The return of full-employment economics

Full employment has come to be regarded as dangerous and outdated. **Graeme Cooke** and **Tony Dolphin** reject this assertion and argue instead that full employment is the most plausible strategy for raising living standards and adequately funding our public services.

For 30 years after the second world war, maintaining full employment (for men) was the principal aim of economic policy in the UK, shared by both Labour and Conservative governments. Keynesianism was dominant, with even small rises in unemployment triggering tax cuts or public spending increases to boost demand in order to bring the jobless total back down. This approach was startlingly successful: unemployment rarely rose above 2 per cent, underpinning an era of rising and broadly shared prosperity.

However, this political consensus dramatically collapsed during the 1970s. A period of stagflation (high unemployment coexisting with high inflation) fatally undermined the economic logic of Keynesian remedies. At the same time, a resurgent group of economic liberals and free-market thinkers sharpened this critique of the post-war consensus. Turning it on its head, they claimed that the pursuit of full employment was counterproductive because it risked choking off the conditions for free enterprise that were essential to creating jobs. The priority, instead, was to control inflation and the money supply, even if this increased unemployment in the short term. This intellectual movement found political expression in the Conservatism of Margaret Thatcher, and low and stable inflation became the bedrock of macroeconomic policy from the 1980s. Full employment was not just downgraded as a goal; it was seen as dangerous and damaging.

Under Tony Blair and Gordon Brown, there was a change in tone and policy detail, but the pre-eminence of price stability as the macroeconomic goal remained. The Labour government's aspiration was to lower unemployment and increase the employment rate, with a policy focus on macro stability and improving the 'employability' of individuals. Both were achieved – up until 2008 – with some notable successes, such as a large rise in the employment rate of lone parents. However, government policy was not systematically aimed at boosting employment.

Even at the peak of the boom during the 2000s, unemployment remained well above its earlier lows. Indeed, unemployment has been higher in every year since 1975 than it was in any year between 1945 and 1975. This represents a massive loss of potential output and a huge waste of human potential. It has meant lower living standards for millions of people and piled costs onto society running to billions of pounds.

Figure 1

UK POST-WAR CLAIMANT COUNT UNEMPLOYMENT RATE (%)

Source: Bank of England[1] and Office for National Statistics[2]. Figure for 2013 projected on the basis of data to September.
Note: Data comparable to the favoured Labour Force Survey measure is not available prior to 1971

It is time to make full employment once again the central aim of economic and social policy. This should be defined as an employment rate close to the highest levels seen in the OECD – around 80 per cent – alongside very low unemployment. At this level, the labour market would be much more inclusive, with a narrowing of the gap in employment rates between men and women, between London and the south-east and the rest of the country, between different ethnic groups, between those with low or no qualifications and the rest of the population. There would be work for those who wanted it, leaving only frictional unemployment.

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We recognise how ambitious this goal would be. Despite the relative resilience of the UK labour market, an extra million jobs need to be created over the next five years simply to lift the employment rate back to its pre-recession level of 73 per cent.[3] If the employment rate was 80 per cent now, almost 3.5 million more people would be in work. Nevertheless, in this essay we set out both why we think full employment matters and also how it is achievable in the UK.

1 Bank of England (2010) 'The UK recession in context — what do three centuries of data tell us?', data annex. http://www.bankofengland.co.uk/publications/Documents/quarterlybulletin/threecenturiesofdata.xls (no password required)
2 Office for National Statistics (2013) 'Labour Market Statistics, October 2013', 16 October 2013. http://www.ons.gov.uk/ons/rel/lms/labour-market-statistics/october-2013/statistical-bulletin.html
3 After allowing for likely population growth in the coming years.

THE NEW CASE FOR FULL EMPLOYMENT

The economic turmoil of recent years should prompt a more fundamental rethink about the role of employment in the architecture of a resilient and prosperous economy. Previous assumptions have been found wanting: the instability of the last five years and the high unemployment of the last 30 demonstrate that the idea that low inflation is the sole or central condition for economic growth and job creation is flawed. Indeed, a higher employment rate in the 1980s and 1990s would arguably have better protected the economy from its exposure to the recent crisis, as it would have implied lower personal debt, more stable tax revenues and higher domestic demand for non-financial output. Full employment is also part of the answer to some of the big challenges facing the British economy today: it is the most plausible strategy for raising living standards, controlling public debt, and financing public services and the welfare state over the next decade.

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Based on recent experience, it is hard to argue that the pursuit of full employment would be economically dangerous. Over the last two decades, the trade-off between unemployment and inflation has been weak, with the former varying between three and 10 per cent while the latter has remained consistently low. In fact, fluctuations in inflation have been largely the result of shifts in global commodity prices, with little to suggest that pursuing a very low unemployment rate would create such pressures in the domestic labour market. This is not hard to explain: wage bargaining is far more decentralised, trade unions considerably weaker, the economy more internationally oriented and the labour supply much more flexible now than it was in the 1970s. If there is a natural rate of unemployment – below which inflation starts to accelerate – it is likely to be below 3 per cent (on the claimant count measure).[4]

The more important trade-off is between employment and productivity, and thus real wages. In the last few years, headline employment in the UK has increased by more than economists expected, given the weakness of output growth. This has been attributed (at least in part) to falling real wages, which have allowed firms to employ more workers, albeit with a consequent fall in productivity. There has also been a very large increase in 'underemployment'.[5] It may be that the risks now associated with a proactive employment policy are low productivity and low wages rather than high inflation. Full employment on the basis of high levels of low-quality work would be a pyrrhic victory – not least because of the high public subsidy through in-work benefits it would imply.

In the short term, it is very likely that higher employment would mean productivity growth remains weak, because of the characteristics of the people who would be brought into the workforce. In 2009, only half of those with no qualifications were in employment, compared to three-quarters of

4 Equivalent to about 5 per cent on the Labour Force Survey measure.
5 NIESR (2013) 'Underemployment in the UK', 2 May 2013. http://niesr.ac.uk/press/underemployment-uk-11285#.UneaiC1FBoB

those qualified at level 2 and five in six of those qualified at above level 4.[6] Indeed, the TUC estimates that almost 80 per cent of net job creation since June 2010 has taken place in industries where the average wage is less than £7.95 an hour.[7] However, for people with only low-level skills, bad jobs are better than no jobs.

We can be more ambitious case in the medium term. Maintaining labour demand and as expanding labour supply will act to squeeze up wages. Research has found that real wages have become much more sensitive to unemployment since 2003, suggesting that a tighter labour market is an essential precondition for rising pay.[8]

In addition, investing in infrastructure, research and development, productive capacity and the skills of the workforce can boost productivity. Indeed, international economic pressures will make it implausible for the UK to pay its way through low-productivity, low-cost manufacturing and services.

If a higher employment rate forced up wages, this would have a major impact on the public finances as well. IPPR's analysis shows that if real earnings were to grow by 2 per cent in 2013/14, tax credit and benefit spending would be £1.1 billion lower and income tax and national insurance receipts a massive £12.5 billion higher than if real wages fall by 1.5 per cent, as is predicted by the Office for Budget Responsibility. This alternative outcome would make a significant contribution to securing the public finances and increasing living standards. We found that increasing the employment rate from its current level of 71.5 per cent to 73 per cent would deliver a net gain to the exchequer of £5.5 billion. Spending on tax credits and benefits would fall by £2.4 billion a year, while income tax and national insurance receipts would rise by £3.1 billion, making a major contribution to controlling the welfare budget, reducing the deficit and helping to fund vital public services.

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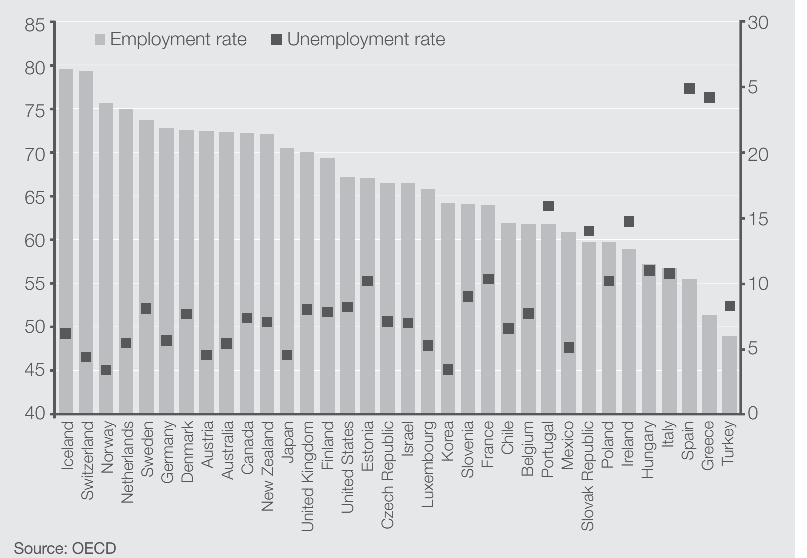
COMPARATIVE INSIGHTS ON FULL EMPLOYMENT

Another compelling reason for thinking that full employment is neither risky nor impossible is found in the record of other advanced, industrialised nations. As figure 2 shows, countries with a variety of economic models – the Scandinavian economies; Germany, Austria, Switzerland and the Netherlands; Australia, Canada and New Zealand; and Japan – all have higher employment rates than the UK. Indeed, despite recent jobs growth, the employment rate for those aged 16 to 64 in Britain remains below its pre-recession peak, after averaging 73 per cent over the five years prior to the recession and having reached similar peaks in the two previous cycles.

6 UK Commission for Employment and Skills (2011) *UK Employment and Skills Almanac 2010*, London. http://www.ukces.org.uk/publications/er26-skills-almanac-2010
7 TUC (2013) 'Four in five jobs created since June 2010 have been in low-paid industries', press release, 15 July 2013. http://www.tuc.org.uk/economic-issues/labour-market/four-five-jobs-created-june-2010-have-been-low-paid-industries
8 Gregg P and Machin S (2012) *What a drag: The chilling impact of unemployment on real wages*, London: Resolution Foundation. http://www.resolutionfoundation.org/media/media/downloads/What_a_drag_1.pdf

Figure 2

EMPLOYMENT AND UNEMPLOYMENT RATES ACROSS THE OECD (2012, %)



Source: OECD

Looking comparatively, four models of high employment rates stand out. First is the United States, which has a dynamic job-creating private sector with minimal labour market regulation but also a high level of low-paid work (overwhelmingly in the service sector). Second is Japan, which relies on an extremely productive, manufacturing-oriented export sector to subsidise an inefficient domestic service sector (in the context of substantial state-led economic coordination). Third are the Scandinavian countries, which marry high degrees of openness to trade and investment with high levels of public sector employment (supported by relatively high taxation). Fourth are countries like Germany and the Netherlands, which combine competitive export sectors with social investment welfare states and collaborative labour market institutions that involve the state, employers and unions (albeit with significant recent growth in the share of low-paid work).

There are some fairly obvious reasons why these approaches – in isolation – are either impossible or undesirable in the UK. However, each has important lessons. Taken together, the international lessons imply that a plausible strategy for full employment in this country will require the creation of more innovative, job-creating private sector firms, especially outside of London and the south-east. It will require increasing levels of investment and openness to trade, especially with emerging markets. It will require social investment spending to be prioritised, alongside labour market policies that reduce inactivity. It will require that care needs arising from demographic and gender change are socialised (in the public and private sectors). And it will require the development of institutions capable of brokering and coordinating employer, workforce and public interests, increasingly at the city or sector level.

Another clear international lesson is that achieving a high overall employment rate will require bringing into the workforce many people who are currently underrepresented.[9] This includes those living in regions outside London and the south-east, those with low or no qualifications, mothers with young children, people with disabilities, and certain ethnic groups. A higher employment rate means a more inclusive labour market, though this will require it to be more flexible for employees, not just employers.

A STRATEGY FOR FULL EMPLOYMENT OVER THE NEXT DECADE

A plausible strategy for pursuing full employment will look very different today than it did in the postwar decades. It will not be based on attempts to fine-tune the economic cycle through changes in tax and spending. Instead, it means prioritising job creation and employment promotion across a range of policy areas, as we set out below.

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Taken together these policy directions could make full employment a reality, though there will be significant headwinds. Pressure on the public finances limits the scope for public sector employment, although rising demand for health, education and personal care services will generate jobs, even if more are in the private sector. Globalisation will continue to cause some jobs to migrate to other countries, although it will also open up new markets for UK firms. Technological change will reduce demand for employees in some occupations and industries, although it will create new opportunities in others.

However, economic theory and international lessons suggest substantial progress can be made, in particular in the following five areas.

1. Entrenching pro-employment monetary policy

The Bank of England's Monetary Policy Committee (MPC) has issued 'forward guidance' to the effect that interest rates will not increase before unemployment falls to 7 per cent (unless there is a significant increase in inflation pressures). This is designed to be a one-off measure but should be entrenched permanently. The government should instruct the MPC to give equal weight to employment and inflation, as does the Federal Reserve in the United States. It should strive to keep unemployment as close as possible to its natural rate while at the same time keeping inflation close to its target rate.

Minimising the risk of an increase in cyclical unemployment is crucial because it reduces the possibility of hysteresis (people who are unable to find work becoming discouraged and quitting the labour market altogether). Monetary policy should be the main tool for achieving this aim. However, should the UK again find itself with a very high level of cyclical unemployment and no scope to cut interest rates, the potential for fiscal measures to support growth and employment should be utilised. This

9 Some groups – male graduates living in the south for example – already have very high employment rates that cannot be increased much further.

requires a new fiscal framework that reduces debt over the medium term while building in the possibility of a discretionary, temporary tax cut or increase in capital spending in response to any future sudden increase in unemployment.

2. Driving up job-creating business and capital investment

The job creation needed to achieve full employment will be largely a task for private sector firms, but government policies can support them. For example, obtaining finance is a significant longstanding constraint on private investment and expansion. Establishing a British investment bank and increasing competition in banking would help to tackle this problem. Government also needs to ensure that the necessary infrastructure is in place and that people entering the workforce have the right skills. The government should also look at the composition of its spending. For example, our failure in recent years to build sufficient houses to meet demand is pushing up prices and rents and adding to the housing benefit bill. More money should be spent building houses, thereby creating jobs, which will eventually lead to a lower benefit bill.

Policymakers in the UK have used the country's bad experience with industrial policies in the 1970s to justify a largely hands-off approach. Meanwhile, other countries – even the United States – have supported industries where they have a competitive advantage. In the last few years there has been a growing recognition in the UK that when the government has become involved in supporting a sector – such as encouraging foreign direct investment in the car industry – it can be successful in generating good jobs. However, action remains piecemeal: it needs to be turned into an active industrial strategy.

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This should focus on identifying those sectors of the economy where the UK has an actual or latent competitive advantage and where there is the possibility of jobs-rich expansion, and then designing the right set of sector-specific policies to support them. Such sectors might range from the high-value-added manufacturing industries like automobiles and aerospace that the UK needs to boost exports and rebalance the economy, to domestic sectors like care for the elderly, where demand is certain to increase.

3. Prioritising social investment in public spending

A key test for the next spending review should be the impact of different elements of public expenditure on employment. This would mean prioritising social investment spending in two areas. The first is childcare and social care services that enable those with caring responsibilities (often women) to stay connected to the labour market while also generating jobs. Evidence suggests that such services are most efficiently – and equitably – financed through collective pooling of risk, even if they are delivered across the public, private and voluntary sectors.[10] High-quality early years provision also increases the chances of later success at school, thereby raising overall human capital.

10 Lloyd E and Penn H (2012) *Childcare markets: can they deliver an equitable service*, Bristol: Policy Press

The second area to prioritise is back-to-work support, to improve the efficiency of the labour market and bring those who are currently inactive closer to employment. In the UK, the school-to-work transition should be a particular focus, given the large number of young people who lack decent qualifications or work experience. Learning from countries like the Netherlands and Denmark, the aim should be a distinct work, training and benefits track for young people that is separate from the adult welfare system and designed to prevent the drift into long-term inactivity.[11]

To fund these priority areas, difficult decisions must be taken to hold down the growth in expenditure on income transfers. Similarly, it will be necessary to continue gradually increasing the state pension age, to control its cost and encourage older workers to stay in employment longer.

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4. Mobilising cities to lead jobs growth and labour market institutions

In some parts of the country, the private sector has not been able to adapt quickly enough to the effects of rapid technological change and globalisation. This has caused job losses in some industries and occupations, and the closing down of production capacity in others. Often, this is because there are barriers to growth or insufficient incentives to invest. To overcome these problems, the UK should devolve power and resources to the regions, for example in the areas of transport, skills and welfare-to-work provision and funding, so that they can deal with local barriers to growth and stimulate their own economies by supporting innovation, investment and infrastructure upgrades.

If responsibility for revitalising the regions and lifting their employment rates is to be placed with local authorities, local enterprise partnerships (LEPs) and other local bodies, they will need to be given greater fiscal autonomy. Subnational agencies in the UK control just 12 per cent of their revenues, compared to an EU average of 40 per cent. Aligning spending decisions about economic development and employment with revenue-raising powers would create a virtuous circle. Successful policies to boost growth and employment would lead to higher revenues and so more funds to improve economic performance even further.

5. Bolstering the chance of work for those facing disadvantages

For some people who face significant labour market disadvantages, large-scale and standardised back-to-work support is ineffective at helping them to access employment.[12] Even when such programmes are able to improve their 'employability', those with a pre-existing disability or health condition look relatively less attractive to prospective employers. This can be the result of unacceptable discrimination. But sometimes it is reasonable, if the individual's productivity is lower or their risk of future absence from work is higher. Ex-offenders and those with a drug or alcohol addiction may also fit into this category.

11 Cooke G (2013) *No more NEETs: A plan for all young people to be learning or earning*, London: IPPR. http://www.ippr.org/publication/55/11516/no-more-neets-a-plan-for-all-young-people-to-be-learning-or-earning

12 For latest figures, see https://www.gov.uk/government/collections/work-programme-statistics--2

Experiments should be undertaken on the use of 'demand-side' strategies to more actively promote employment for those who are likely to face labour market disadvantage. Such 'incentives to hire' could include a structurally lower rate of national insurance contributions or the state taking on liability for sickness absence (for temporary periods). Similarly, for those who have been looking for work for a long period, society should provide paid work carrying out tasks of social value. Entrenching this kind of intermediate labour market programme as a 'backstop' to back-to-work support would place an upper limit on the duration of unemployment.

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THIRD-GENERATION EMPLOYMENT POLICY

In this essay we have set out a 'third generation' of postwar employment policy. The first attempted to pursue full employment through managing demand, in the context of a highly regulated and relatively closed labour market up to the 1970s. This ultimately meant that 'insiders' benefited relative to 'outsiders' and inflationary pressures built up. The second – Labour's post-1997 policy of boosting workforce skills and activation – avoided these problems, but opened up others. Insufficient attention was paid to matching rising skills with shifting employer demand, and the absence of policies to explicitly raise and shape the demand for labour, beyond ensuring macroeconomic stability, will have discouraged some from seeking to enter the labour market. The third-generation policy would boost the demand for labour while simultaneously expanding labour supply. In this way, it would avoid the problems encountered by previous policies and enable the UK economy to reach levels of employment and a degree of inclusion in the labour market higher than it has ever experienced before.

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