

A JOB FOR EVERYONE

WHAT SHOULD FULL EMPLOYMENT
MEAN IN 21ST CENTURY BRITAIN?



REPORT

Tony Dolphin
and Kayte Lawton
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ABOUT THE AUTHORS

Tony Dolphin is senior economist and associate director for economic policy at IPPR.

Kayte Lawton is a senior research fellow at IPPR.

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IPPR
4th Floor
14 Buckingham Street
London WC2N 6DF
T: +44 (0)20 7470 6100
E: info@ippr.org
www.ippr.org
Registered charity no. 800065

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EXECUTIVE SUMMARY

Full employment should be the central aim of economic and social policy. In an era of limited public budgets, striving for full employment will be vital for raising family living standards and generating the resources needed to fund a sustainable welfare state. For the last three decades, macroeconomic policy in the UK has focused on controlling the budget deficit (except during recessions), while using monetary policy to keep inflation low. It was believed this would deliver stable growth and consequently full employment. This report argues that full employment should not be a consequence of macroeconomic policy; rather that it should be its central focus.

But what is full employment?

One definition would be an unemployment rate that is as low as it could be without triggering increasing inflation. At present, this might mean an unemployment rate of around 5 per cent (or 1.5 million people). This is broadly what the last Labour government achieved from 2001 to 2006. But throughout this period, and despite strong improvements in employment among some groups traditionally described as ‘inactive’, such as lone parents, over 4 million people continued to claim out-of-work benefits. It is an odd definition of full employment where more than one in 10 of the working-age population claim such benefits.

Full employment should, therefore, be defined with respect to the employment rate, rather than the unemployment rate. From 2001 to 2006, this hovered around 73 per cent – the same level at which it peaked (much more briefly) in the two previous economic cycles. Cutting unemployment to 5 per cent would be consistent with getting back to an employment rate of 73 per cent; but this should only be a start. The employment rate should then be pushed to new highs, in line with the highest levels seen in the OECD – that is, much closer to 80 per cent. Achieving this level would, necessarily, mean progress in reducing many of the unequal outcomes in the current labour market, including regional differences in employment rates and differences between the employment rates of various groups.

In particular, policy will need to concentrate on increasing the employment rate of three groups of potential workers not just by making them more employable – as Labour sought to do in the 2000s – but also by increasing demand for their services:

- women – in particular mothers, older women and women from certain ethnic backgrounds
- ‘disadvantaged’ groups – people with work-limiting disabilities, young people, older people and those with few or no skills
- victims of rapid technological change and globalisation – those previously employed in declining industries and found disproportionately in the north of England and the west Midlands.

The benefits of achieving full employment on this definition are clear. Studies show that employment is one of the biggest determinants of personal wellbeing. A higher employment rate also tends to create more inclusive labour markets and improve employment opportunities for those further away from the labour market. Once the employment rate moves above the tipping point of 73 per cent, employers will have to show a greater willingness to adapt to the particular needs of ‘disadvantaged’ groups – and policy measures will be needed to support them to do so, just as policy measures might be needed to encourage such potential workers to enter the labour market. Full employment also has the potential to help tackle poverty and support higher living standards at a time when the benefits system will have to take less of the strain. This will be particularly true

if full employment can be achieved in part by tackling the UK's high levels of household worklessness and increasing the number of dual-earner couples, especially among parents.

Full employment and a renewed focus on job creation would also bring more general benefits. The recent recession and its effect on tax revenues, together with demographic changes, have made it more difficult to sustain spending on welfare and public services: welfare spending has been cut in previously unimaginable ways, and more cuts are mooted. The underlying constraint on the postwar settlement – that full employment was a necessary condition for a high level of public service provision and welfare support – has reasserted itself. One way to limit the need for higher taxes or even deeper public spending cuts is to increase the employment rate.

The inflation risk from a higher employment rate would be very small. Over the last two decades there has been no observable trade-off between inflation and unemployment in the UK.

Achieving an employment rate well above 73 per cent cannot be achieved by macroeconomic policy alone. Increasing employment among those with no skills is best done by improving their skill levels, so education and vocational training has a vital role to play in increasing the overall employment rate. Mothers will only go back to work if it pays them to do so, so either childcare has to be made more affordable, or the real wages that they earn – often in part-time jobs – need to increase (or both). Mothers also need more flexibility, in particular over working hours, because they typically still bear the prime responsibility for caring, even if they are in work. A sustainable increase in employment rates in the north of England and the west Midlands to closer to the levels in the south of England can only be achieved by the creation of more private sector jobs, but there is a role for government to play in enabling this to happen. Sick and disabled people might not be able to work eight hours a day, five days a week, so the labour market needs to be made more flexible for them, not just for the firms that might employ them.

The policy action required ranges across many government departments, not just HM Treasury and the Department for Work and Pensions. Increasing the employment rate to closer to 80 per cent requires the government make it the central aim of all its economic policies. It should present a vision of what full employment would look like – in terms of higher employment rates for certain groups, more sustainable public services and welfare provision, and a greater focus on job creation – and then it should make clear how its policies will help to fulfil this vision.

INTRODUCTION

For a quarter of a century after the second world war, maintaining a low unemployment rate was one of the principal goals of economic policy in the UK. Whenever there was a significant increase in unemployment, the government responded, usually by cutting taxes or increasing public spending, to boost demand and growth in the economy and so bring about an increase in employment and a decline in unemployment. Adopting such an approach was seen as a crucial element of the postwar settlement in the UK that delivered the national health service, increases in the school-leaving age and improved national insurance against unemployment and other risks. Unless unemployment remained low, it was believed government spending would rise to levels that could not be supported by tax revenues.

This Keynesian approach to managing the economy was abandoned in the 1970s when the trade-off between inflation and unemployment, which was one of its key underpinnings, appeared to break down. By the 1980s, macroeconomic policy was focused on tight control of the government's budget deficit, with monetary policy (set in relation first to money supply growth, then the exchange rate and finally inflation itself) used to bring inflation down and keep it at low levels. This, it was believed, would deliver stable growth and consequently low unemployment.

Throughout the postwar period, the focus has been very much on the unemployment rate – explicitly in the Keynesian era and implicitly in the monetarist era. Policy was, therefore, designed to ensure that demand for labour matched its supply, so that unemployment was at a level that represented the ‘normal’ amount of movement between jobs in a dynamic economy.¹ Much less attention was paid to the supply of labour. People of working age are either in employment, unemployed or inactive (out of work and not looking for a job). Until the mid-1980s, and then much more significantly from the mid-1990s, policy was primarily concerned with getting people out of unemployment and into employment, not at increasing the supply of labour by reducing inactivity.

Policy has not completely ignored the supply of labour throughout the last 70 years, and there is a blurred line between unemployment and inactivity. In the mid-2000s, when the Labour government felt that unemployment had stabilised at its lowest possible level consistent with low inflation, it began to explore policies that would lift the employment rate. It introduced measures to boost the employment of lone parents and to reduce the numbers of people claiming incapacity benefit (and it announced plans to increase the state pension age). Although employment among lone parents in particular rose significantly during the 2000s, once the financial crisis and consequent recession created a new set of economic problems for it to deal with, the focus switched elsewhere.

Whether policy focuses on the demand or the supply of labour has implications for what we mean by full employment. Is it simply reducing the unemployment rate to the lowest level compatible with stable and low inflation; or is it, in addition, reducing the inactivity rate to its lowest feasible level too? In other words, is full employment about a low unemployment rate alone, or about a low unemployment rate combined with a high employment rate? In this report, we argue that it should be the latter.

There are good reasons for arguing that policy should be designed to increase the employment rate by reducing levels of both unemployment and inactivity. The idea of high employment to underpin the postwar settlement is still relevant. A higher employment rate may also help to raise incomes among low-income households, easing the burden on the

¹ This is what economists call ‘frictional unemployment’.

tax and benefit system. And employment is not just about material gains. Access to paid work is vital for social identity and participation in a modern capitalist society, and studies of wellbeing show that being out of work is one of the greatest contributors to a sense of low self-esteem.

Making a higher employment rate a central aim of economic policy would be an ambitious step for any government to take. Some of the people that will have to make the transition from inactivity to employment if such a policy is to be successful will be the ones that face the biggest hurdles when seeking work. This is not a task that could be left to the Treasury alone; it would require policies across government that focus on maximising the potential for growth and job creation. The private sector will be the engine of job creation over the next decade, but this does not mean that the state has no role to play. The government spends billions of pounds a year on benefits, tax relief and services and it influences economic decisions through its fiscal policies, procurement policies and regulation. Targeting a higher employment rate will require all of this activity to be focused on growth and jobs over the long term.

These policy issues will be discussed at more length in a later paper. This report focuses on what 'full employment' might mean in the UK in the 21st century. It begins in section 1 with a brief review of employment policy and outcomes in the UK throughout the postwar period. Section 2 sets out the potential benefits of full employment for individuals, families and the state, and section 3 discusses the trade-offs between employment on the one hand and inflation, real wages and productivity on the other. Finally, section 4 sets out a vision of what full employment might look like in contemporary Britain.

1. EMPLOYMENT IN POSTWAR BRITAIN

POLICY AND OUTCOMES

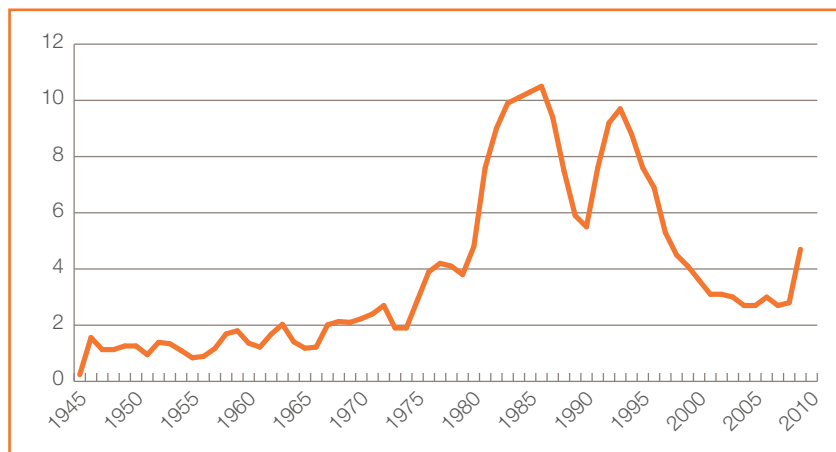
In this section we briefly summarise developments in the UK labour market since the end of the second world war, concentrating on the aims of economic policy, developments in the unemployment and employment rates, and some of the key shifts in the labour market that explain the performance of the headline indicators. We also analyse employment rates in 2006 – the last time that the UK labour market might be described as being at ‘full employment’ (though we argue later that a more ambitious definition of full employment should be adopted in the UK for the next decade).

The evolution of British (un)employment policy

The goal of maintaining ‘full employment’ was adopted by governments in most advanced economies after the end of the second world war, and it remained an explicit priority for economic policy until the 1970s. However, throughout this period ‘full employment’ was understood to mean ‘low unemployment’; that is, ensuring that the demand for labour matched its supply (excluding ‘frictional’ unemployment: people in transition from one job to another). Very little attention was paid to the supply of labour, or to the level of inactivity among people of working age.

In the UK, full employment underpinned the postwar welfare state, which it was argued could only be sustained in the absence of mass unemployment. During this period, full employment was associated with an unemployment rate of 2 per cent or less. Whenever unemployment threatened to rise above this level, the government sought to bring it down again, deploying the Keynesian techniques of tax cuts and increases in public spending to boost aggregate demand in the economy. The assumption was that increases in aggregate demand would boost output, and thereby employment, but would not lead to higher inflation because of the spare capacity in the economy represented by high unemployment.

Figure 1.1
UK postwar
unemployment rate (%)



Source: Bank of England, ‘Three centuries of data’, www.bankofengland.co.uk/publications/Documents/quarterlybulletin/threecenturiesofdata.xls, and ONS labour market statistics

Note: data from 1971 is the current claimant count measure;² data prior to 1971 is from Feinstein 1972

The postwar consensus began to break down in the late 1960s when inflation and unemployment increased simultaneously, and it completely collapsed in the 1970s.

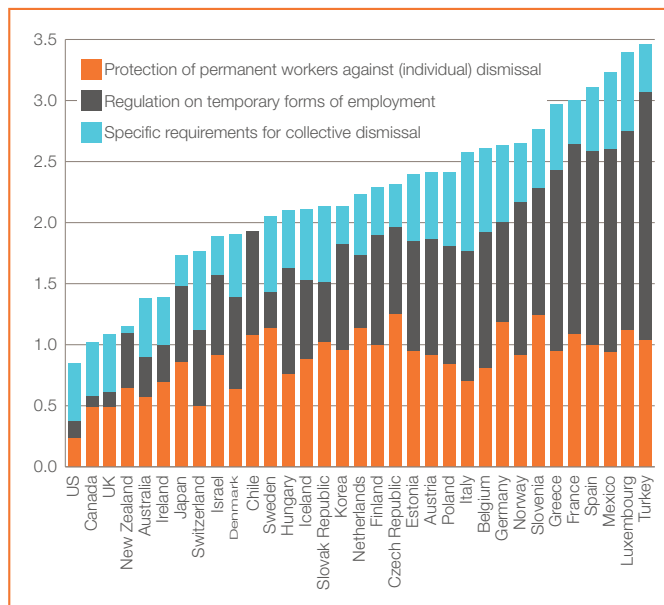
2 There are two main measures of unemployment in the UK: the claimant count measure records the number of people claiming jobseeker’s allowance; the Labour Force Survey (LFS) measure is estimated based on a monthly survey which asks people if they are in employment, seeking work or not seeking work. The LFS measure is widely judged to be more comprehensive and a better indicator, but there is less comparable historical data available.

After the 1973 oil shock, which caused unemployment and inflation to both jump even higher (a phenomenon now known as ‘stagflation’), a new economic orthodoxy began to emerge. The main aims of economic policy were now seen to be keeping inflation, and therefore interest rates, low and stable in order to promote growth led by private sector investment, while maintaining a tight control on the government’s budget deficit (Mitchell and Muyskens 2008). Interest rates, rather than taxation and public spending, became the main means for countering fluctuations in the economic cycle. After experiments with targeting the money supply and the exchange rate (both informally by shadowing the Deutschmark and formally in the EU’s exchange rate mechanism), the current regime of directly targeting inflation was put in place in 1993.

Low unemployment was no longer explicitly targeted. In fact, at times high unemployment was seen as a necessary price to pay for low inflation. Governments in the 1980s and 1990s found they could win re-election with far higher levels of unemployment than had been thought possible in previous decades (Mulgan 2000). The problem of unemployment was gradually recast as one of employability – the attractiveness of individuals to prospective employers – rather than being associated with fluctuations in demand (Allen et al 2007). With individuals shouldering more of the burden of adapting to changing economic conditions, institutions and legislation that thwarted adaptability were removed or reduced in scope.

Over the last 30 years the UK labour market has been deregulated to the point that the OECD believes it to be the third least regulated labour market among its member countries, after the United States and Canada. However, analysis suggests that this has not been a significant factor behind the relatively high employment rates seen in recent years (Gregg and Wadsworth 2011). It is notable that countries with relatively highly regulated labour markets, in particular Germany, have had an even better employment performance, while the US performance has been worse.

Figure 1.2
Employment protection
in 2008 (on a scale
from 0 [least stringent]
to 6 [most restrictive])



Source: OECD³

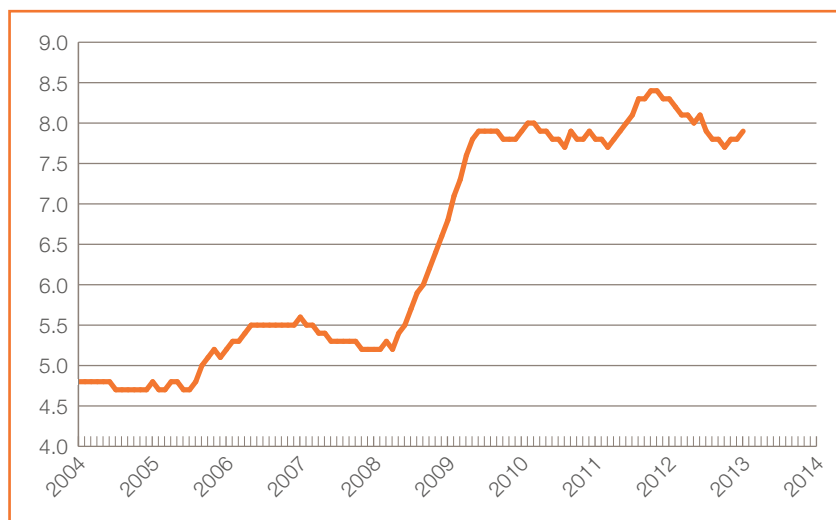
3 <http://www.oecd.org/employment/emp/oecdindicatorsofemploymentprotection.htm>

The ‘employability paradigm’ that emerged in the 1980s was largely retained by Labour governments after 1997, at least until unemployment began to increase after the financial crisis. From its first term, Labour invested heavily in active labour market programmes and policies to improve work incentives, including the minimum wage and tax credits for low earners. However, in the early 2000s, as unemployment fell and then stabilised at its lowest level for over two decades, attention gradually shifted from getting the unemployed into work to reducing the numbers described as economically inactive – that is, to increasing the employment rate.

At the peak of the labour market, in 2005, the government announced its ambition for an 80 per cent employment rate across the working-age population, effectively creating a new definition of full employment, to be achieved in part by narrowing the employment gap for disadvantaged groups. New back-to-work programmes were put in place for lone parents and disabled people, alongside changes to benefit rules that reduced eligibility to inactive benefits and increased work-search requirements for claimants. Additional support was also provided for childcare costs to enable mothers and particularly lone parents to work. Employment rates among lone parents increased substantially in the 2000s, with some improvement in employment rates among disabled people. But the switch of focus from employability to the demand for labour – and to supporting greater demand for certain types of workers or areas in particular – that would have been required to achieve Labour’s 80 per cent employment rate target never took place, not least because the financial crisis and consequent recession created a whole host of new problems.

Although unemployment in recent years has increased far less than most economists would have expected given the depth of the recession, it has still risen by almost one million since the recession began (from 1.62 million in the first quarter of 2008 to 2.52 million in the first quarter of 2013). The unemployment rate, which was 5.2 per cent at the beginning of 2008, now stands at 7.8 per cent.

Figure 1.3
UK unemployment rate
(aged 16+), 2004 to
2013 (%)



Source: ONS labour market statistics

When the likely depth of the recession became apparent, the Labour government reverted for a short time to the Keynesian policies that were in vogue in the 1950s and 1960s, in particular by cutting, temporarily, the rate of VAT and bringing forward planned public

capital spending in order to support demand, growth and, ultimately, employment. This was, however, a short-lived experiment, which was thrown completely into reverse by the Coalition government. Over the last three years the Coalition has favoured the 1980s policy mix of attempting to get the public finances back into balance, while the Bank of England uses interest rates and other monetary measures to boost output and employment growth.

British economic policy, therefore, currently operates without a target either for the unemployment rate or the employment rate, though the Coalition's macroeconomic policies aim to get the economy growing again and are, therefore, implicitly targeted at reducing unemployment. Monetary policy is likely to remain very easy, and extraordinary measures such as quantitative easing and Funding for Lending are likely to remain in place until unemployment has fallen significantly from current levels. However, whether policy remains easy enough to accommodate a fall in unemployment back to its pre-recession levels will depend on the outlook for inflation.

Meanwhile, a range of active labour market policies and welfare measures are being put in place. Some of these are aimed at reducing unemployment; others – although there is no longer talk of a target for the employment rate – are aimed at reducing inactivity; most are designed to do both. The Work Programme, for example, is focused on finding work for those who have been out of work for a long period of time, but it is not confined to those claiming jobseeker's allowance; many people on other out-of-work benefits, such as employment and support allowance, are also required to participate. It will, therefore, cover people currently described in the Labour Force Survey as inactive. Similarly, universal credit, which is designed to strengthen work incentives, will replace income-based jobseeker's allowance and income-based employment and support allowance.

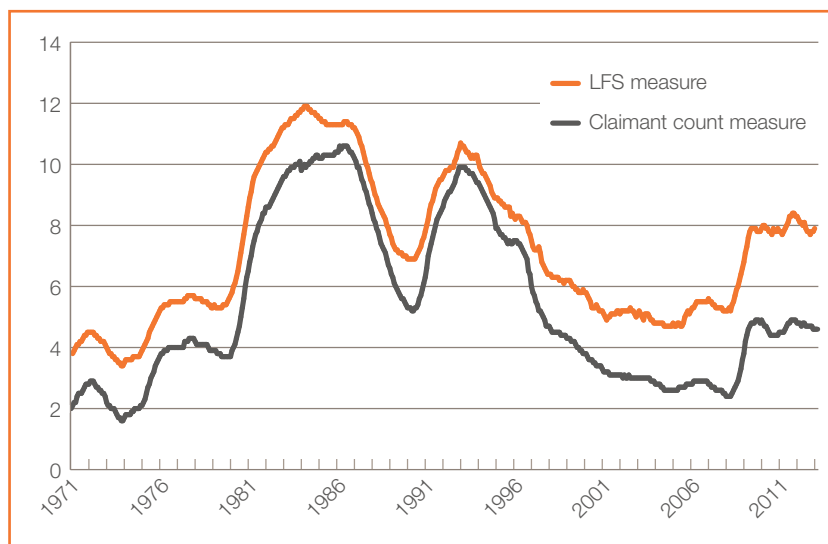
Headline indicators of UK labour market performance

As far as unemployment is concerned, the postwar period in the UK splits neatly into two halves. Throughout the whole of the first half, up to 1974, unemployment was lower than at any single point in the second half. The claimant count (the proportion of the workforce in receipt of unemployment benefit) averaged less than 2 per cent, though from around the mid-1950s it appears to have been on a very gradual upward trend (with some small cyclical fluctuations). In the second half of the postwar period, swings in unemployment were much greater. Over the whole period unemployment averaged almost 6 per cent, but for a time in the 1980s it was in excess of 10 per cent.

Unemployment data from the Labour Force Survey, which uses the International Labour Organisation (ILO) definition of unemployment, is only available from 1971 onwards.⁴ This captures all those who are looking for work, not just those who are able and willing to claim what is now jobseeker's allowance; it therefore produces higher estimates of unemployment than the claimant count measure. As well as being more comprehensive, the other advantage of the ILO measure is that it is not subject to changes in the rules governing eligibility for out-of-work benefits. Changes in these regulations are one reason why the gap between the two measures has fluctuated over time. More recently, the widening gap between the two measures might reflect the declining real value of jobseeker's allowance, meaning that some people do not bother to claim it.

4 The ILO definition covers people who are out of work, want a job, have actively sought work in the previous four weeks and are available to start work within the next fortnight.

Figure 1.4
UK unemployment rate (aged 16+), ILO/
Labour Force Survey
measure (%)



Source: ONS labour market statistics

Both the claimant count and the ILO measures of unemployment increased following the early 1970s recession before stabilising at a level that, for the claimant count measure, was the highest since the beginning of the second world war. The severe recession at the beginning of the 1980s saw a much bigger increase in unemployment, which reached a postwar peak of 12 per cent on the ILO measure in 1984 (and a peak of 10.5 per cent on the claimant count measure in 1986). Although unemployment fell to 7 per cent during the 'Lawson boom' at the end of the 1980s, it rose back above 10 per cent in the subsequent recession and it was not until 1997 that it reached the 7 per cent level again. As the economic recovery that began in 1993 extended into the 2000s, unemployment continued to fall, reaching a low point of 4.7 per cent in 2004 and 2005.

Even before the financial crisis, unemployment had risen back above 5 per cent, but the recession that followed saw unemployment increase to around 8 per cent – a level that has persisted, with relatively minor fluctuations, for almost four years. However, based on historical experience and given the depth of the recession, unemployment has risen by far less than it might have done. Real GDP fell by over 6 per cent in 2008 and 2009, from peak to trough, compared to falls of 4.6 per cent in the early 1980s and 2.9 per cent a decade later. Yet, as is apparent from figure 1.3, the increase in unemployment was less than occurred in these earlier recessions. The corollary of this outcome is that employment is 200,000 higher in the UK now than it was at the beginning of 2008, even though real GDP is over 3 per cent lower. In other words, there has been a significant fall in UK productivity, defined as output per person, over the last five years.

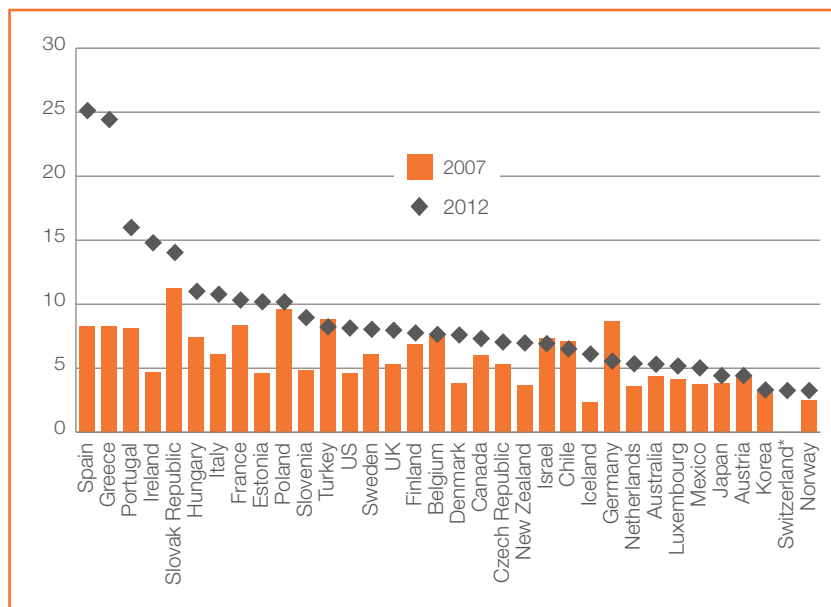
Economists have struggled to explain this 'productivity puzzle', but part of the explanation is likely to be a fall in real wages. Over the last five years, average earnings (excluding bonuses) have increased by 9 per cent, while prices are up 18 per cent over the same period. This has enabled firms to keep on more employees than they would otherwise have done. Weak investment spending may also have played a role; lower investment can lead to a drop in labour productivity because output per worker is partly determined by the amount and quality of capital used. Other possible explanations include the changing composition of the workforce (a rise in the share of part-time and self-employed workers) and a shift in its industrial composition (though there is evidence of falls in productivity

across most sectors of the economy). Five years on from the recession, the least likely explanation for lower labour productivity is probably labour hoarding. This may have been a factor when output began to decline, but five years is a long time to hoard labour in the hope of an upturn in demand.

In 2012, based on consistent definitions, the UK's unemployment rate was the 15th highest among 34 OECD countries. Unemployment across the OECD ranged from 3 per cent in Norway to 25 per cent in Spain. Unsurprisingly, the highest rates – and the biggest increases since 2007 – are found in those countries that have been hardest hit by the financial crisis, in particular Spain and Greece. Prior to the financial crisis, the UK had the 18th highest unemployment rate among these countries, and its increase in unemployment over the last five years is the 14th highest. Overall, therefore, it is reasonable to characterise the UK's unemployment experience in recent years as being close to the average.

The one country that stands out in figure 1.5 is Germany. Prior to the economic crisis it had one of the highest unemployment rates in the OECD; now it has one of the lowest, having seen unemployment fall by over 3 percentage points in the last five years, at a time when it has increased in a large majority of countries.

Figure 1.5
Harmonised unemployment rates across OECD countries, 2007 and 2012 (%)

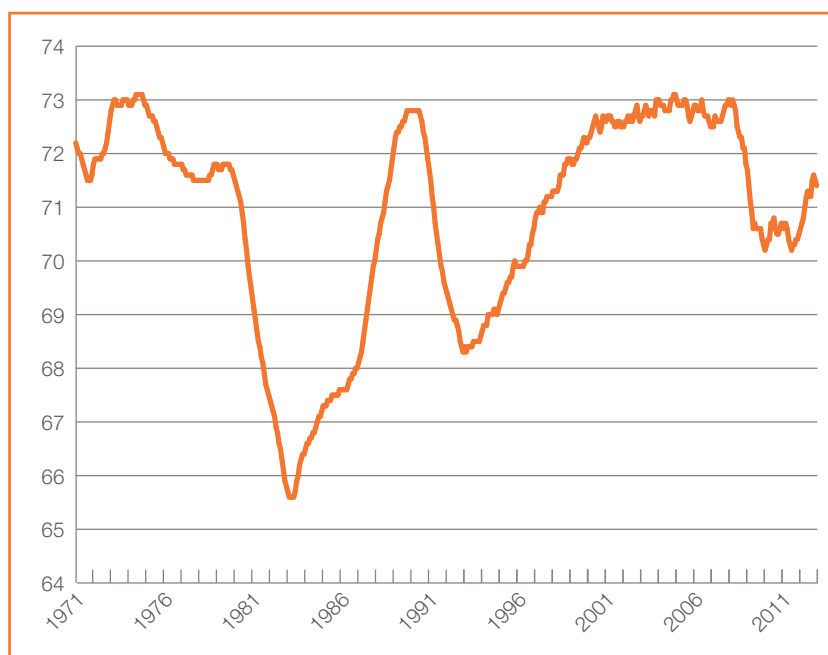


Source: OECD⁵
* No data for 2007

While the unemployment rate is a reasonable measure of the amount of slack in the labour market (though it does not take into account people who are working fewer hours than they would wish), it may not be the best measure of progress towards full employment because it does not reflect the level of economic inactivity in the economy. An alternative measure is the employment rate: the percentage of people of working age who say they are currently in paid work.

5 <http://www.oecd.org/employment/emp/onlineoecdemploymentdatabase.htm#unr>

Figure 1.6
UK employment rate
(aged 16 to 64) (%)



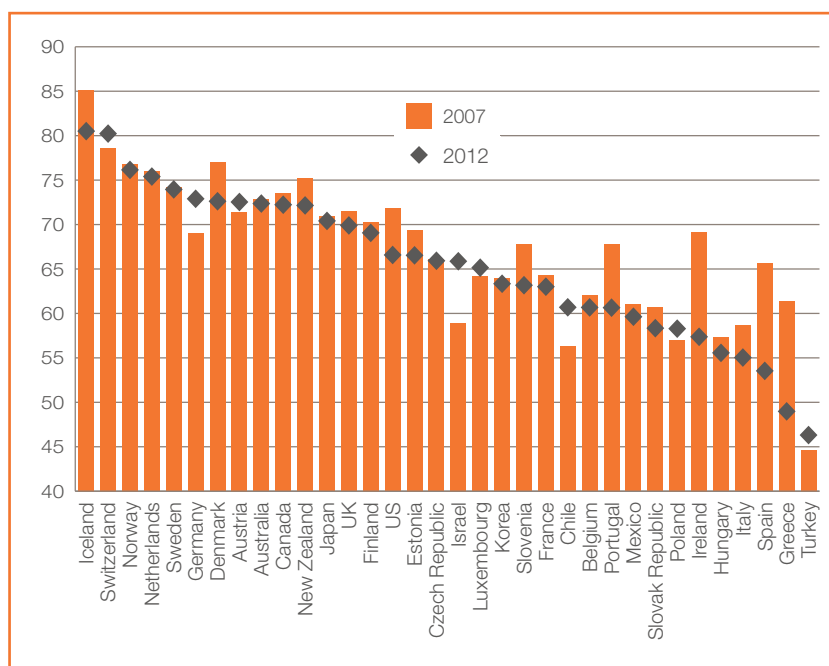
Source: ONS labour market statistics

In the UK during the last 40 years, peaks in the economic cycle have been associated with an employment rate of 73 per cent. Prior to 2000, these peaks tended to be short-lived, but during the last Labour government's term in office the employment rate was close to this level for several years. This shows the importance for employment of sustaining growth in the economy, which expanded in every year from 1992 to 2007. On its own terms, therefore, Labour's employment policy was successful. Although this run was brought to an end by the financial crisis and subsequent recession, the employment rate fell far less than might have been expected in 2008 and 2009, and has subsequently recovered about half of its fall despite the stuttering nature of the economic recovery.

The UK's employment rate in 2012 was the 13th highest out of 34 OECD countries (down from 11th highest in 2007). The highest employment rates are found in social democratic economies in Scandinavia and in the social market economies of Germany, the Netherlands, Austria and Switzerland, though Canada, Australia and New Zealand also have higher rates than the UK. Mediterranean countries tend to be among those with the lowest employment rates, not least because significantly fewer women are in work.

In terms of the employment rate, therefore, the UK is already performing relatively well, though there is scope to do better by matching the rates seen in a number of other European countries. However, the last Labour government's short-lived ambition of lifting the employment rate to 80 per cent of the working-age population looks ambitious; no OECD country managed this in 2012 (though Iceland and Switzerland were very close).

Figure 1.7
Working-age
employment rates
across OECD countries,
2007 and 2012 (%)



Source: OECD⁶

International comparisons suggest that if a future government wished to increase the employment rate in the UK above 73 per cent – its level at the peak of the last three economic cycles – it should look to Scandinavia and Germany for an indication of how this might be achieved. It will find that strong investment in public services, encouraging high maternal employment, discouraging (or at least not encouraging) early retirement, and heavy investment in job creation and active labour market programmes combined with strong benefit conditionality are all important factors.

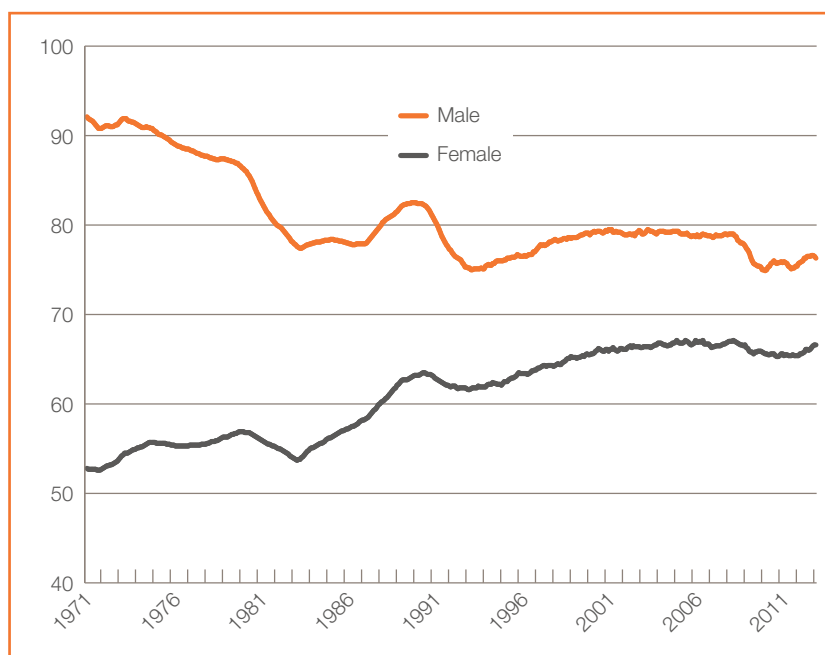
Key developments in the UK labour market

Although the employment rate in the UK peaked at 73 per cent in the early 1970s and again in the mid-2000s, the structure and composition of the labour market was very different in the two periods. This creates a very different context for thinking about what full employment might look like in contemporary Britain. In the immediate postwar period, full employment was characterised by full-time employment among able-bodied, working-age men, who were the main or only breadwinner in most families. Most working-age households had someone in work, while employment was more evenly spread across the regions and nations of the UK. In many ways, the contemporary British labour market is considerably more complex, with a more diverse workforce and a greater variation in employment patterns.

The most striking change has been in the labour market participation of men and women. At the beginning of the 1970s, more than 90 per cent of working-age men were in employment, but this had fallen below 80 per cent in 2007, and is now close to 76 per cent. Meanwhile, there has been a steady increase in labour market participation among working-age women, from just over half being in work in the early 1970s to two-thirds in 2007 (and on the latest data).

6 <http://www.oecd.org/employment/emp/onlineoecdemploymentdatabase.htm#unr>

Figure 1.8
UK employment rate by
gender (aged 16 to state
retirement age) (%)



Source: ONS labour market statistics

The structural decline in the male employment rate has been accompanied by an increase in economic inactivity – not being in work or seeking work. This has occurred for positive and negative reasons. Since 1971, there has been a large increase in the proportion of young men staying in education beyond the age of 16. One in three men aged 16 to 64 who describe themselves as ‘inactive’ are students. But there has also been a large increase in the number of working-age men who are ‘long-term sick’, and they account for another one-third of those who are inactive. (The remainder, for the most part, say they are inactive because they are retired, looking after their families, or for other reasons). It is noticeable that the steepest declines in the employment rate occurred following the recessions in the early 1980s and early 1990s. This suggests hysteresis – a cyclical decline in employment leading to a permanent structural decline – may have been to blame. Some men, it appears, having lost their jobs, and perhaps describing themselves as unemployed for a time, decided the chances of finding another job were so slim that they gave up looking.

Among women, the employment rate has increased by around 15 percentage points since the early 1970s. This is almost entirely accounted for by higher labour market participation among mothers (Berthoud and Blekesaune 2006). Over this period, dual-earner families have become much more prevalent among couples, and this has been a big contributor to rising living standards and reduced child poverty.⁷

Increased employment among women, and particularly mothers, has occurred at the same time as there have been other shifts in the labour market. These shifts have helped to accommodate more women in the labour force, and in some cases have been driven by the growing number of female workers. The share of employment in services grew from 63 to 83 per cent between 1978 and 2011 (the biggest increases were in health and

⁷ Forthcoming IPPR papers will look at how supporting second earners can reduce poverty, and the role of women as breadwinners.

social work, administrative and support services and professional, scientific and technical industries). This increase was largely at the expense of employment in manufacturing. In contrast to manufacturing, where the vast majority of jobs are full-time, in many parts of the service sector more flexible forms of employment are available where the provision of services tends to fluctuate more in line with customer demand (Turner 2001). Less than one-fifth of all jobs at the end of the 1970s were part-time (Blanchflower and Freeman 1993); they now account for 27 per cent of the total. And while 13 per cent of men work part-time, 43 per cent of women do.

There have also been significant shifts in the occupational mix of the workforce, which some have described as polarisation. New technologies tend to complement the work of high-skilled workers, raising their productivity. At the same time, there are many low-skilled jobs that are hard to mechanise. Over the last decade or so, there have been big increases in the number of people in the UK employed as managers and senior officials, professionals and associate professionals or technical workers, but there has also been a sizable increase in the number of people working in personal services. This would appear to bear out the polarisation thesis.

Another important feature of the UK labour market since the 1980s has been a significant increase in the number of workless households. In 1977 and 2012 the UK had a similar employment rate, at around 71 per cent, but in 2012 18 per cent of all non-pensioner households contained no working adult, compared to just 8 per cent of households in 1977 (Gregg and Wadsworth 2011). The rate of household worklessness has been steady at between 17 and 20 per cent over the last 15 years; all of the increase came before 1997 and was probably, in part, associated with the sharp falls in employment after the recessions in the early 1980s and 1990s. Stubbornly high levels of worklessness are a major concern for policymakers given the very high risk of poverty faced by workless households compared to working households (even where wages are low) and the poorer outcomes associated with children growing up in workless households.

The increase in worklessness at the household level reflects two major trends in society. First, the share of households containing one adult rather than two doubled between the early 1980s and the late 2000s, from 20 to 40 per cent (Gregg and Wadsworth 2011). The risk of household worklessness is clearly greater when a household contains only one adult rather than two. But among parents, the employment rate is also lower for lone parents than for partnered people: in 2012, the employment rate for lone parents was 59 per cent, compared to 90 per cent for married/cohabiting fathers and 71 per cent for married/cohabiting mothers. Second, the increase in female employment has been greatest among women living in households with working partners, with fewer instances of working women substituting for working men within households (Berthoud and Blekesaune 2006). This has caused the worklessness rate to increase among couples, as well as driving up the number of 'work-rich' households, where all adults are in work. The share of mixed households, where some adults work and others do not, has been squeezed as a result of these two trends.

There have also been substantial differences in the performance of regional labour markets, with growth in the number of employee jobs over the last 30 years varying from 42 per cent in the south west of England to 8 per cent in the north east of England. This is the result of a complex mix of factors, of which the most important is deindustrialisation as a result of the combination of technological change and increased competition from overseas producers in low-cost economies. Regions which had the greatest concentration

of jobs in manufacturing prior to 1980 – the north of England and the west Midlands – have generally seen the lowest growth in jobs. Although service sector jobs have replaced manufacturing jobs in these regions, they have not done so at a sufficient pace. This is even more apparent when looking at the growth of jobs outside public administration, education and health (which together approximate to the public sector).

Table 1.1
Increase in employee
jobs, December 1982 to
December 2012, (%)

Region	Industry/sector		
	Total	Admin, education and health	Other industries
South West	42.2	74.4	32.5
Northern Ireland	40.3	33.3	44.3
South East	35.8	47.9	32.0
East	29.1	52.3	22.5
East Midlands	26.8	79.7	14.3
Wales	25.6	74.9	8.8
United Kingdom	21.9	48.3	14.2
Yorkshire and the Humber	17.6	65.0	5.2
London	17.0	13.3	18.1
West Midlands	12.5	57.1	1.7
Scotland	12.5	40.6	3.6
North West	12.1	49.0	2.1
North East	8.3	46.8	-4.1

Source: ONS nomis database

Towards the end of the 1990s, there was a sense that regional divergences in jobs growth would narrow because the decline of spatially-specific sectors – like much of manufacturing in the north – was so advanced that future shocks would have a smaller spatial dimension. This view was partly driven by the fact that in the 1990s recession, the unemployment gap narrowed and almost disappeared. But employment growth in the north of England and west Midlands has continued to lag behind the rest of the country over the last 10 years.

‘Full employment’ in the mid-2000s

The UK’s employment rate was very stable between 2000 and 2008, recording an annual average in the range 72.5–72.9 per cent in every one of these years. This is also close to the level it reached, but failed to breach, in each of the two previous economic cycles. An assessment of the labour market in 2006 provides an insight into areas where employment could be increased to raise the employment rate to new levels.⁸

First, in 2006 female employment rates were still well below male employment rates for all age groups except 16- and 17-year-olds. While this relates in part to the fact that women with children are far more likely to take time out of the jobs market than men, the employment rate gender gaps could be narrowed further. Scandinavian countries that have the highest aggregate employment rates have relatively high female employment rates.

⁸ In addition to the analysis that follows, tables showing the split of employment between full- and part-time workers and the occupational breakdown of the workforce can be found in the appendix.

Table 1.2
Employment rates by
age, 2006 (%)

	Total	Male	Female
Overall (16–64)	72.8	78.8	66.9
16–17	35.5	32.4	38.9
18–24	65.4	68.2	62.6
25–34	80.1	88.1	72.2
35–49	82.3	88.7	76.0
50–64	64.9	72.3	57.7
65+	6.7	9.6	4.5

Source: ONS Labour Force Survey

Second, in 2006 the employment rate was significantly lower for men and women aged 50 to 64 than it is for those aged 25 to 49. Employment rates for older workers will narrow as the state pension age for women is gradually increased to 65 in 2018, at which time it will be in line with the male pension age. A higher employment rate would be achieved if the rate of early retirement could be reduced. It is probably inevitable that some people will have made enough money to retire well before they reach the state pension age, but there is evidence that others retire early because they find themselves out of work in their 50s or early 60s and unable to find another job. They retire with less income and, as a result, a lower standard of living compared to their prior expectations.

Third, in 2006 people with a disability – other than men with DDA⁹ but not work-limiting¹⁰ disabilities – had lower employment rates than people with no disability. Employment rates vary substantially for people with different disabilities – more so even than is reflected in table 1.3 – but there is scope for the aggregate employment rate to be increased by efforts to increase employment among those with a work-limiting disability and women in the DDA disabled-only category.

However, there is some evidence that the employment prospects of disabled people have worsened over the last 40 years. Berthould (2011) found that, after controlling for a range of other relevant factors, a disabled person was 28 per cent less likely to be in employment in 2000 than a non-disabled person, compared to 17 per cent less likely in 1975, and that this figure had not fallen between 2000 and the publication of his report. Nickell and Faggio (2005) found that the risk of inactivity among men with a long-standing illness or disability had increased significantly since the 1970s.

Increasing employment levels for disabled people is particularly important because they represent over 7 million people – almost one in five of the working-age population (of whom over 6 million have a DDA disability). Halving the gap between the employment rates of disabled people in each of the three categories shown in table 1.3 and the rates of non-disabled people would have meant an extra 1.1 million in employment in 2006. This would have increased the employment rate by almost 3 percentage points, to 75.6 per cent.

9 DDA means that an individual would be considered disabled under the Disability Discrimination Act, which defines a disabled person as ‘a person with a physical or mental impairment which has a substantial and long-term adverse effect on his ability to carry out normal day-to-day activities’.

10 The presence of a work-limiting disability is self-reported.

Table 1.3
Employment rates by
disability, 2006 (%)

	Total	Male	Female
DDA and work-limiting disabled	33.1	33.2	32.9
DDA disabled only	67.7	84.6	56.9
Work-limiting disabled only	67.6	71.0	63.4
Not disabled	78.1	84.6	71.6

Source: ONS Labour Force Survey

Fourth, in 2006 there were substantial variations between the employment rates of different ethnic groups, in particular among women. Hogarth et al (2009) suggest that male employment rates have been converging, at least for the last two decades, but that the employment gaps among women of different ethnicities have remained relatively stable. Raising the UK's aggregate employment rate is likely to involve a further convergence of male employment rates and the start of some narrowing of the gaps between female rates.

Table 1.4
Employment rates by
ethnicity, 2006 (%)

	Total	Male	Female
White	73.8	79.4	68.3
Mixed	64.7	68.1	61.8
Indian	68.9	77.5	59.8
Pakistani/Bangladeshi	44.5	64.6	23.7
Black	62.5	67.5	58.2
Other ethnic groups	57.6	67.0	48.2

Source: ONS Labour Force Survey

Fifth, in 2006 the employment rate among people with no qualifications was considerably lower than the rate among those with even a minimal Level 1 qualification. There are around 4 million people with no qualifications – or 10 per cent of the working-age population – and their employment rate is significantly lower than the employment rate of people with only Level 1 qualifications (another 6 million). There is, therefore, a considerable benefit – in terms of employment – from acquiring even low-level qualifications. Dolphin et al (2011) show that among those groups traditionally regarded as being disadvantaged in the labour market – older workers, ethnic minorities, disabled people – employment rates increased between 1992 and 2006, but that the reverse was true for those with no qualifications, whose employment rate fell between 1992 and 1998 and then remained stuck at its lower level.

Table 1.5
Employment rates by
highest qualification,
2006 (%)

	Total
NVQ Level 5	88.8
NVQ Level 4	85.8
NVQ Level 3	79.2
NVQ Level 2	79.7
NVQ Level 1	74.3
No qualification	53.5

Source: UKCES (2011)

Note: Qualifications based on the National Qualifications Framework: Level 5 = Masters/Doctorate; Level 4 = First degree; Level 3 = A level or equivalent; Level 2 = GCSE A–C or equivalent; Level 1 = GCSE D–G or equivalent.

Sixth, in 2006 there were still huge gaps between employment rates across the regions of the UK (from 76.7 per cent in the south east to 66.9 per cent in Northern Ireland). If the spatial gap between employment rates could have been narrowed by lifting employment rates across the whole of the UK to be in line with the rate in the south east, 1.7 million

more people would have been in work in 2006. This would have lifted the employment rate to over 77 per cent – into the top three highest in the OECD.

Table 1.6
Employment rates by
region, 2006 (%)

	Total	Male	Female
North East	68.8	73.7	64.0
North West	70.5	75.5	65.6
Yorkshire and the Humber	71.8	77.6	65.9
East Midlands	74.2	79.9	68.5
West Midlands	71.1	77.8	64.5
East	75.2	82.4	68.1
London	68.3	75.6	61.0
South East	76.7	83.2	70.4
South West	75.7	81.3	70.2
Wales	69.0	74.2	64.0
Scotland	73.6	78.3	69.2
Northern Ireland	66.9	73.5	60.5

Source: ONS Labour Force Survey

This is not a fantastical suggestion. Some of the 1.7 million people could have come from the unemployed – whose numbers averaged 1.67 million in 2006, but more could have come from the over 9 million who were described as inactive.

Table 1.7
Reasons given for
economic inactivity, 2006
('000s)

	Total	Male	Female
Total	9,161	3,232	5,929
Student	1,966	982	984
Looking after family/home	2,430	190	2,240
Temporarily sick	199	96	104
Long-term sick	2,189	1,134	1,055
Discouraged	48	28	20
Retired	1,424	441	983
Other	905	361	544
Wants a job	2,081	847	1,234
Does not want a job	7,080	2,386	4,695

Source: ONS Labour Force Survey

Of the inactive group, although they were not actively looking for work (otherwise they would have counted as unemployed), just over 2 million said that they wanted a job. This will have included the small numbers who described themselves as discouraged from looking for work, but the bulk of these 2 million had either retired early involuntarily, were among the long-term sick or were in the nebulous 'other' category. Achieving an employment rate that is among the highest among the OECD countries – and possibly one that is around 80 per cent – is not, therefore, a ridiculous ambition if the right employment opportunities could be made available to these groups.

For disadvantaged jobseekers, the performance of local labour markets is particularly important. In the US, studies of urban areas with different employment rates during the late 1990s' boom found that disadvantaged jobseekers moved into work at much higher rates in areas where unemployment was below 4 per cent (Freeman and Rodgers 1999). In the UK, Gregg and Wadsworth (2003) estimate that the employment rate among

disadvantaged groups only starts to converge with the overall rate when the employment rate in a local labour market reaches at least 73 per cent of the 16 to 64 population.

Conclusion

Policymakers have accepted a relatively high unemployment rate in the UK for far too long. More urgency should be given to the task of bringing unemployment down from around 8 per cent to its pre-recession level of around 5 per cent. But this would not be enough. Policymakers should also seek to reduce the rate of inactivity; that is, to increase the employment rate in the UK so that it is among the highest levels seen in OECD countries (in other words, approaching 80 per cent for the working-age population). This will necessitate a big change in the focus of macroeconomic policy compared to the last 30 years, alongside considerable reforms to fiscal policy, the benefit system and public services to drive job creation and enable a greater range of people to work.

To achieve this aim, policy will need to concentrate on three areas.

1. Increasing the employment rate for women, in particular mothers, older women and women in certain ethnic groups.
2. Increasing the employment rate among 'disadvantaged' groups in the labour market: the disabled, older people and those with no skills.
3. Increasing the employment rate of the 'victims' of rapid technological change and globalisation, who will have been employed in declining industries and are found disproportionately in the north of England and the west Midlands.

2. THE CASE FOR FULL EMPLOYMENT

STRONGER PUBLIC FINANCES AND A MORE INCLUSIVE LABOUR MARKET

Increasing the employment rate would bring a number of benefits to the UK economy and society. Most obviously, having more people in work would mean higher levels of output (real GDP) and output per capita. These variables are often used as measures of success, so the UK economy would move up international league tables. Higher output would also strengthen the public finances; other things being equal, tax revenues would be higher and public spending on welfare lower.

However, it is perhaps the distributional effects of higher employment that should be most welcomed. A higher employment rate would, necessarily, mean people who are usually disadvantaged in the labour market find it easier to get and hold on to a job. Economies approaching full employment typically see rates of poverty fall more quickly while some measures of social exclusion improve. But this will only happen if there are sufficient job opportunities, and if the labour market adapts to these people who will not all want – or in some cases be able – to work full-time, eight hours a day, five days a week. Achieving an employment rate in the UK that is in line with the highest across other countries will, therefore, necessitate changes on the part of employers and the state.

Labour market inclusion

A key benefit of a tight labour market – one in which unemployment is low – is that employment rates experienced by people who tend to find themselves at a disadvantage when searching for work improve relative to those of other groups. In most advanced economies, this includes people from ethnic minority backgrounds, those with long-term health conditions and disabilities, younger and older people, mothers, and people with few or no formal qualifications. People with these characteristics often find themselves at the back of the jobs queue because employers perceive them to be less productive, or because they cannot easily combine work with their other responsibilities. In a tight labour market, the competition for each new opening is less intense and employers are forced to utilise groups of workers that they might be more reluctant to employ in less buoyant times. One consequence is that people in these groups, who had previously been discouraged from seeking work, enter the labour market, so increasing the potential supply of workers.

Evidence from the US and the UK shows how sustained low unemployment in the 1990s and 2000s helped to narrow the gap between the employment rates of disadvantaged groups and other workers. The US jobs boom in the second half of the 1990s was associated with a rapid improvement in employment rates among young people, black people and the least qualified (Freeman 2001, Bernstein and Baker 2003). Around two-thirds of this improvement is put down to stronger labour demand and about one-third can be explained by improved labour supply (Bartik 2001). In the UK, strong jobs growth between 1995 and 2007 saw the headline employment rate rise by 3 points, while people from an ethnic minority background saw an 8-point improvement and the employment rate among disabled people grew by 9 points (DWP 2007). Regional labour market inequalities narrowed too (Dolton et al 2011). However, the recent recession and subsequent recovery will mean that some of these gains have been reversed (Berthoud 2009, Hogarth et al 2009). In future, having a full employment ambition would mean the maintenance of labour demand in downturns will be a policy priority in order to support those that are likely to experience disadvantage in the labour market.

In the 1990s and 2000s, in both the US and the UK the increase in the employment rate of disadvantaged groups, relative to the rate for other workers, was the result of sustained increases in labour demand created by a healthy macroeconomic environment, policy

reforms to boost labour supply, and the interactions between the two. The increase in supply – or willingness to work – was associated with welfare reforms that reduced eligibility to out-of-work benefits and raised the level of job-search conditionality for claimants. In the US, welfare reforms brought in by the Clinton administration in the mid-1990s introduced time-limited welfare benefits and new welfare-to-work programmes (Green et al 2012). In the UK, the Labour government introduced the New Deal schemes from 1998 and took steps to make work more attractive to potential low earners through legislating for a minimum wage and a more generous system of tax credits.

As tables 1.2 to 1.6 suggest, if the UK government adopted a full employment target that required lifting the employment rate to new postwar highs – perhaps close to 80 per cent – there would have to be disproportionate increases in the employment rates among a number of groups that have traditionally had low employment rates, including some ethnic minority groups, disabled people, mothers, younger and older workers and those with no skills. In some instances, people in some of these groups might not want to work full-time. As the state pension age increases, for example, it is likely that there will be increasing numbers of older workers seeking to manage their transition from full-time work to retirement through a spell in part-time employment. Mothers, and increasingly fathers, need employment conditions that are flexible enough to enable them to find suitable childcare arrangements. Some disabled people might be able only to work limited hours, and young people might want to combine work with vocational education or training.

When the economy is buoyant and the labour market is tight, employers will react to some extent by becoming more flexible about working terms and conditions so that they can attract the workers they need in order to meet demand for their goods and services. But, historically, this has been sufficient only to allow the employment rate to increase to a peak of around 73 per cent. If it is to move significantly beyond this level, employers will have to show a greater willingness to adapt to the particular needs of ‘disadvantaged’ groups. It is likely that policy measures will be needed to support them to do so, just as policy measures will also be needed to encourage such potential workers to come into the labour market.

This would also help counter criticism that a full employment policy would inevitably result in a big increase in immigration, with employers preferring well-qualified migrants, particularly from central and eastern Europe, who are prepared to accept relatively low wages, to less-qualified domestic workers. Free movement of labour in the EU makes the current period very different from the postwar one, and may reduce incentives for employers to adapt their working practices in order to bring more disadvantaged people into the workforce, though it should also be noted that reduced immigration without complementary labour market policies is unlikely to help these groups. If any full employment policy is to be successful in improving labour market inclusion, it will need to take account of migration policies and patterns.

Family incomes, poverty and social exclusion

Countries that have high employment rates, such as the Scandinavian countries, tend also to be more equal and to have lower levels of poverty and social exclusion. Therefore, it is often assumed that if more people in the UK were in work, the incidence of poverty here would fall. Since average incomes from earnings are always higher than the average income provided by state benefits, this makes a good deal of sense. Furthermore, a low unemployment rate will tend to put upward pressure on wages, so helping to alleviate poverty among working families on low incomes. There is evidence that this is precisely what happened in the United States during the late 1990s economic boom. The real

incomes of the poorest fifth of households grew by 2 per cent a year between 1995 and 1999, compared to a 0.6 per cent annual fall during the 1980s and early 1990s (Bernstein and Baker 2003). Relative poverty in the US was 2.2 points lower in 2000 than in 1985, with two-thirds of the decline accounted for by the higher employment rate (De Beer 2007).

However, while it seems intuitive that increasing the employment rate will reduce absolute poverty, it is less clear what its effect will be on relative poverty, which is the more commonly used metric. Rising employment tends to push up median incomes – and consequently raises the relative poverty line. The result is that families who remain without work find themselves further below the poverty line. This effect can be important when higher employment rates do not translate into substantially lower levels of household worklessness (because the additional jobs are filled by second earners in families where someone already works). In part as a result of this effect, while the aggregate employment rate in the UK was 2 percentage points higher in 2000 than in 1985, relative income poverty was also higher (De Beer 2007).

Over the last two decades, changes in tax and benefit policies in the UK have had a much larger impact on household poverty than have shifts in employment. Between 1997 and 2010 the number of children living in poverty fell by 1 million, but the increase in the generosity and coverage of benefits and tax credits over this period was four times as important as changes in working patterns among parents in explaining this fall (Dickens 2011). Labour market projections suggest that there will be an additional 1.5 million jobs in the UK in 2020 compared to 2010, yet relative poverty among families with children is also projected to increase, mainly due to reductions in the generosity and coverage of means-tested benefits (Brewer et al 2012).

None of this invalidates the idea of trying to move the UK economy towards a much higher employment rate. Indeed one of the reasons for doing so would be to ultimately lower household worklessness, and thereby to lower poverty. This might not occur as the employment rate moved back up to its previous peak of around 73 per cent, but surely would if it reached 80 per cent. However, this evidence suggests that maximising the benefits of full employment will require a mix of policies capable of boosting labour demand and addressing some of the household-level factors that dampen labour supply among some groups, such as the lack of affordable childcare. It also confirms that cash transfers will continue to have a vital role in supporting household incomes among working families.

There is also some research from the US suggesting that achieving a higher employment rate can lead to a reduction in social problems. Crime rates fell in major cities in the late 1990s, and this has been attributed to the fact that a greater proportion of potential perpetrators – disproportionately young black men – were diverted into employment (Freeman and Rodgers 1999). However, other research shows the US employment boom had little impact on the poorest one-tenth of families, who remained too disconnected from the labour market to benefit from the general increase in labour demand (Freeman 2001). There was also little impact on serious social problems like homelessness and malnutrition (ibid). Full employment is not, therefore, a panacea and should not be thought of as a replacement for wider policies designed to tackle social exclusion.

The public finances

The postwar welfare state explicitly required high levels of employment to generate the tax receipts needed to fund its provisions. For Beveridge, and those in the Attlee government responsible for implementing his proposals, policies to ensure unemployment remained low

were a necessary adjunct to the introduction of the NHS, longer compulsory education and extended national insurance. However, when unemployment increased significantly in the 1970s and remained at elevated levels throughout the next two decades, governments were able to raise more tax revenues, introduce a wider range of charges and cut other areas of spending (relative to GDP) in order to maintain their commitment to welfare provision.

The depth of the recent recession and the sluggish nature of the recovery that has followed it, together with underlying demographic pressures, have thrown this commitment into doubt. Welfare spending has been cut in previously unimaginable ways: child benefit, for example, once thought of as a universal benefit, is no longer available to higher-rate taxpayers. And more cuts are mooted.

The underlying constraint on the postwar settlement – that full employment was a necessary condition for a high level of public service provision and welfare support – has reasserted itself. However, whereas in the 1940s and 1950s full employment could be defined by a low level of unemployment, over the next decade or two it should be defined as a high employment rate. Reducing unemployment back to its pre-recession levels (that is, by around 1 million) and lifting the employment rate to 73 per cent will be insufficient in terms of increased revenues and reduced government spending to put the public finances back onto a long-term sustainable basis. Demographic pressures on spending, particularly the state pension and pensioner benefits, and falls in revenues as North Sea production declines mean that a growing gap will open up between government spending and revenues in the long-term – even if the deficit is eliminated over the next few years (Lawton and Silim 2012).

This gap can be closed in one of three ways (or by some combination of them). First, government spending could be cut, meaning reductions in the level and quality of public services. Second, tax revenues could be increased. Third, output and employment could be increased. Targeting a higher employment rate would, in effect, be adopting the third approach.

The effectiveness of this approach would depend on how the additional work associated with a higher employment rate was distributed across households. As discussed above, the rate of household worklessness for a given level of employment has increased substantially over the last three decades because of the increase in single-adult and lone-parent households and in worklessness among couple families. If a large share of additional jobs in a full employment economy go to people with a partner already in work, then the impact on welfare spending is likely to be much lower than if a greater share of extra jobs went to single adults or people with an out-of-work partner.

Conclusion

Full employment – defined as an employment rate close to 80 per cent – has the potential to bring a number of benefits for the UK economy, over and above boosting GDP. Other things being equal, tax revenues would be higher and welfare spending lower, making the welfare state (and the provision of public services at current levels) more affordable. Poverty would be reduced, provided that increases in the employment rate led to falls in the number of workless households. And labour market inclusion would increase as previously ‘disadvantaged’ groups found it easier to compete in the labour market – though policymakers might have to intervene to get some people in these groups back into the workforce by offering help and encouragement to both individuals and firms to employ them.

3. POTENTIAL DOWNSIDES TO FULL EMPLOYMENT INFLATION, REAL WAGES AND PRODUCTIVITY

There is a strong case for making full employment a strategic national priority for the UK. Significantly higher levels of employment have the potential to raise living standards, to open up new opportunities for those who find themselves cut off from the labour market, and to support a sustainable and popular welfare state. However, shifting towards a full employment economy may also be associated with some important trade-offs, and there are intense debates about the relationship between employment, inflation, real wages and productivity. The literature on these trade-offs is extensive and it is impossible to do justice to it in this report. Yet it is vital for policymakers to understand how a goal of achieving full employment may interact with other key economic indicators, and where trade-offs may need to be made. In this chapter we summarise the main arguments with particular reference to the implications for a policy aimed at achieving full employment.

The unemployment–inflation trade-off

For most of the postwar period, UK governments pursuing ‘full employment’ policies were focused on achieving as low a rate of unemployment as possible without triggering high inflation. In the period up to the early 1970s, it was believed that there was a trade-off between inflation and unemployment – the Phillips curve – so policy could be eased when unemployment was high or rising because inflation would be low, and could be tightened when inflation was rising because unemployment would be low. However, following the stagflation experienced in the 1970s, it was accepted that the simple Phillips curve did not fully describe the relationship between unemployment and inflation. In particular, an idea gained traction that there was a level of unemployment – the non-accelerating inflation rate of unemployment (NAIRU) or natural rate – below which inflation would increase uncontrollably. Policies to boost demand and reduce the actual level of unemployment to close to the NAIRU were still valid (though monetary rather than fiscal policies were now preferred). But reducing the NAIRU – and thereby lowering actual unemployment – would require ‘supply-side’ policies, particularly those designed to reduce rigidities in the labour market.

Although the macroeconomic policy framework in the UK is now primarily aimed at keeping inflation in line with its target rate, it is still underpinned by this thinking. The monetary policy committee (MPC) believes inflation is determined by the amount of spare capacity in the economy. When there is a lot of spare capacity, inflation will tend to fall; when there is none, it will increase. Therefore, it tightens or loosens policy in order to speed up or slow down growth in demand and output, so as to reduce or increase the amount of spare capacity. In turn, this is expected to bring inflation back into line with the target rate. Unemployment is one measure of spare capacity in one – important – part of the economy: the labour market. Policy, therefore, approximates to controlling the gap between actual unemployment and the NAIRU in order to keep inflation low and stable. The idea that there is an inverse relationship between unemployment and inflation has, therefore, survived.¹¹

The original Phillips curve suggested that this inverse relationship between inflation and unemployment is a stable one. When unemployment is high, inflation would be low, and vice versa. This was based on the simple idea that the scarcity of jobs in a period of high unemployment would cause workers and prospective workers to accept lower nominal wages (and wage increases) than they otherwise would. This would in turn lead

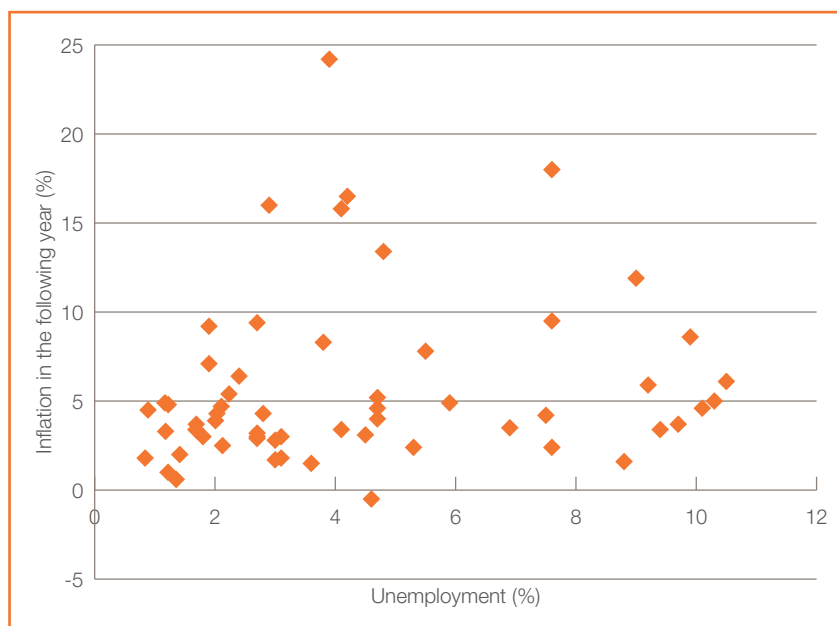
¹¹ In recent years, with the economy struggling to emerge from recession, the MPC has kept monetary policy easy even though inflation has persistently exceeded its target rate. This should not be seen as a total abandonment of this approach. The MPC would argue that most of the inflation pressures in the UK were caused by external factors, the decline in sterling following the financial crisis and administrative changes such as increases in VAT and university fees.

to lower prices (or price increases). On the other hand, low unemployment would lead to competition for scarce labour resources, causing wages to be bid up, leading to higher price inflation. In theory, therefore, governments could trade-off a little more inflation for a little less unemployment. Full employment could always be achieved, at the cost of higher inflation.

However, the stable relationship between unemployment and inflation posited by the Phillips curve began to break down in the late 1960s and early 1970s, and then collapsed completely in the wake of the first ‘oil shock’ in 1973. Economists, with Milton Friedman prominent among them, argued that employers and workers take expected inflation as well as unemployment into account in the wage bargaining process. If the government tried to sustain lower unemployment by accepting higher inflation, inflation expectations would increase, leading to a further increase in inflation, so that ultimately the relationship between unemployment and inflation would disappear. High inflation would co-exist with high unemployment.

A simple analysis of the relationship between unemployment and inflation in the UK over the last 60 years does not suggest there is any stable inverse relationship between unemployment and inflation. Figure 3.1 plots unemployment, based on claimant count data, against inflation, measured by the retail prices index, from 1955 to 2012. In each case, the inflation data is for the year after the unemployment data to allow for a lag between tightness in the labour market leading to higher inflation (for instance, unemployment in 2000 is plotted against inflation in 2001). The correlation between the two series is 0.16, suggesting a weak positive relationship between unemployment and inflation – the opposite of what theory predicts.

Figure 3.1
The inflation–unemployment trade-off in the UK



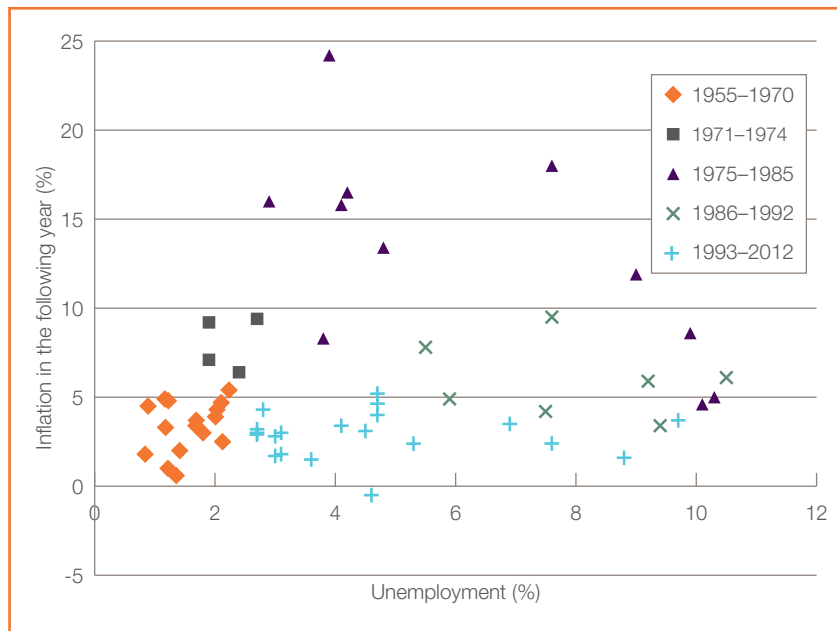
Source: ONS and Bank of England

Economists have attempted to resurrect the negative relationship between inflation and unemployment by building models that incorporate inflation expectations, as suggested by Milton Friedman. The problem with these models is that inflation expectations cannot be

measured directly, and the models produce very different results, depending on how the modellers assume expectations are formed. In particular, it matters whether expectations are based on recent actual inflation numbers – in which case inflation will tend to be ‘sticky’ – or on an assessment of the likely inflation outturn taking into account factors such as the policy setting, in which case inflation will adjust more rapidly.

Fortunately, some understanding of how the relationship between inflation and unemployment has developed over the last 60 years can be gained by breaking the period down into a number of sub-periods. Figure 3.2 plots the same data as figure 3.1, but five different periods are distinguished.

Figure 3.2
The inflation–unemployment trade-off in the UK, 1955–2012



Source: ONS and Bank of England

1955–1970: For the first part of this period there is some evidence of an inverse relationship between unemployment and inflation, though in the latter half of the 1960s unemployment and inflation were both reaching new highs.

1971–1974: A transition period with unemployment and inflation both increasing, inconsistent with the original Phillips curve but as predicted by Friedman.

1975–1985: Bookended by the first oil shock and a collapse in oil prices, inflation expectations were high in this period; but there is some suggestion of a negative relationship between unemployment and inflation.

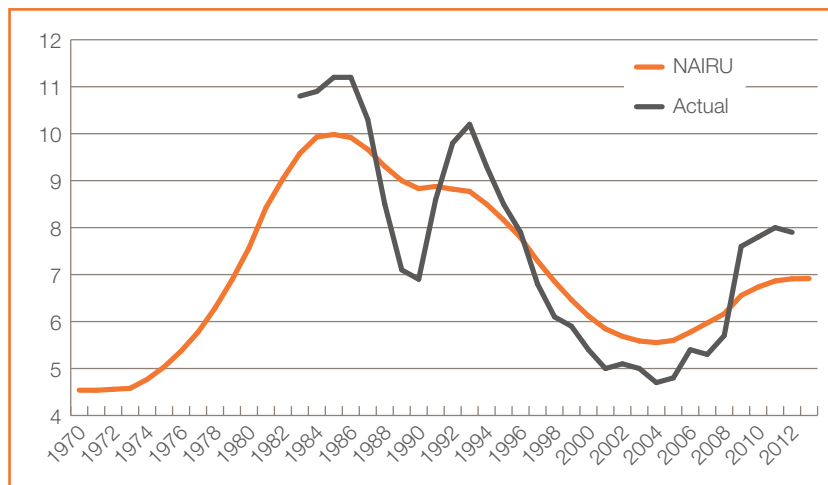
1986–1992: A second transition period during which inflation expectations were falling due to lower oil prices and the realisation that governments were determined to bring inflation down.

1993–2012: For the last 20 years, the Phillips curve appears to have been flat, with inflation relatively low while unemployment has varied from 3 to 10 per cent and fluctuations in inflation have reflected global commodity prices rather than the domestic labour market.

It is unclear yet whether the financial crisis, recession and sluggish recovery have changed the macroeconomic landscape permanently, but the experience of the past 20 years suggests the trade-off between unemployment and inflation is now a very weak one. In the past 10 years in particular, external influences – particularly commodity price movements – appear to be a much more important driver of inflation than the unemployment rate. Reducing unemployment could, therefore, be given a bigger weight in the setting of macroeconomic policy.

The experience of the past 20 years also suggests that if the NAIRU exists it is below 3 per cent (based on the claimant count measure). The fact that there is no obvious NAIRU for the last 20 years in figure 3.2 does not mean that one does not exist; it may be that unemployment has been above that level throughout the period. However, this is not the conclusion of the OECD, which produces estimates of NAIRUs for its member states. It thinks unemployment fell below the NAIRU in the late 1980s at the height of the ‘Lawson boom’ – a conclusion that is plausible given that inflation did accelerate during this period. But it also thinks unemployment in the UK was below the NAIRU from 1997 to 2008. This is far less plausible: inflation, measured by retail prices, averaged less than 3 per cent throughout this period and at no point appeared to be ‘accelerating’.

Figure 3.3
Unemployment and the
NAIRU in the UK (%)



Source: OECD

The level of the NAIRU depends on the nature of the labour market. One reason the employment rate in the UK has failed to go beyond the 73 per cent level in the last three economic cycles is that policy did not try sufficiently to lower the NAIRU.

In the short-term, the risk is that the NAIRU increases as a result of hysteresis: the tendency for cyclical unemployment to become permanent, or structural. This tendency was behind the big increase in the NAIRU experienced by the UK in the 1980s. Following the early 1980s recession, a high level of cyclical unemployment was sustained for an extended period; long-term unemployment rose to very high levels; and workers found it increasingly hard to find a job as their skills became obsolete and they became less attractive to employers as a result.

Portes (2012) argues that improvements in the macroeconomic context, combined with reforms that increased labour market flexibility, reduced long-term unemployment and raised labour market participation in the 1990s and 2000s, subsequently caused the

NAIRU to fall, perhaps by as much as half from its 1980s peak to around 5 per cent in 2008. Nickell (2001) believes the biggest drivers of the fall in the NAIRU in the 1990s were benefit reform and changes to trade unionism, while changes to labour taxes and product market regulation were less important.

The level of the NAIRU is often linked, somewhat crudely, to labour market flexibility: the more flexible a labour market is, so the argument goes, the lower will be the NAIRU. However, this is not borne out by OECD data on NAIRUs and on labour market flexibility, which are only weakly positively correlated. A number of countries, including Iceland and Switzerland (which have the highest employment rates in the OECD), have NAIRUs that are estimated to be lower than the UK's despite having much less flexible labour markets. Labour market institutions matter a lot too. In any case, with the UK's labour market already being the third most flexible in the OECD, progress to reduce the NAIRU, and to increase the employment rate, is very likely to have to take a form other than deregulating the labour market further, particularly if it is judged that moving to a US-style labour market with very weak protection for employees is undesirable.

Rather than follow the US approach, the building blocks of the Swedish model of full employment provide alternative policy tools for keeping inflation pressures low while targeting a high employment rate. Given the absence of a system of coordinated wage bargaining outside the public sector, the UK is unlikely to follow Sweden's example of setting a nationwide 'going rate' in wage deals. It could, however, follow Sweden's example in adopting far more extensive and well-funded active labour market programmes to tackle long-term unemployment and maximise labour supply, while curbing the inflationary pressures of a tight labour market. Decades before such tools became popular in the UK, Sweden was investing heavily in welfare to work and training programmes, employment subsidies, and relocation grants to boost mobility (Erixon 2008). This has been combined with investment in public services, like childcare, that directly create jobs and enable many more to work, particularly mothers. The UK spent less than half as much as Sweden on active labour market programmes in 2008 (OECD 2012).¹²

The employment–real wages trade-off

The last five years have seen a clear trade-off in the UK between employment and real wages. Despite real GDP still being 2.6 per cent below its peak level (recorded in the first quarter of 2008), employment in the UK has reached record high levels in recent months. The corollary is that there has been a slump in productivity. This has been facilitated by a sharp drop in real wages, which has enabled employers to retain staff they might otherwise have felt were unaffordable. Average earnings have increased by 9 per cent in the last five years; consumer prices by 18 per cent.

This is in contrast to the experience of the 1980s. Following the early 1980s recession, despite a stronger economic recovery than the current one, employment did not return to its peak level of Q4 1979 until Q3 1987. Real wage growth was, however, strong during this period as those in work were able to capture the gains of stronger productivity and output.¹³ In part, this might have been due to the changing structure of the economy: as the shift from manufacturing to services accelerated, strong wage pressures among mid-

¹² The UK spent 0.35 per cent of GDP on 'active' labour market programmes (which includes job matching services like Jobcentre Plus, training programmes for the unemployed, employment subsidies and supported employment for disabled people) in 2008–09, compared to 0.85 per cent in Sweden.

¹³ Economists refer to this as an 'insider-outsider' problem. Those in work, the 'insiders', benefited from the economic recovery while the unemployed, or 'outsiders', did not.

to high earners offset the effects of rising unemployment and diminishing union power, which would normally have dampened wage gains (Gregg and Machin 2012).

Recent developments in employment and real wages do not just reflect the effects of the recession and the sluggish recovery. They are an extension of trends that began to emerge well before the economy went into recession. Since the early 2000s, most groups of workers in the UK have experienced flat or declining real wages; only those at the very top of the income distribution have fared better (ibid). This is surprising because the economy was near to full employment for several years prior to the 2008–2009 recession. The stagnation of median real wages in the UK since around 2003 has led to debates about whether the UK is embarking on a period of ‘decoupling’ between wage growth and productivity similar to the one the US has experienced since the mid-1970s (Whittaker and Savage 2011, Pessoa and Van Reenen 2012). Real median wages in the US have been broadly flat since around 1973, despite large rises in productivity (Mishel et al 2001).

A number of explanations have been put forward to explain this phenomenon. Pessoa and Van Reenen (2012) argue that the main explanation is widening wage inequality and an increase in non-wage compensation. Gregg and Machin (2012) highlight the effects of a weakening in the power of trade unions and active labour market policies that make the unemployed a better substitute for the employed, so weakening the bargaining power of those in work. Accelerated technological change and increased competition from low-cost competitors in emerging economies are also likely to have been part of the explanation, putting downward pressure on the real wages of particular groups of workers.

This recent experience suggests lower real wages are one route to full employment, in the sense of a higher employment rate and that prioritising full employment would involve difficult decisions about how the proceeds of growth are shared between wages and jobs. However, it is not clear that wage moderation makes for an effective job creation tool over the long-term. A number of European countries, including France, the Netherlands and Germany, tested this thesis in the 1990s and 2000s (Muet 2000, Meager and Speckesser 2011). Wage moderation has been an explicit part of German employment policy since the mid-1990s, together with tax changes designed to improve labour supply among second earners. Real wages in Germany grew by just 5.3 per cent between 1995 and 2009 while GDP per worker hour grew by 20 per cent (Meager and Speckesser 2011). However, the effectiveness of this strategy is questionable: employment growth was lower in Germany in the decade prior to the financial crisis than in many of the European countries that did not implement wage moderation policies. It would, in any case, be difficult for the UK to adopt a deliberate policy of wage moderation. Only in European countries that retain a system of coordinated wage bargaining across large parts of the labour market are such policies possible.

A stronger proposition is that, in the long run, faster job creation, and thereby full employment, requires higher real wages in order to boost demand and to attract more people into the labour market (for example, mothers who find the current gap between wages and childcare costs insufficient incentive to work). Many proponents of full employment policies support them precisely because they believe they will enable workers to secure strong real wage growth (see Pollin 2011, Bernstein and Baker 2003). In a flexible labour market, strong labour demand may act as an alternative source of bargaining power for low to middle earners who can no longer rely on effective collective bargaining processes. This is an increasingly important argument given emerging evidence about labour market polarisation and the growth of low-wage employment, as well as stagnating

real median wages in the UK (Goos et al 2010, Plunkett 2011). Ultimately, the UK economy will be stronger if both the employment rate is increased and real wages grow steadily.

The employment–productivity trade-off

Evidence for an employment–productivity trade-off in the short-term is convincing. In the recent recession and recovery, the countries that experienced the largest falls in productivity also saw the smallest falls in employment (Meager and Speckesser 2011). In a number of countries, including the UK, unlike in previous recessions, productivity has fallen sharply since the beginning of the recession. Factors that might be behind this development include a rise in self-employment, part-time and temporary work and sluggish real wage growth (Grice 2012).

There is also evidence of a negative correlation between changes in productivity and employment outside of recession. During the 1990s and 2000s, OECD countries with the strongest employment growth tended to have smaller than average productivity improvements and vice versa. A series of model-based studies have found that for every 1 per cent increase in the employment rate, between 0.3 and 0.7 per cent of the GDP gain is lost through lower productivity (OECD 2007, Boulhol and Turner 2009).

However, some countries have been able to combine strong productivity growth and rapid job creation: most notably the US in the second half of the 1990s. This was driven by dramatic productivity gains in the technology sector, and in other sectors that were using new technologies (Green et al 2012). Productivity growth was consequently driven by sectors where employment was also growing strongly as new opportunities were exploited (Manyika et al 2011). In the UK, strong employment and productivity growth co-existed between the mid-1990s and mid-2000s (Corry et al 2011).

These episodes are, however, probably exceptional. In the short to medium term at least, an increase in the employment rate, particularly one that takes it to new highs, is likely to be associated with a reduction in the average productivity of the workforce. Raising the employment rate will necessarily mean bringing into employment more people who have only low-level qualifications or no formal qualifications at all, who lack substantial work experience, or who have been out of work for a long time. Inevitably, their average level of productivity will be lower than that of the present workforce. Improving the employment rate typically also results in an expansion in labour-intensive sectors, which tend to be less productive. Policymakers should accept weaker productivity growth in the short term in return for stronger job creation and a higher employment rate. Strong productivity growth is needed in sectors open to global competition, including most manufacturing sectors and high-value services that can be exported. But in domestically traded industries such as construction, retailing and personal services, a portion of productivity gains can be more easily sacrificed in order to maximise job creation, without threatening the UK's international competitiveness (Commission on Social Justice 1992).

The problem with this approach over the long term is that low-productivity jobs and industries are typically associated with low wages and weak wage growth, as well as with poor job quality on a number of other dimensions such as autonomy, creativity and opportunities for development. Relying on these industries to fuel a full employment strategy implies increasing the share of people in low-wage, poor-quality jobs, which already account for a relatively large proportion of the UK labour market (Cooke and Lawton 2008). It is important, therefore, that policies designed to deliver full employment are accompanied by other policies that seek to tackle the UK's reliance on low-productivity, low-cost business

models in the domestic economy. Efforts to develop industrial policies tend to focus almost exclusively on support for the UK's export and high-tech industries, which are not jobs-rich. They should also address ways of improving productivity in domestic sectors. Eventually, this would be working with the grain of what firms want because a higher employment rate will also inevitably lead to more competition for labour, and thereby put upward pressure on higher real wages. Firms will need to offset this by increasing productivity levels.

In this way, some of the fall in average productivity levels across the economy that will result from a higher employment rate could eventually be reversed as new labour market entrants build up skills and experience (Boulhol and Turner 2009). Reforms should aim to raise qualification levels among those with only low-level or no qualifications and encourage firms to adopt higher-value competitive strategies.

Conclusion

For the last 20 years there has been no observable trade-off between inflation and unemployment in the UK, but the existence of such a trade-off remains at the heart of the country's macroeconomic framework. Now is the time for policymakers to give achieving low unemployment at least an equal weighting alongside achieving low inflation when setting policy – and not just while the economic recovery is sluggish and unemployment is stuck close to 8 per cent, but into the medium term.

Policymakers should also seek to increase the employment rate above its previous peak level of 73 per cent. In the short term, this will mean the UK has more low productivity and low real wage jobs, because there will have to be disproportionate increases in the employment rates of people with no qualifications, or with only low-level ones. In the medium term, therefore, more steps should be taken to improve average skill levels across the workforce and to encourage companies, particularly in the domestic sector, to adopt a high-productivity, high-quality approach, rather than the low-productivity, low-cost one that currently predominates. Only then will the UK have achieved the ideal combination of full employment, higher living standards and better job quality.

4. WHAT WOULD FULL EMPLOYMENT LOOK LIKE IN CONTEMPORARY BRITAIN?

Although postwar governments in the UK have often used the rhetoric of full employment when talking about their economic aims, none has adopted a formal employment target. Prior to the 1970s, keeping unemployment low was a direct objective of policy and the government had some informal notion of what level of unemployment was deemed acceptable. But for the last three decades, governments have focused more on inflation, with a rather vaguer subsidiary aim of ensuring the economy was operating close to its full potential, thereby indirectly targeting an unemployment rate close to the NAIRU. There has been no concerted effort to reduce the NAIRU; nor – apart from briefly in the 2000s – has explicit consideration been given to what an appropriate level for the employment rate might be for the UK and what needs to be done to achieve that rate. This section sets out the case for targeting an employment rate above the 73 per cent level that proved the high point of the last three economic cycles. But first, we present one idea of what an 80 per cent employment rate would look like.

Imagining full employment

The postwar full employment economy was one where full-time paid work was available for every able-bodied, working-age man, typically supported by unpaid domestic and care work, or low-waged part-time paid work, carried out by women. A contemporary understanding of full employment has to reject this male breadwinner model, to reflect radically different social norms but also the realities of the modern labour market, in which families typically need two pay packets to achieve an acceptable standard of living.

However, this does not imply that a full employment economy is one where all or most adults are expected to work a 40-hour week, or a society where paid work is prioritised over all other activities. Not all economic inactivity is bad. Full-time education is an obvious desirable alternative to work for some adults at some point in their lives. It is also not clear that all caring should be paid for and some people will opt for unpaid caring roles. In a contemporary full employment economy, individuals and families should have opportunities to share care and work in ways that make sense for them, as well as having time to be active citizens in their wider communities. Younger and older people should have flexible options for their transitions into and out of the labour market. This should be supported by a policy framework that promotes full employment but enables men and women to make choices about how care and paid work are shared, what training they undertake and how they manage their retirement. This will require reform of policies, for example in the area of parental leave, and reform of companies' employment practices.

What would an 80 per cent employment rate look like, compared to the 73 per cent rate achieved in the mid-2000s? There are an infinite number of combinations of shifts in the underlying employment rates – of men and women; of those with high and low qualifications; of those with and without disabilities; and of those living in different regions – that could bring about this result. The presumption, though, based on historical experience of past increases in employment rates and on what has happened in other countries, is that, in general, employment gaps would be narrowed.

The following analysis sets out one possible scenario.

The employment gap between men and women would be reduced. Employment rates would increase across all age groups, except for those aged 16 and 17 who will increasingly remain in full-time education or training. The biggest increases would be for the 18 to 24 age group – because it is assumed that moving to full employment would be associated with a big fall in youth unemployment – and for those aged 50 to 64 – as

older workers find it easier to get a job in a tight labour market and are less likely to take early retirement.

Table 4.1
Employment rates by sex
and age (%)

	2006	Future scenario	Change required (pp)
Overall (16–64)	73	80	+7
Male	79	83	+4
Female	67	77	+10
16–17	36	30	-6
18–24	65	75	+10
25–34	80	85	+5
35–49	82	88	+6
50–64	65	70	+5
65+	7	10	+3

Source: ONS Labour Force Survey and authors' calculations

A move to full employment is also expected to bring about a narrowing of differences in employment rates between those with and without disabilities.

Table 4.2
Employment rates by
disability (%)

	2006	Future scenario	Change required (pp)
DDA and work-limiting disabled	33	50	+17
DDA disabled only	68	78	+10
Work-limiting disabled only	68	78	+10
Not disabled	78	84	+6

Source: ONS Labour Force Survey and authors' calculations

Although cultural differences make it unlikely that employment rates will be identical irrespective of ethnicity, a shift to full employment is likely to bring the employment rates of different ethnic groups closer together. Indeed, it could be argued that an ambitious employment rate objective could not be achieved unless the employment rates of ethnic groups narrow.

Table 4.3
Employment rates by
ethnicity (%)

	2006	Future scenario	Change required (pp)
White	74	80	+6
Mixed	65	77	+12
Indian	69	78	+9
Pakistani/Bangladeshi	45	64	+19
Black	63	77	+14
Other ethnic groups	58	75	+17

Source: ONS Labour Force Survey and authors' calculations

Employment rates of those with the highest qualifications are already very high and it might be difficult to increase them much more. Any move to a significantly higher employment rate will, therefore, necessitate large increases in the employment rates of those with low or no qualifications – or alternatively, and preferably, a large reduction in the proportion of the workforce that falls into these categories.

Table 4.4
Employment rates by
highest qualification (%)

	2006	Future scenario	Change required (pp)
NVQ Level 5	89	90	+1
NVQ Level 4	86	90	+4
NVQ Level 3	79	85	+6
NVQ Level 2	80	85	+5
NVQ Level 1	74	84	+10
No qualification	54	75	+21

Source: UKCES (2011) and authors' calculations

Full employment might be said to have only been achieved when the same employment rate exists across all regions of the UK. An alternative scenario, which involves a halving of current differences between the employment rate in the south east and in other regions, is presented in table 4.5.

Table 4.5
Employment rates by
region (%)

	2006	Future scenario	Change required (pp)
North East	69	78	+9
North West	71	79	+8
Yorkshire and the Humber	72	80	+8
East Midlands	74	81	+7
West Midlands	71	79	+8
East	75	81	+6
London	68	78	+10
South East	77	82	+5
South West	76	82	+6
Wales	69	78	+9
Scotland	74	81	+7
Northern Ireland	67	77	+10

Source: ONS Labour Force Survey

Targeting employment rather than unemployment

When governments in advanced economies have set explicit targets for the labour market, they have generally chosen to do so by reference to unemployment. For example, the Federal Reserve still has a mandate to deliver low inflation and low unemployment in the United States. And there is talk in the UK of the monetary policy committee adopting, probably temporarily, an informal target for unemployment – or at least making a commitment not to increase interest rates until unemployment has fallen below a certain rate.

This is a throwback to the postwar 'Keynesian' era, when governments tried to manage the economic cycle, mainly through fiscal policy, so as to keep unemployment low. Policy is set so that growth is sufficient to allow any spare resources in the economy – particularly spare resources in the labour market – to be put to work. It is, therefore, aimed at ensuring the demand for labour is sufficient to match the supply.

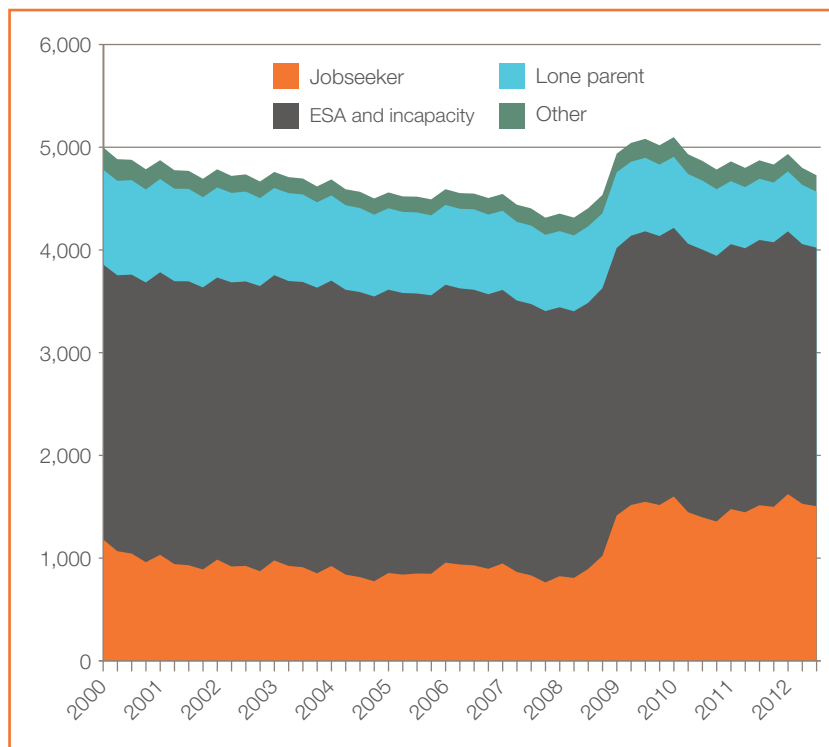
This is not a bad approach, and at the present time – when unemployment in the UK is around 1 million higher than it was before the recession began in 2008 – it has much to commend it. If a large proportion of the 2.5 million people who are looking for work in the UK were in employment, they would be materially and psychologically better off, the economy would be stronger and the government would find it much easier to get to grips with its fiscal deficit. Preventing long-term unemployment by aggressively responding

to increases in short-term unemployment is also the best way of heading off the risk of hysteresis (an increase in inactivity).

Unemployment is, however, an imperfect measure of slack in the labour market. There are over 1.4 million people in the UK currently working part-time who say they are doing so because they cannot find full-time work.¹⁴ This underemployment represents wasted resources just as much as unemployment does. There are also 71,000 people who are neither in work nor looking for work because they are discouraged from doing so, presumably by the lack of opportunities. And an unknown proportion of the 1.37 million people aged under 64 who are retired will have done so because they too despaired of ever finding work.¹⁵

The limitations of unemployment as a target measure are also revealed by the fact that, despite 15 years of uninterrupted growth before the recent financial crisis and a fall in the unemployment rate to below 5 per cent in 2004 and 2005 (for the first time in 30 years), the number of people in the UK claiming out-of-work benefits never fell below 4 million. A policy of targeting a big drop in the numbers claiming such benefits is equivalent to a policy of targeting a significantly higher employment rate in the medium term (unless claimant reductions are achieved by cutting eligibility).

Figure 4.1
Numbers claiming out-of-work benefits ('000s)



Source: ONS labour market statistics

14 See the latest release of the ONS labour market survey: <http://www.ons.gov.uk/ons/rel/lms/labour-market-statistics/april-2013/statistical-bulletin.html>

15 Some of these people will be women who have reached the state pension age, but there are 456,000 men in this category.

The crucial difference between a target for the unemployment rate and a target for the employment rate is that the former focuses on ensuring that demand for labour is sufficient to match supply, while the latter has the additional aims of increasing both the supply of and demand for labour. Structural unemployment and inactivity, as well as cyclical unemployment, are targeted.

However, specifying an employment rate target is not without its definitional problems. The employment rate is usually measured as the number of people aged 16 to 64 in employment as a percentage of the total population in the same age group. This creates problems at both ends of the age spectrum. Young people in full-time education count as employed if they have a part-time job, and as not employed if they do not. So an increase in the proportion of a cohort of the population that are full-time students without work, which might well be the result of deliberate policy action, would – other things being equal – lead to a fall in the employment rate, which, if this was a target variable, would suggest it was undesirable. Meanwhile, increases in the state pension age mean that the upper limit of 64 – which has in any case historically only been appropriate for men – will no longer be the right cut-off point.

These problems are not insurmountable. An employment rate target could be based on the population excluding those in full-time education from the numerator and denominator and including men and women up to their respective state pension ages only. But they illustrate how introducing an employment rate target at a time, for example, when the state pension age is being increased, might not be as straightforward as it appears.

There are other reasons for thinking that a formal employment rate target might not be the best approach. First, governments in the postwar era up to the 1970s did not have an explicit target, or even an official view, of what full employment meant in a statistical sense; but they still achieved full employment – in the then-understood sense of low unemployment – throughout this period. If voters and politicians buy into the arguments behind adopting full employment as a principal aim of economic policy, governments might not need a formal target to drive their actions. Second, while an inflation target has the advantage of making low inflation easier to achieve because it anchors expectations, there is little reason to believe that an employment rate target would serve the same purpose. Third, it would be a waste of time and effort to come up with a new technical definition of full employment if most economists and other commentators continue to use recognised ideas like a 4 or 5 per cent unemployment rate to judge the performance of the labour market. Fourth, targets that can only be achieved at some unspecified time in the future lack credibility. This lack of credibility would be increased by comparisons with the government's target for eliminating child poverty, which it is widely accepted will never be met. Fifth, politicians are likely to be wary to commit to a target before they know they can achieve it.

The alternative would be to adopt the rhetoric of full employment and to commit to policies designed to deliver it, without specifying precisely what full employment means. This would represent a return to the economic priorities of the postwar period, but with a notion of full employment being a high level of the employment rate rather than a low level of the unemployment rate. However, politicians would find it awkward not to be able to answer the question, 'What do you mean by full employment?'. A recognisable number – like the inflation target – gives greater clarity to the direction of policy and allows for an assessment of how well policies are performing in facilitating progress towards its achievement.

A clear vision of what full employment would look like could also help to mobilise opinion in favour of the policies the government needs to put in place to achieve an employment rate well above its previous peak of 73 per cent, to ensure that fewer people are claiming out-of-work benefits and to deliver higher real wages – and ultimately it is having these policies in place that is important. The government should, therefore, adopt a definition of full employment as an unemployment rate below 5 per cent and an employment rate of 80 per cent for the non-student, working-age population.

If these levels were reached, there would be great benefits to the economy, not least in terms of higher household incomes and stronger public finances. The extent of these benefits will depend on precisely how full employment is achieved, in terms of the pay and job quality associated with new employment opportunities and how they are spread across individuals, families and places. A follow-up paper to this report will present the results of an analysis of the impact on the public finances and on household incomes of different full employment scenarios. It will also set out a number of strategic policy priorities for advancing towards full employment and putting it at the heart of economic and social policy. In particular, it will examine the policies needed to make progress on the demand for labour as well as the supply, recognising that a high employment rate will require policies focused on increasing the employment chances of disadvantaged groups (and regions) where activation policies alone will not do the trick.

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APPENDIX

Table A1.1
Full-time and part-time
working, 2006 ('000s)

	Total	Full-time	Part-time
20–24: total	2,700	2,110	587
20–24: male	1,444	1,213	230
20–24: female	1,256	898	357
25–49: total	17,157	13,568	3,584
25–49: male	9,229	8,810	417
25–49: female	7,928	4,758	3,166
50+: total	7,595	5,217	2,371
50+: male	4,204	3,526	674
50+: female	3,390	1,691	1,697

Source: ONS labour market statistics

Table A1.2
Employment by
occupation, 2006
(% of total)

	Total	Male	Female
Corporate managers and directors	6.9	9.1	4.3
Other managers and proprietors	2.7	2.9	2.5
Science, research, engineering and technology professionals	4.7	7.3	1.8
Health professionals	3.7	1.8	6.0
Teaching and educational professionals	4.6	2.9	6.6
Business, media and public service professionals	4.7	5.3	4.0
Science, engineering and technology associate professionals	1.8	2.6	0.9
Health and social care associate professionals	1.3	0.7	1.9
Protective service occupations	1.2	1.8	0.5
Culture, media and sports occupations	1.8	2.1	1.5
Business and public service associate professionals	7.1	7.3	6.9
Administrative occupations	9.3	4.7	14.7
Secretarial and related occupations	3.3	0.5	6.5
Skilled agricultural and related trades	1.1	1.8	0.3
Skilled metal, electrical and electronic trades	4.3	7.9	0.1
Skilled construction and building trades	4.2	7.6	0.1
Textiles, printing and other skilled trades	2.2	2.8	1.6
Caring personal service occupations	6.2	1.4	11.8
Leisure, travel and related personal service occupations	2.0	1.2	2.9
Sales occupations	6.5	4.0	9.4
Customer service occupations	1.9	1.2	2.7
Process, plant and machine operatives	3.4	5.0	1.6
Transport and mobile machine drivers and operatives	3.9	6.9	0.4
Elementary trades and related occupations	1.9	2.7	0.8
Elementary administration and service occupations	9.3	8.5	10.1

Source: ONS labour market statistics

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