of automobile manufacturing across the world may ensure that overcapacity is sustained even as the world emerges from the



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recession. Of course, there is a collective action problem here since no one country wishes to contract its domestic automobile industry to the long-run benefit of the rest of the world.

As we have already noted, the structure of employment protection rules will impact on the rate at which unemployment rises. Strict rules will, of course, slow the rate of job loss in a downturn at the expense of slowing the rate of job gain in the upturn. Making the rules stricter in response to a recession is probably not to be recommended at a time when firms are under severe financial pressure.

### **Bringing unemployment down in the recovery and preventing persistence**

*Can labour market policy make a difference in the short run?*

The speed of the recovery will, of course, depend crucially on how macroeconomic policy develops, how credit markets recover and how the manifest problems facing the world economy are resolved. Generally speaking, those economies which have seen faster falls in employment relative to GDP in the downturn will probably see faster rises in employment relative to GDP in the recovery. Indeed, the existence of flexible short-term contracts and, particularly, widespread temporary employment agencies may allow faster expansion of GDP without excessive inflationary pressure.

*What measures are to be avoided?*

In order to prevent unemployment persistence and, indeed, to sustain labour supply more generally, it is crucial to continue the labour market attachment of those who lose their jobs. Historically, we have not been good at this. Under the pressure of rising unemployment, the force of the 'something must be done' argument tended to grow and it was easy to succumb by removing people from the labour force via early retirement, disability and so on. While this reduced the number of the non-employed who were actually looking for work (the unemployed) in the short run, in the long run the inactive population became larger while the unemployment rate was unaffected. The growth potential of the economy was reduced and the fiscal position was worsened.

There is a long and unfortunate history of this policy response so, by the early 2000s, in the vast majority of OECD countries there were more inactive men aged 25–54 than unemployed men in the same age group, mostly long-term sick or disabled. Furthermore, in many countries, inactivity rates among men aged 55–64 had risen to very high levels in the three decades up to the mid-1990s, despite male life expectancy having risen steadily throughout. The consequences for pension systems were plainly adverse. So one thing to avoid above all others, is to be tempted into providing individuals with incentives to retire early or to enter long-term sickness or disability. Sustaining and enhancing long-run labour supply is the direction in which to move.

### **How do we maintain labour force attachment?**

As we have already noted, the key to maintaining the long-term growth potential of the economy is to prevent those who lose their jobs from getting into a situation where it is very hard to get back into work. So they must avoid going into long-term unemployment, early retirement or the disability benefit system. In normal times, it is sensible to devote significant resources to assisting those who are already in one or other of these states back into the labour market. In a recession, given limited resources, the main focus has to be on those entering unemployment. There will, of course, be much larger numbers of these than in normal times.

The standard policy shortly after entry into unemployment is mandatory participation in an activation programme, monitoring of job search, counselling and job search assistance in return for receipt of benefits. For those lacking skills, policies to enhance employability may be in order although such evidence as we have suggests that training for the unemployed is not a very successful policy. Targeted recruitment subsidies can be more effective. EU countries vary greatly in the rigour and effectiveness of their activation policies.

When unemployment duration reaches a given point, six months or twelve months say, then to sustain labour market attachment it is worth introducing a job/training guarantee in return for continuing receipt of benefits. The work would be temporary (6–12 months) and part-time with the individual continuing to search for a regular job at the same time. The work would be socially useful, requiring mini-

mal training, organised at public expense by local authorities or voluntary groups. Only a small minority of EU countries have mandatory schemes for all the unemployed who reach a certain duration although in most EU countries unemployed individuals can be referred to such schemes by the employment service.

There are two problems with all these kinds of policies. First, they are expensive. However, in a serious recession, fiscal policy is going to be expansive and some of the extra expenditure should be diverted in this direction. Second, a highly professional and well organised employment service is required. Furthermore, its capacity must be increased rapidly as the inflow into unemployment rises, otherwise activation and related policies may be overwhelmed.

### **Tackling vulnerable groups in the short and long run**

#### *The short run*

The vulnerable groups are the young, the unskilled and those potentially suffering from long-term sickness or disability. As we have already noted, for the first two groups, the focus has to be on assistance in obtaining work and enhancing employability which should start immediately upon entry into unemployment. For the third group, if individuals lose their jobs because of sickness or ill-health, it is vital to mobilise support before they enter long-term disability. This plainly involves medical support, a focus on the sort of work which the individual can manage and immediate access to effective psychological therapies for those affected by depression and anxiety disorders which may indeed be worsened by unemployment. The worst strategy is simply to allow general practitioners to sign people off work with no further intervention.

#### *The long run*

For the young, the evidence suggests that countries which have so-called dual systems have lower levels of relative youth unemployment and smoother and more rapid transitions from education into work. A dual system is simply one where a national apprenticeship is the way into skilled work for those outside university. The essence of these schemes is that they are national, there is a contractual relationship between employers and workers, the training is of

high quality and there are standards which are imposed at a national level, like a driving test. These schemes have been around for a very long time in Austria, Denmark, Germany and Switzerland, and are hard to start up from scratch. However, some countries feel that it is worthwhile trying to move in that direction, notably Norway, Australia and Britain, because the benefits for the young are so great.

For the unskilled and those without qualifications, it is plain that the quality of schooling at the lower end of the ability range is a key factor. Evidence from the International Adult Literacy Survey indicates that there are huge cross-country variations in the proportion of the population of working age who have minimal skills. It is clear that the labour market will work much better and poverty will tend to be much lower if there is only a small group of individuals with very low literacy and numeracy skills. Those at the bottom of the ability range require additional resources for them to receive effective education. If they can develop marketable skills when young, their entry into the labour market is much easier to organise effectively.

In many, if not most, countries of the developed world, there are more prime age men (aged 25–54) on disability benefit than there are on unemployment benefit. This was not the case in the 1970s. The key factors are the structure of the disability benefit system and the way in which individuals are moved into this system from employment or unemployment. In order to reduce the numbers on disability benefit, two things are required. The first is to control the inflow using policies described above. The second is to apply the standard activation mechanisms allied to medical support to individuals who are already on disability benefit. A good example is the Pathways to Work scheme introduced recently in Britain which has already had some success.

Overall, policies should be work friendly and always aim at enhancing labour supply over the longer term.

### **European Economic Recovery Plan**

It is worth briefly commenting on the European Economic Recovery Plan in this context. This Plan covers a number of the points considered here. In particular, it focuses on using flexible working time

to avoid ‘wasteful’ labour shedding due to temporary demand disturbances. The problem is, of course, knowing what demand disturbances are going to be temporary. We can be fairly certain that the demand for sophisticated capital goods will recover with the world economy and that the demand for new housing will not recover rapidly in countries which have seen huge house-building booms. But, in many industries, the longer term prospects are less certain.

The Plan rightly concentrates on activation measures for the unemployed and the necessity of avoiding long-term unemployment, recommending the use of temporary hiring subsidies. It also recommends reducing social charges on lower incomes to support the low skilled. As a temporary measure as part of a recovery plan this is, perhaps, not a well-targeted policy. It is expensive, it has little impact on poverty since most low paid individuals are not in poor households, and will probably have little impact on employment.

### Summary and conclusions

The key in a recession is to sustain the attachment of workers to the labour force and to protect those who lose their jobs. Therefore

- It is worth subsidising worker retention in those sectors where demand is likely to return to pre-recession levels. This can be a very effective policy for sustaining attachment to the labour force.
- At all costs countries should avoid providing individuals with incentives to retire early or to enter long-term sickness or disability.
- Those entering unemployment should participate in an activation programme including monitoring of job search, counselling, job search assistance and medical/psychological support for those suffering from ill-health. Policies to enhance employability and targeted recruitment subsidies may be worthwhile. It is important to expand the capacity of the system to cope with the increased inflow into unemployment.
- Beyond a certain level of unemployment duration, it is worth introducing a job/training guarantee in return for continuing receipt of benefits.
- National apprenticeship systems generate smoother and more rapid transitions from education to work and lower youth unemployment than average. Things are even better if those towards the

lower end of the ability range have achieved high levels of literacy and numeracy by the end of compulsory school.

- Strict controls over entry into long-term disability and activation mechanisms plus medical support for those already in long-term disability help to control the number of inactive individuals in the working age population.