

PREVENTING LONG-TERM UNEMPLOYMENT

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in J. Phillpott (ed.)

Working for Full Employment, 1997



INTRODUCTION¹

Unemployment is one of the major sources of misery in our society. When people record their sense of well-being, it is found that being unemployed makes a person much more unhappy than being poor.² So a civilized society should not tolerate our present levels of unemployment. The European Unions member governments have called for unemployment to be reduced to 5 per cent. Is it possible? If we seriously want a big cut in unemployment, we should focus sharply on those policies which stand a good chance of having a really big effect. It is not true that all policies which are good in general are good for unemployment. There are in fact very few policies where the evidence points to any large unambiguous effect on unemployment and I list in [Annex 1](#) some widely advocated policies for which there is little clear evidence.

There is, however, one issue on which there is almost universal agreement, but so far little radical action in Europe. This is the issue of long-term unemployment (LTU) where it is quite clear what could be done to reduce it. At present nearly half of Europe's unemployed have been out of work for over a year (in Britain the proportion is around 40 per cent). I believe that to prevent long-term unemployment would be one of the most significant supply side improvements which could be made in Europe. I shall therefore concentrate on this issue, and offer eleven points for Britain and other European governments to consider, if they seriously want a large and permanent cut in unemployment.

LONG-TERM UNEMPLOYMENT IS AN ALMOST TOTAL WASTE

In any economy there has to be some short-term unemployment to ease mobility and to restrain wage pressure by providing employers with a pool of workers able to fill vacancies. But long-term unemployment appears to be largely useless, since it exerts very little downward pressure on inflation. This is because employers are generally unenthusiastic about long-term unemployed people as

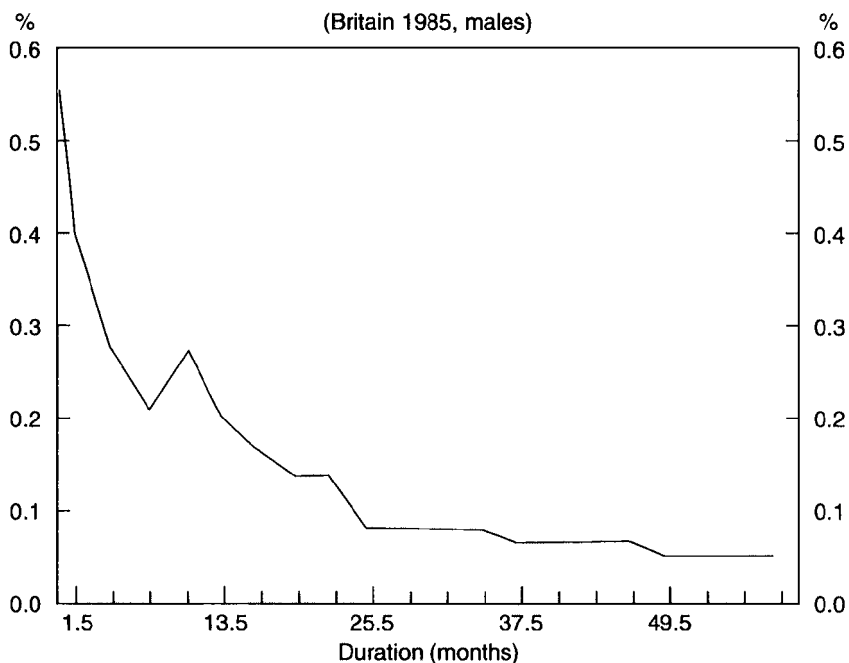


Figure 12.1 Percentage of unemployed people leaving unemployment in next three months: by duration of unemployment experienced so far

Source: These data relate to registered (claimant) unemployment and come from the *Employment Gazette*

potential fillers of vacancies. Whether this reaction is justified (by the demoralization and deskilling of the workers) or not justified is unimportant.

The fact is that unemployed people in Europe have a declining chance of leaving unemployment the longer they have been unemployed. This is illustrated for Britain in Figure 12.1. As a result, it is perfectly possible for employers to experience labour shortages even when there are millions of long-term unemployed. This, more than anything else, makes it impossible without new labour market policies to reduce European unemployment below around 9 per cent of the workforce without inflation rising. The secret of good employment policy is to identify those types of unemployment which can be reduced without rekindling inflation. The prime candidate here is long-term unemployment and I would urge the governments of Europe to focus much more heavily on this issue, which is such a massive fiscal burden, rather than dispersing their anti-unemployment measures over too wide a front and in the end achieving little.

EUROPEAN LTU IS DUE TO HOW WE TREAT UNEMPLOYED PEOPLE

As everybody knows, the proportion of the labour force who are long-term unemployed is much higher in the EU than in the USA, Canada, Japan, Sweden and Norway (see [Table 12.1](#)).³ Why is this? The main reason is almost incontrovertible: it is the long duration for which unemployment benefits are payable. This is illustrated in [Figure 12.3](#), which shows on the vertical axis the maximum duration of benefit and on the horizontal axis the percentage of unemployed people in long-term unemployment (over a year). In countries like Japan, USA, Canada and Sweden benefits run out within a year or so and unemployment lasting more than a year is rare. By contrast in the main EU countries benefits have typically been available indefinitely or for a long period and long-term unemployment is high.

Table 12.1 Short-term and long-term unemployment as percentage of labour force (1980s average)

	<i>Long-term</i>	<i>Short-term</i>	<i>Total</i>
Australia	1.9	5.5	7.4
Belgium	8.0	3.0	11.1
Canada	0.8	8.4	9.2
Denmark	2.4	5.6	8.0
Finland	0.7	4.1	4.8
France	3.9	5.0	9.0
Germany	3.0	3.6	6.7
Greece	2.9	3.6	6.6
Ireland	8.1	6.1	14.2
Italy	6.4	3.4	9.9
Japan	0.4	2.0	2.4
Netherlands	4.7	5.0	9.7
New Zealand	0.4	4.1	4.5
Norway	0.2	2.5	2.7
Portugal	2.5	4.7	7.3
Spain	10.1	7.4	17.5
Sweden	0.2	2.2	2.4
UK	4.2	5.2	9.5
USA	0.6	6.5	7.1

Sources: OECD *Employment Outlook*, OECD *Labour Force Survey*

The relationship shown in [Figure 12.3](#) is of course a partial correlation. But if one allows for multiple causation, the effect of benefit duration upon the aggregate unemployment rate remains strong and clear.⁴ It is interesting to note from [Table 12.1](#) that short-term unemployment differs very much less between countries than long-term unemployment, because some short-term unemployment is inevitable in any system in which unemployment benefits are available for some period. But long-term unemployment differs sharply according to how

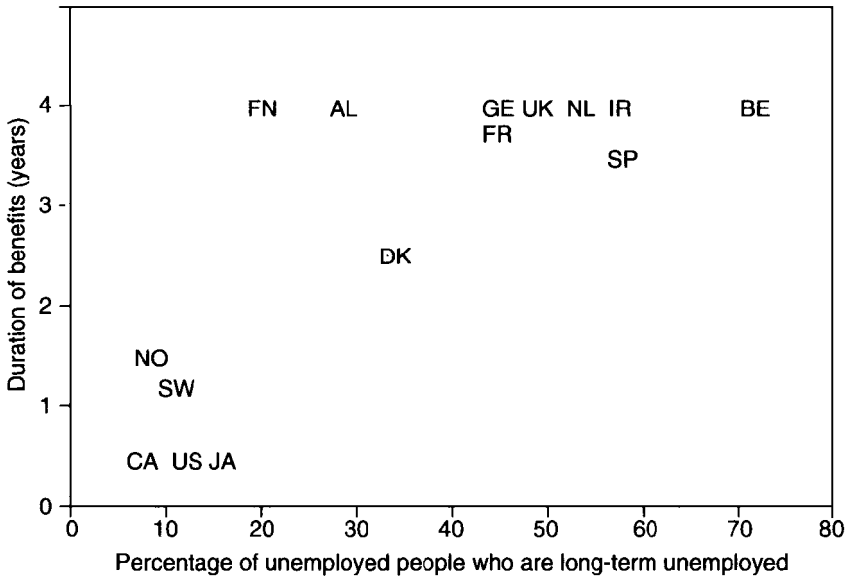


Figure 12.3 Percentage of unemployed people out of work over twelve months by maximum duration of benefits (1984)

unemployed people are treated. It is in some ways an ‘optional extra’ which can be easily accommodated according to the social institutions of a country.

The effect of unemployment benefit availability upon unemployment is not unforeseen. Unemployment benefits are a subsidy to inactivity and it should not be surprising if they lead to an increase in inactivity. In principle, of course, the benefits are meant to protect individuals against an exogenous misfortune and there is meant to be a test of willingness to work. But in practice it is impossible to operate such a test without offering actual work. So after a period of disheartening job search, unemployed individuals often adjust to unemployment as a different lifestyle.

WE DO NOT WANT A EUROPEAN UNDERCLASS

So what should we do? One possibility would be to reduce the duration of benefits to, say, one year and put nothing else in its place. This would be the American-style solution. But we know this only produces extra employment because people thrown onto the labour market accept an ever-widening inequality of wages. A much better approach would be to help people to be more employable so that they would justify a higher wage. This leads to my central proposal.

STOP SUBSIDIZING INACTIVITY AND SUBSIDIZE WORK INSTEAD

After twelve months the state should accept a responsibility to find people work for at least six months.⁵ That should become the method through which it supports their income. In return the individual would recognize that if he wishes to receive income, he must accept one of a few reasonable offers. These offers would be guaranteed by the state paying to any employer for six months the

benefit to which the unemployed individual would otherwise have been entitled. This system would have huge advantages:

- At the twelfth month it would relieve the public finances of any responsibility for people who are already in work. It is very difficult to prevent fraud without being able to offer full-time work.
- Between months twelve and eighteen, people would be producing something rather than nothing. How much would depend on the type of jobs offered.
- But the biggest effect would come after the eighteenth month. Provided the work had been real work with regular employers, unemployed people would have reacquired work habits plus the ability to prove their working capacity. They would have a regular employer who could provide a reference or (even better) retain the individual on a permanent basis. The main justification for the proposal is not that it employs people on a subsidized basis but that, by doing so, it restores them to the universe of employable people. This is an investment in Europe's human capital.

JOBS SHOULD BE WITH REGULAR EMPLOYERS

This is the central objective of the exercise. Job creation schemes in the past have often failed because the jobs have been marginal and have failed to make the individual more employable thereafter. The job subsidy should therefore be available to any employer (private or public). There should also be the least possible restrictions on the kind of work that could be done. Clearly no employer should be allowed to employ subsidized workers if he was at the same time dismissing regular workers. But there should be no condition (as in the UK's former Community Programme and subsequent similar schemes) that the work done should be work that would not otherwise be done for the next two years. Such a requirement is a formula for ineffectiveness. The reason why job creation schemes have so often had these disastrous limiting conditions is the fear of substitution and displacement. This fear is understandable but misplaced.

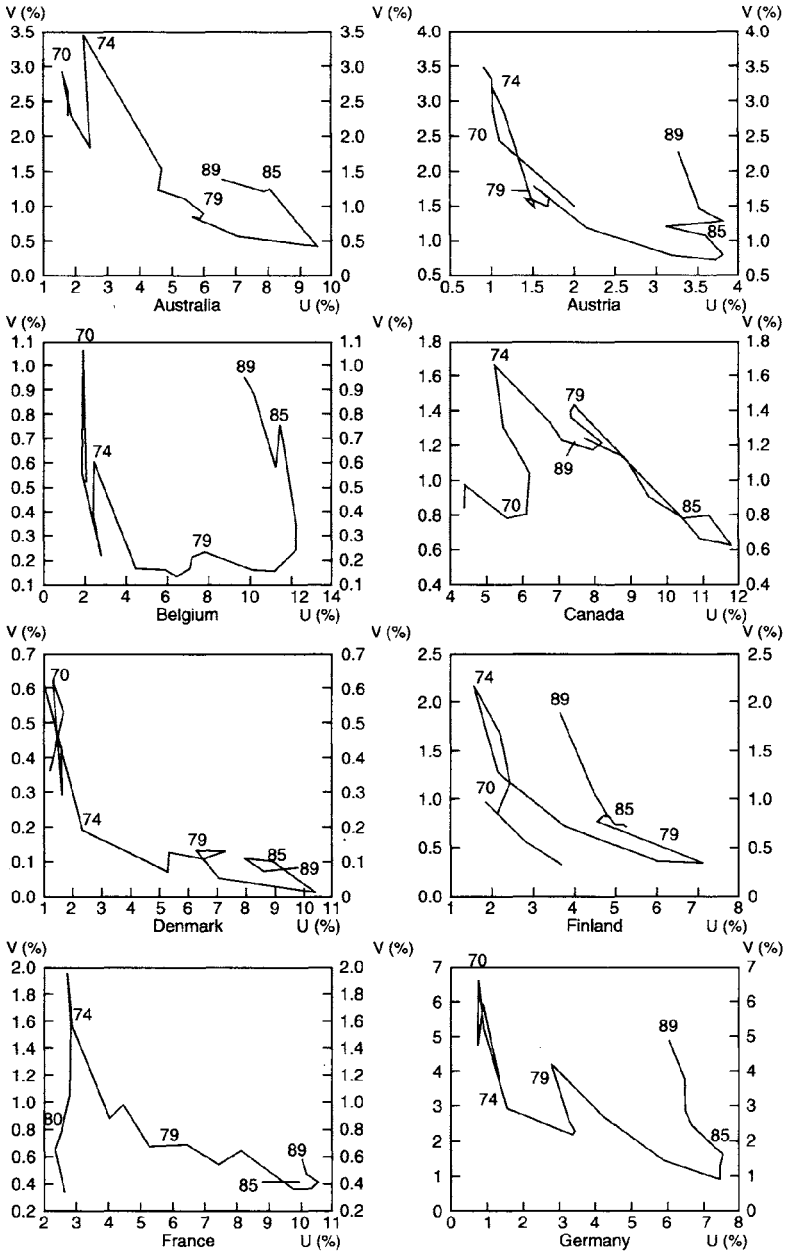
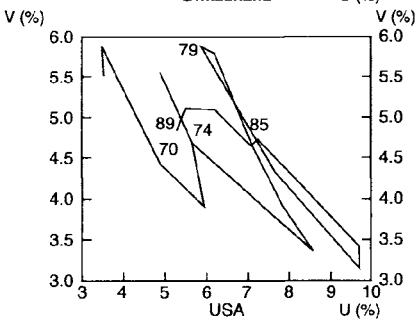
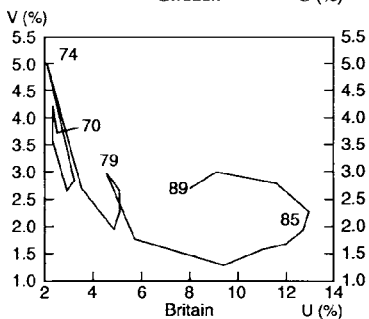
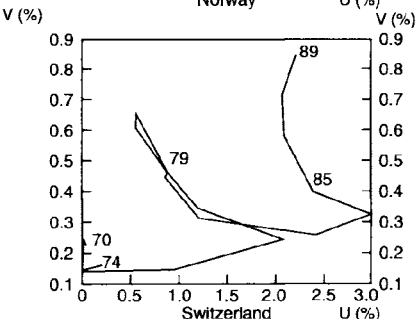
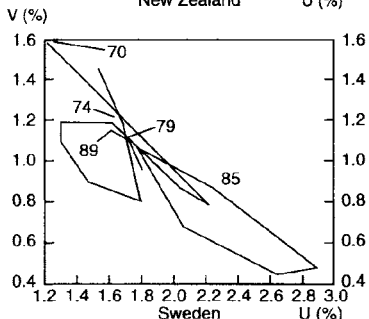
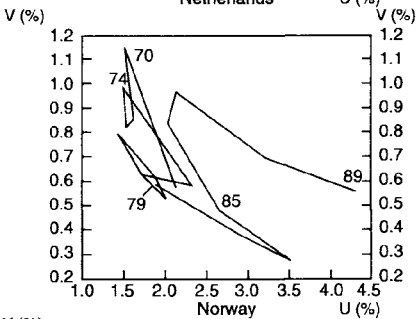
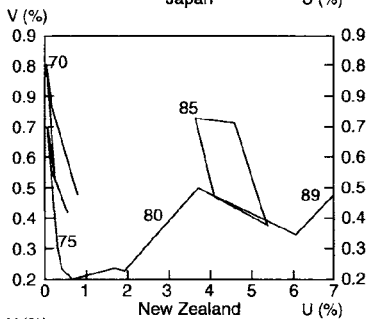
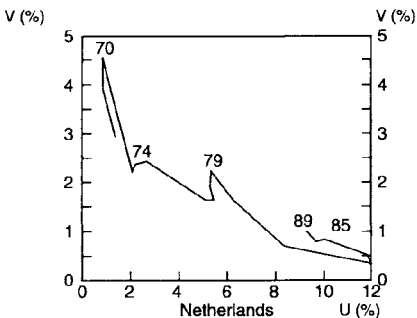
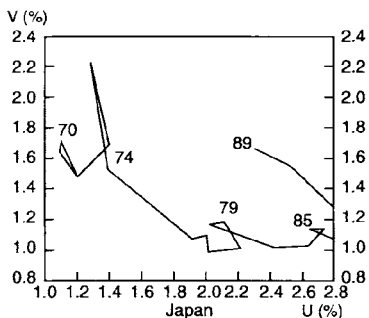


Figure 12.2 Vacancy rates (V) and unemployment rates (U), selected countries



SUBSTITUTION AND DISPLACEMENT ARE NOT MAJOR PROBLEMS

Most opposition to active labour market measures is based on fears of displacement and substitution. In their extreme form these derive from the ‘lump-of-labour fallacy’: there is only a certain number of jobs so if we enable X to get one of them, some other person goes without work. It is easy to see how the confusion arises. In the most immediate sense, the proposition is true. If an employer has a vacancy and, due to a job subsidy, X gets it rather than Y, then Y remains temporarily unemployed. But by definition Y is inherently employable. If he does not get this job, he will offer himself for others. Employers will find there are more employable people in the market and that they can more easily fill their vacancies. This increases downward pressure on wage rises, making possible a higher level of employment at the same level of inflationary pressure.⁶

On average over the cycle the level of unemployment is determined by the level needed to hold inflation stable. Active labour market policy increases the number of employable workers and thus reduces the unemployment needed to control inflation. Equally, in the short run a government that has a given inflation target (or exchange rate target) will allow more economic expansion if it finds that inflationary pressures are less than would otherwise be expected. Many people find it difficult to believe that (inflationary pressure being equal) jobs automatically expand in relation to the employable labour force. So it is perhaps worth giving some more general evidence.

MORE EMPLOYABLE WORKERS CAUSE MORE JOBS

People are inclined to suppose that there is some magic in the job-creating powers of the USA and Japan. The truth is that jobs have grown faster there mainly because the numbers available and wanting work have also grown, largely due to births, deaths and migration. In Europe the labour force has grown much more slowly, which is the main reason why employment has grown more slowly.⁷ This is illustrated in [Figure 12.4](#). To ram home the point, [Figure 12.5](#) shows that the same applies to ‘jobs for men’ and ‘jobs for women’. They respond with remarkable precision to the ratios of men and women in the labour force. In almost every country the proportion of men aged 16 to 64 wanting to work has fallen and the proportion of women wanting to work has risen. This is the overwhelming source of the change in male/female labour in employment, which has tended to occur within nearly all industries.

However, this evidence clearly relates to the medium run and for some people that is too long to wait. In today’s Britain they will not have to wait that long. An increase in the number of employable people shifts the short run trade-off between employment and inflation to the right. More people can be employed at

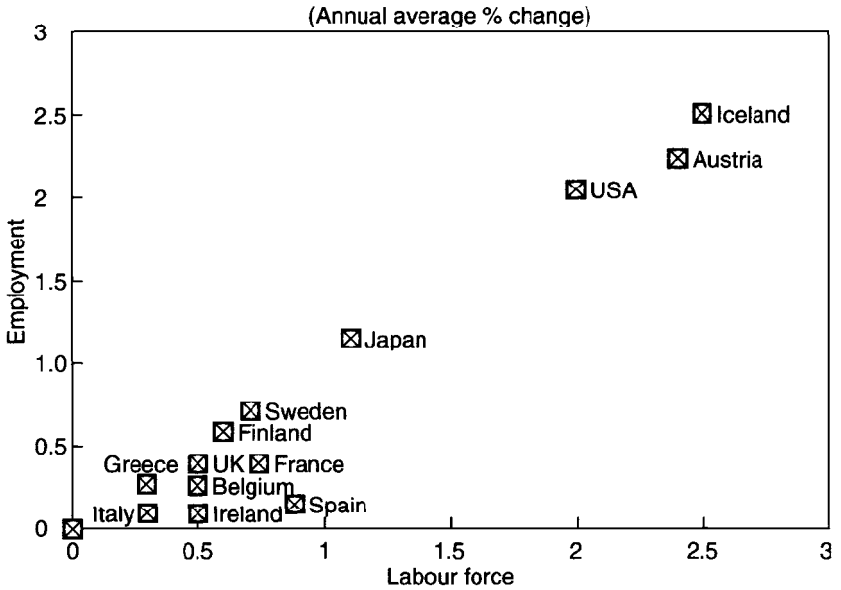


Figure 12.4 Percentage growth in labour force and in employment, 1960–89

Source: OECD

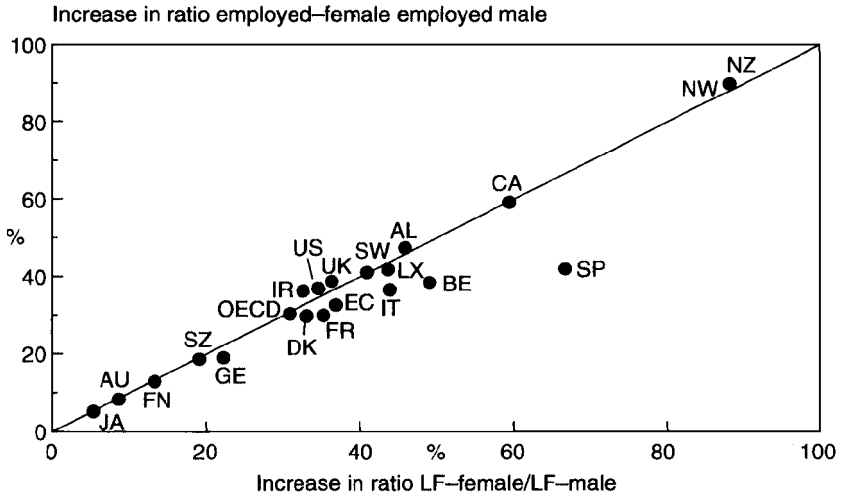


Figure 12.5 Change in relative labour force and change in relative employment: by sex, 1970–90

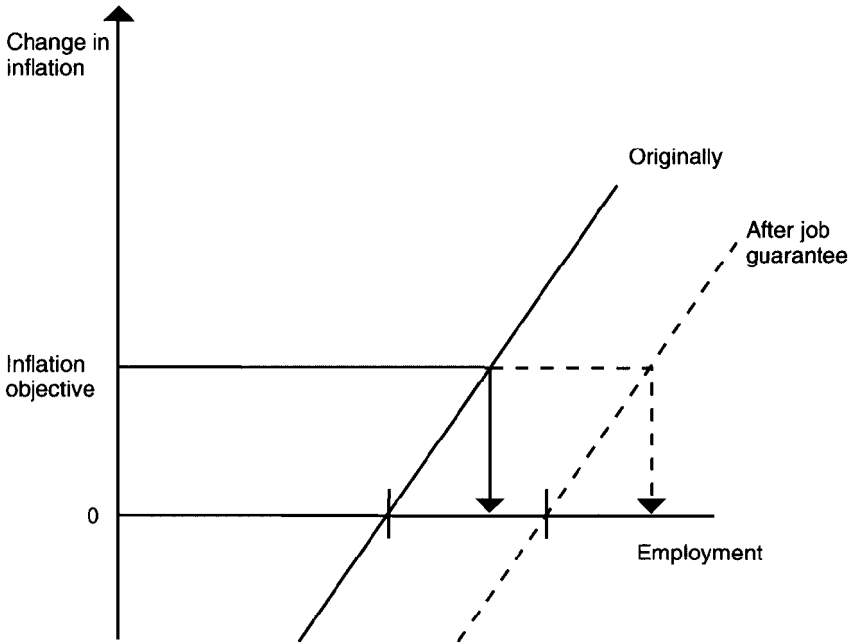


Figure 12.6 The inflation constraint

the same level of inflation or, if the same number are employed, inflation will be lower (see Figure 12.6). What will happen depends on monetary policy. If monetary policy is unresponsive, inflation will fall and employment will grow: there will be a ‘bit of both’. But if, as in Britain, there is a fixed inflation target, a shift in the trade-off stemming from a rise in the employment rate equilibrium will lead even in the short run to an equal change in employment.

But surely, people will say, it must become more difficult for short-term unemployed to find jobs. The answer is ‘not really’. For each month roughly 300,000 people enter and leave unemployment. About 250,000 leave before twelve months are up. So 50,000 flow into long-term unemployment and 50,000 flow out. Under our system no more need flow out. They just flow out faster, so that the stock of long-term unemployed becomes very small.⁸

THE SOCIAL BENEFITS WOULD BE HUGE

We can now proceed to sum up the effects of the scheme and its impact on human welfare. In a formal sense it would abolish long-term unemployment. However, this is to overclaim since someone who reverts to unemployment after eighteen months (after a temporary job) is not really short-term unemployed, even though this would be his classification in the statistics. So let us consider the impacts on the flow of a cohort entering unemployment.

- *Up to 12 months:* some people who would not like to accept a programme job may find some other job. Others may delay taking a job because their potential employer has an incentive to wait for the subsidy. It is reasonable to assume these effects cancel out. More important is the hope that a completely new climate would develop in which neither individuals nor the employment service accept the idea that someone should reach the humiliating position of being confronted with temporary work as the only possible source of income. In Sweden in the 1980s typically about 3 per cent of the workforce reached the fourteenth month of unemployment (when benefit ran out). In Britain the figure was about five times larger.
- *Twelve to eighteen months:* all the cohort is now employed.
- *After eighteen months:* the proportion employed should be very much higher, due to the employability of those concerned. Thus it is reasonable to suppose that unemployment would fall by roughly the same size as the stock of long-term unemployed, leading to a substantial increase in production. Suppose average unemployment fell to 5 per cent compared with say 9 per cent, output would be at a minimum 2 per cent higher. This is the social gain (not to mention a net gain in psychic well-being among those affected). What is the social cost? Very little. The employment service would need more administrative staff, but this is a tiny cost compared with the gain.⁹ The typical EU country spends only 0.1 per cent of GNP on its employment service. All this is illustrated in [Figure 12.7](#).

A Benefits

	<i>Social</i>	<i>Fiscal</i>
Up to 12th month	More job search	Some benefit savings
Months 12–18	Everyone works	Cheaters cost nothing but some deadweight
After 18th month	Higher proportion work	Major savings on benefits + higher taxes

B Costs

Extra administration

Figure 12.7 Benefits and costs of the scheme (to society and to the Exchequer)

THE POLICY WOULD SAVE TAXPAYERS' MONEY

The balance is also acceptable if we focus exclusively on the benefits and costs to the public finances.

- After the twelfth month the taxpayers stop supporting those who are already fraudulently in work or who prefer other jobs to those provided through the subsidy.
- Between the twelfth and eighteenth months, the taxpayers keep paying benefit but now it goes to employers not workers. Any employer who would anyway have hired somebody unemployed between twelve and eighteen months will of course claim the subsidy. So there would on this account be some deadweight (i.e. extra expenditure). However, this deadweight has to be balanced against the fact that some people who would have previously drawn benefit do not now claim subsidized jobs. One should note that the maximum deadweight can be exactly calculated since we know how many of those eligible for subsidized jobs would have found work anyway. (This is never the case for a partial scheme when only some people choose subsidized jobs instead of drawing benefit.)
- After the eighteenth month, there will be major savings on benefits and extra taxes received. On any reasonable estimate the total of all these will be a positive saving to the government, and a saving higher than the cost of the employment service. In [Annex 2](#) we give some illustrative calculations which suggest that such a scheme in Britain would save about one quarter of a billion pounds net in a typical year. It would reduce unemployment by around 400,000.

PREVENTION IS BETTER THAN CURE

Why does this analysis seem so much more cost effective than most existing active labour market policy? Because it is much more drastic. Job subsidies without compulsion to accept an offer can easily be ineffective. What is needed is a shift of regime. In passing, note that I have not suggested doing anything extra for the existing long-term unemployed. This is deliberate. Helping people who are already LTU is very difficult and can easily fail. Therefore, prevent long-term unemployment, and let the existing LTU find their own solutions within the existing programmes, as eventually they will.

A PHASED PLAN IS NEEDED

This reform cannot be introduced overnight. The simplest approach would be to phase it by age, starting with those under 25 years of age who reach the twelve-month hurdle. By the end of a parliament it could be extended to people of all age groups reaching the twelve-month hurdle. In Britain and throughout the EU

only politicians can decide to abolish the existing system for dealing with unemployed people, which has developed almost by mistake. No one would now design a system like the existing one. But it requires courage and commitment to change it. One thing however is sure. Unless it is changed, we shall in the year 2000 be almost as far from the EU's target for reducing unemployment as we are now.

NOTES

- 1 I am extremely grateful to Richard Jackman with whom every idea in this paper was developed.
- 2 A.E.Clark and A.J.Oswald, 'Unhappiness and unemployment', *The Economic Journal*, vol. 104, no. 424, May 1994.
- 3 Due to the growth of long-term unemployment, total unemployment is now much higher than it used to be at any particular level of vacancies (see [Figure 12.2](#)).
- 4 Layard, Nickell and Jackman (1991) *Unemployment, Macroeconomics Performance and the Labour Market*, Oxford: Oxford University Press, p 55 (see [Annex 1](#)). The other variables relate to the replacement ratio, active labour market policy, collective bargaining and the change in inflation.
- 5 As in Sweden, anyone who failed to find regular work within that period would be entitled to go back onto benefits after six months; but re-entry onto benefits would be conditional on having worked at least fifteen out of the last fifty-two weeks.
- 6 In Sweden two-thirds of those entitled to temporary jobs because their benefits have come to an end do not exercise their right to subsidized work.
- 7 To absorb more people requires a downward adjustment of the real wage. But in most countries real wages do not adjust reasonably quickly.
- 8 The argument is essentially the same even when we allow for the fact that there will be more churning as some of those who get the subsidized jobs will lose them after six months. If this happens they of course need jobs, but at the same time they release existing jobs to be filled by other people. All this is in the steady state. In the transition new jobs get created, which increases the flow of new hirings, as is necessary if the stock of unemployed is to fall.
- 9 Personally I strongly favour more training, but here I focus on a virtually costless proposal.
- 10 Layard, P., Nickell, S. and Jackman, R. (1991) *Unemployment, Macroeconomic Performance and the Labour Market*, Oxford: Oxford University Press.

ANNEX 1

Policies whose effects are difficult to forecast

In a book by Layard *et al.* (1991)¹⁰ we show that

- 1 Social security taxes (or other employment taxes) on employers have an ambiguous effect on average unemployment over the cycle because they are frequently borne by workers—just like income taxes.
- 2 Job protection rules also have an ambiguous effect, by reducing dismissals as well as reducing hiring.
- 3 Productivity improvement (based for example on Research and Development) also has an ambiguous effect, since it frequently leads to equal increases in wages.
- 4 In economies with major union influence, decentralizing wage bargaining may increase rather than reduce wage pressure—and thus increase unemployment.

Our research was based on data up to 1989, but experience since then in Britain and elsewhere provides little reason to change these conclusions about the determinants of average unemployment over the cycle.

ANNEX 2

Effects of the proposals

Here are some approximate calculations on the effects in Britain of the job guarantee as proposed at twelve months. First I give the basic relevant numbers of unemployed (stocks and flows) in the absence of the policy. Then I set out clearly the assumptions about the scheme and its effects, and finally the estimated results.

Table 12.2 Existing unemployment: stocks and flows

	<i>Sept 1990</i>	<i>Sept 1993</i>	<i>Average</i>
<i>Stocks</i>			
At 52–78 weeks	15,709	313,965	214,837
At 78–104 weeks	68,225	211,304	139,764
At 104+ weeks	278,653	499,113	388,883
<i>Flows (quarterly)</i>			
At 52 weeks	88,425	219,972	154,198
At 78 weeks	45,989	131,317	88,650
At 102 weeks	32,206	99,344	65,775

Detailed assumptions about the scheme

The subsidy is offered for six months for all unemployed flowing past fifty-two weeks who accept the job guarantee, which we assume is 80 per cent of those eligible. (This is much higher than in Sweden even in this present recession.) The subsidy equals the benefit, which averages £65 per week (including housing subsidy). The other assumption is that the scheme reduces unemployment beyond seventy-eight weeks by 30 per cent (a rather conservative estimate).

Table 12.3 Results

	<i>At 1990 numbers</i>	<i>At average numbers</i>
<i>Cost to the Exchequer</i>	£	£
Subsidy	480m	830m
Extra administration	120m	220m
Savings on benefit		
at 52–78 weeks	–390m	–720m
at 78+ weeks	–350m	–530m
	–140m	–220m
<i>Fall in unemployment</i>	<i>People</i>	<i>People</i>
At 52–78 weeks	115k	210k
At 78+ weeks	100k	160k
	215k	370k