Flexible with the Truth?

Exploring the Relationship between Labour Market Flexibility and Labour Market Performance

A Report for the TUC

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Views expressed in this report are the author's own and not statements of TUC policy

Executive Summary

This report looks in detail at the relationship between labour market flexibility (LMF) and economic performance. It is designed to inform the TUC ToUChstone pamphlet *Will labour market regulation prevent economic recovery?*

Between the early 1980s and the mid-1990s, the orthodox policy stance known as "neoliberalism" became the dominant policy view in most developed economies. The OECD's 1994 *Jobs Study* was typical of this approach, stressing the role of LMF as an essential precondition of economic success for developed economies. But since the late 1990s there has been a partial retreat from neoliberal orthodoxy, as a growing body of research suggested that the idea that there was some simple positive relationship between the flexibility of a country's labour market and its economic performance was simply not supported by the empirical evidence.

One might have thought that the implosion of global credit markets and the ensuing economic crisis would drive the final nail into the coffin of the orthodox economic prescription for success, but paradoxically the crisis has presented an opportunity for supporters of labour market deregulation to make a comeback. Neoliberal commentators argue that highly regulated labour markets perform reasonably well during boom periods but cannot cope with recessions – and that therefore the UK and other developed economies need to deregulate their labour markets to ensure a strong economic recovery (even though the UK already has one of the most deregulated labour markets in the developed world).

The aim of this report is to respond to the proponents of further deregulation by asking firstly whether there *is* any relationship between LMF and economic performance; and secondly, if there is a relationship, does more regulation mean worse economic performance? Or can increased regulation *improve* economic performance in some circumstances?

What is labour market flexibility?

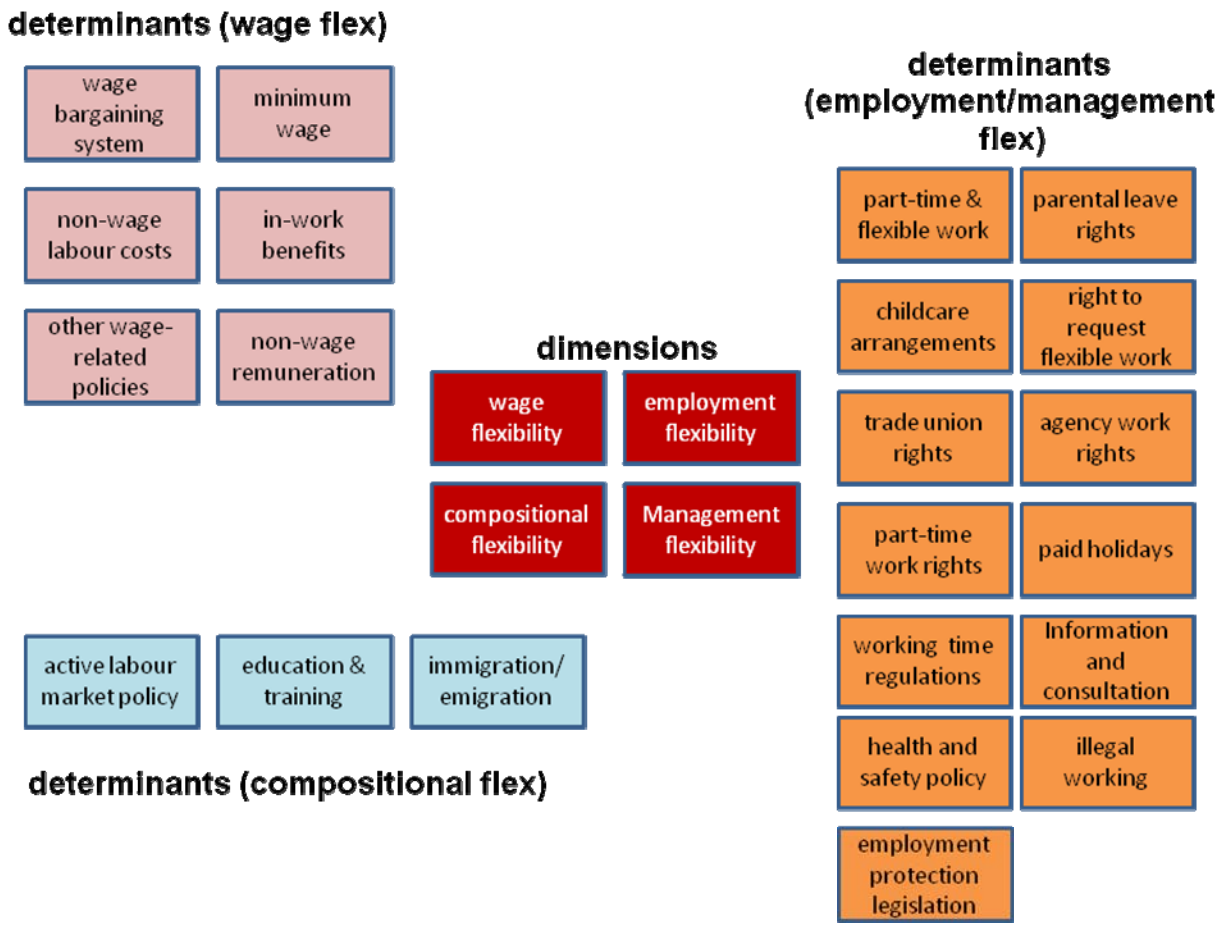
We can view LMF as comprising four **dimensions**:

i) **wage flexibility** – how free wages are to adjust.
ii) **employment flexibility** - the extent to which workers are free to adjust employment, and to choose whether to work or not, and how many hours to work.
iii) **Management flexibility** - the extent to which managers are free to manage the employment relationship, including the role and functions workers perform in the workplace, their shift patterns, etc.

iv) **Compositional flexibility** – the extent to which the composition of employment according to geographical location, industry, occupation, skill or nationality of worker is free to adjust.

Figure 1.2 (reproduced below) shows a schematic representation of twenty-two different **determinants** of wage flexibility, divided into three groups: factors which mainly affect wage flexibility, factors which mainly affect compositional flexibility and those which mainly affect employment and/or management flexibility.

Figure 1.2. Schematic representation of the determinants and dimensions of labour market flexibility



There are two broad approaches to how to assess LMF, and its desirability, from the viewpoint of economic theory. One is the "orthodox" view, an extreme form of neoclassical economics broadly associated with the right of the political spectrum. The central assumption of the orthodox view – is that the labour market is characterised by *perfect competition* and there are no labour market frictions – e.g. workers can move from one job to another costlessly. The implication of the orthodox assumptions is that most (though not all) forms of labour market regulation are either pointless or counterproductive. For example, employment protection legislation will introduce artificial frictions in to the labour

market by making it harder for workers to move from one job to another, and is likely to reduce employment levels.

The other approach – or more accurately, an umbrella of approaches – is the “progressive” view, which has a more positive outlook on labour market regulation. Some progressive economists remain within a neoclassical framework but modify it by assuming *imperfect competition* rather than perfect competition. This transforms their policy recommendations; it can be shown that many forms of labour market regulation such as minimum wages, working time regulations, trade unions and active labour market policies actually *improve* either economic efficiency or can lead to a more equitable distribution of earnings. Other progressive economists take the more radical step of jettisoning neoclassical economics completely and using different models instead. This report makes no judgement as to which progressive critique of orthodoxy is the “right” one, but shows instead that both the progressive neoclassical and radical approaches to the labour market are useful for analysing labour market flexibility in a more realistic setting than that attempted by orthodox economists.

It is also important to be clear on from whose perspective – employers or employees – the labour market is being measured. In many (although not all) aspects of the employment relationship, employer and employee interests stand in opposition to one another; an initiative that increases flexibility for the employer may reduce it for the employee, and vice versa. The neoliberal view that there is a diametric opposition between LMF and labour market regulation only makes sense seen from an employer perspective – and an unsophisticated employer at that. From the employee perspective, regulation can actually *enhance* labour market flexibility across several dimensions.

Defining economic performance

The empirical research examined in this report uses several different measures of economic performance. Variables which are obvious indicators of labour market performance include:

- Labour market status – employment, unemployment and inactivity.
- Earnings and productivity.
- Subjective measures of job satisfaction and security.

Wider measures of economic well-being include:

- Overall national income or output.
- Other production-related economic measures such as investment, profitability, innovation and skills acquisition.
- The price level.
- Well-being measures which are subjective (e.g. happiness) or which combine subjective and objective assessments (e.g. health).
- Social justice or fairness.

- Income inequality.
- Environmental quality or outcomes.

Macroeconomic evidence on the relationship between LMF and economic performance

The simplest macroeconomic evidence involves **two-way graphs** ("scatterplots") of a particular measure of labour market flexibility (e.g. an employment protection index, or trade union density) against a particular measure of labour market performance (e.g. the unemployment rate, or the rate of productivity growth over a certain period of time) for a selection of countries. Graphs of this type are used widely in research on labour market flexibility (for example, by OECD in their annual *Employment Outlook*.) However, they are of limited usefulness because they do not control for any other factors which might affect labour market performance – given the limitations of this method it would be rash to rely on it as any kind of definitive guide to policy. This report uses two-way graphs to examine the relationship between two different measures of labour market flexibility (the OECD's index of employment protection and trade union density) and several different measures of labour market performance (including the employment rate, the unemployment rate, the level of productivity, and changes in productivity). In general, we find no strong relationships between any of the LMF variables and any of the economic performance variables.

More sophisticated macroeconomic evidence on the relationship between LMF and economic performance uses **regression** techniques, normally based on cross-country panel data sets. A labour market or wider economic outcome is regressed on a set of measures of labour market flexibility or rigidity, control variables (e.g. macroeconomic indicators), plus (sometimes) country specific 'fixed effects' and/or time trends. The regression approach is far more sophisticated than two-way graphs but still suffers from drawbacks:

- The flexibility variables are often **poorly measured**. For example, employment protection (EP) has many different dimensions, and any single indicator inevitably throws away a lot of information about cross-country differences in institutional arrangements.
- It is difficult to establish that the **direction of causality** runs from labour market institutions to economic outcomes rather than the other way round. Labour market institutions are at some level the outcome of social or governmental choices rather than exogenous factors.
- Economic outcomes are the product of many other factors aside from labour market institutions e.g. product market structure, innovation, macroeconomic volatility, public infrastructure spending etc. Most of these are not controlled for in macro regressions and hence there is a danger of **omitted variable bias**.

Most regressions of this type use unemployment rates in OECD countries as the dependent variable. Our review of recent studies of this type shows that:

- the strongest effect found in the regressions is that countries with co-ordinated wage bargaining systems have lower unemployment controlling for other factors. This runs completely counter to the orthodox economic model.
- The 'tax wedge' on employees (i.e. overall employment taxes as a percentage of labour costs) is associated with higher unemployment, but the effect is relatively small. Also these results do not take account of what tax receipts are spent on: there is a lot evidence, for example, that tax-financed spending on transport infrastructure can *improve* economic performance.
- High levels of employment protection and generous unemployment benefit systems are positively correlated with unemployment in *most* of the surveyed papers, but not all of them; and the estimated effects are small.
- In the main, the results are not very robust to changes in the regression specification (e.g. the inclusion of interaction terms between the different regressor variables).
- Some of the most recent papers find that employment protection legislation is *negatively* correlated with joblessness and with labour market inactivity. Again, this finding runs counter to the orthodox model.
- Recent work looking at the determinants of productivity (rather than employment) finds a positive relationship between labour market regulation (particularly employment protection) and productivity growth. Again this runs counter to orthodox theory, although the effect is small.

Overall, the aggregate macro evidence for the orthodox proposition that labour market regulation has a negative impact on economic performance is mixed, at best. The results from the macro regressions are not very robust either, varying according to the precise set of variables included in the regressions (for example, whether interactions of variables, macroeconomic factors, country-specific fixed effects or time trends or time trends are used) or which particular measure of labour market performance is used.

A completely different approach to measuring labour market flexibility at the macro level is taken by Monastiriotis (2006) who instead uses data for the UK broken down by region and measures the extent of flexibility in each region according to data from the UK Labour Force Survey on use of flexible working arrangements between the mid-1980s and mid-2000s. He finds that flexibility in the UK economy increased between the mid-1980s and mid-1990s but has been declining since the mid-1990s – a view which is at odds with HM Treasury, which argues that LMF has increased since 1997. Monastiriotis's results from regressing regional unemployment levels on various flexibility indicators suggest that flexibility is *positively* associated with unemployment – contrary to the predictions of the orthodox economic model.

Micro-level evidence on the relationship between LMF and economic performance

Micro-level studies are in many ways preferable to macroeconomic evidence because they have the advantage of being able to control for other factors which might affect labour

market outcomes in a much more systematic fashion. This makes it easier to establish that causality runs from policies to labour market performance, rather than vice versa. However, the flip-side of this is that the results from micro-studies are not easily generalisable (except through 'meta-studies' which collate information from individual micro studies into a systematic review of the evidence), and for the most part micro-studies focus on the impact of *one particular policy* – so they can't normally be used to assess how different policies interact with one another. Thus, this section discusses micro-studies pertaining to individual policies separately.

Minimum wages

The orthodox labour market framework predicts that a minimum wage will reduce employment if set above the 'market-clearing' wage level. Alternative approaches based on imperfect competition in the labour market (e.g. Manning, 2003a) or the inequality of bargaining power between workers and employers (Kaufman, 2009) suggest, alternatively, that minimum wages can sometimes increase wages for the lowest-paid *without* a negative impact on employment. The latest empirical meta-analysis by Doucougliagos and Stanley (2009) using around 1,500 empirical estimates of the effect of minimum wages in the US finds that once publication bias (a phenomenon whereby minimum wage studies which produce negative employment effects are more likely to be published than those which produce no employment effects) is controlled for, the average estimated employment effect of minimum wages is almost exactly zero. It is likely (though not proven) that this result generalises to other countries. Recent research for the UK Low Pay Commission also finds no overall adverse employment effects of the increases in the National Minimum Wage between 2001 and 2006.

Employment protection legislation

The overall evidence on the impact of employment protection (EP) legislation is mixed. There is no overall agreement between studies of the impact of EP on productivity levels – the most likely pattern is an 'inverted U shape' where very low levels of EP reduce productivity growth, very high levels of EP also reduce it, and levels in between are best. EP also seems to have no strong correlation with subjectively measured job security or job satisfaction. The most robust result from the literature overall is that strong employment protection reduces the extent of job flows and job reallocation between different sectors of the economy. But it is not clear whether this leads to lower productivity or wage growth overall. There are good theoretical reasons for believing that a certain degree of employment protection may help preserve jobs where specific human capital is an important determinant of productivity – particularly when the macroeconomic environment is as volatile as it is at the moment. Given that the UK already has one of the lowest levels of employment protection of any developed country, it is unlikely that a substantial reduction in EP *starting from the level we are at now* would deliver drastically enhanced labour market performance. It could, instead, *worsen* performance. It could also be that reducing EP from where we are now could actually reduce productivity.

Family-friendly policies: childcare subsidy and provision, maternity and paternity leave, and flexible working

The existing literature suggests strongly that **childcare subsidies** boost employment for mothers, and assist women's re-entry into the labour market after having children. There is strong evidence that subsidised childcare has a role to play in reducing the gender pay gap between men and women.

Empirical evidence suggests that **paid maternity leave** increases the time that women spend out of the labour market immediately after giving birth, and increases the likelihood of women returning to employment after the leave period runs out. It also improves worker retention, has positive impacts on child health and a positive impact on mother's health outcomes. There is also some evidence that fathers who take parental leave are more involved in the care of their infants several months after the birth. Unpaid maternity leave has much less impact than paid maternity leave. There seems to be a dichotomy between 'good practice' and 'bad practice' employers in the UK, with some employers offering generous leave packages to staff while others offer just the statutory minimum.

The **right to request flexible working** is a 'soft' labour market regulation in that it gives employees the right to make a formal request for flexible working arrangements but employers can reject the request on a limited number of set business grounds. In orthodox labour market theory, this kind of regulation should have no impact on labour market outcomes, because if it does not adversely affect productivity, the assumption is that employees would already have been able to negotiate it themselves without government intervention – and if it does harm productivity, employers would just refuse the request. But in fact, survey evidence suggests that the right to request flexible working has revealed considerable previously unmet demand for flexible working, which many employees have taken advantage of – and most requests have been accepted by employers. This is powerful evidence that the orthodox model is not a good description of reality.

Flexible working patterns and working arrangements

Whereas the orthodox model assumes that workers have a free choice over the number of hours they work, figures from the UK Employee Work Life Balance Survey suggest that around 30% of employees are working more (or less) hours than they would like to. There is a substantial gap between the average hourly earnings of men and women (male full-time workers in the Annual Survey of Hours and Earnings are paid around 19% more than full-time women). Recent research shows that part-time women working full time have hourly earnings around 25% less than women working full-time, and the gap has widened greatly in the last thirty years. Much of the gap seems to be due to occupational segregation rather than differences in observable characteristics between full-timers and part-timers. Large numbers of women working part-time are working 'below their potential' – their jobs do not utilise their qualifications and skills effectively. Also, women returning to the labour market after having children also often end up in worse jobs than before they left and find it difficult to continue career progression (particularly in the private sector). The implication is that generous maternity leave provisions and employer flexibility about work

roles have a large role to play in reducing gender penalties and segregation in the labour market.

Overall, average hours at work in the UK have been trending downward since the mid-1990s. Research suggests a range of experiences among those who work especially long hours. Some workers are happy to do so whereas others appear to be less happy and suffer health impacts as a result. The Working Time Directive (which limits hours of work to a maximum of 48 hours per week for most workers who do not opt out) does not appear to have had a significant impact on the incidence of working long hours in the UK.

Trade Unions

The orthodox model of the labour market paints a negative picture of trade unions who (like minimum wages) are seen as causing additional unemployment by raising wages above their equilibrium level in union-covered sectors. However, progressive economists see a role for trade unions in raising wages *without* affecting employment if the labour market is imperfectly competitive, and also a potential positive 'voice' role in articulating workforce suggestions and grievances. Recent empirical research on the effects of trade unions on the labour market suggests that while the 'union wage premium' (the extent to which union members earn higher wages than non-members controlling for other factors) remains, it has fallen over the last twenty years, perhaps due to increased product market competition, a tougher bargaining stance by management, or the minimum wage taking over some of the functions of unions at the bottom of the wage distribution. Most research shows that unionised workplaces are also associated with a higher incidence of 'good practices' in the workplace (e.g. product and process innovations, reductions in incidence of disciplinary action, etc.)

Unemployment insurance, in-work benefits and active labour market policy

Orthodox labour economists believe that the more generous **unemployment insurance (UI) benefits** are, the less likely people are to be in work. This is because UI raises the "reservation wage" – the net income from work above which people find it worthwhile to enter work. But the available evidence suggests that the vast majority of people claiming UI want to work and are not deliberately avoiding work. More realistic labour market models which assume that job-search takes time and effort suggest that UI can sometimes enhance efficiency by providing workers with the resources to search for jobs more effectively and secure a better (i.e. higher-paying) job match. The empirical evidence is mixed. Macro evidence suggests (overall) a slight positive correlation between the generosity and duration of UI and unemployment levels. Recent evidence from German UI reforms suggests that tightening the *conditionality* attached to UI (i.e. enforcing job search conditions) is more important than the level of UI. But recent UK research on the introduction of Jobseekers Allowance in 1996 suggests that tightening conditionality can move people off UI into *inactivity* rather than employment. The Danish 'flexicurity' system which combines generous benefits with stringent job search conditions, time limits and relatively limited employment protection performs well in macroeconomic research looking at 'clusters' of policies which promote good labour market outcomes, and may be the 'best

of both worlds', achieving low levels of unemployment without cutting financial support to newly unemployed people.

One means of addressing the issue that out-of-work benefits like UI raise the reservation wage is to raise the level of *in-work* incomes using **in-work benefits** – an important feature of the UK system (most recently in the form of the Working Tax Credit). Provided they are well-designed and well-publicised, research evidence shows that in-work benefits do seem to have a positive overall impact on the employment rates of families with children (although it is important to take the interactions between first and second earners in the household into account, and there is some evidence that in-work benefits can *reduce* employment of second earners for couple households).

Most macro-regression evidence finds no significant impact of **active labour market policies** (ALMPs) on unemployment levels, but the extent and nature of ALMPs is poorly measured in these studies. ALMPs comprise a host of different policies, for example assistance with job search activity, employer subsidies to take long-term unemployed people, direct public sector job creation, training programmes or earnings supplements to provide financial support for work entrants. Evidence from North America, where these types of programme have the longest history, suggests that programmes that offer assistance with job-search, subsidised jobs or earnings supplements perform better than full-time education and training programmes in terms of promoting employment. The quality of evidence on UK ALMPs falls somewhat short of the North American evidence, as random assignment techniques (which are the most reliable way to evaluate policies of this kind) are commonplace in North America but rarely seen in the UK. Most UK evidence shows that the various New Deal schemes have had positive short run effects but shorter long-run effects. But there is a clear need for a more holistic approach to the evaluation of ALMPs in the UK.

Impact Assessments of Labour Market Regulations

Government departments and regulators are required to publish an **impact assessment** (IA) for every regulation they introduce. The IA involves cost-benefit analysis of the impact of each proposed regulation. Each year BIS publishes a summary of the data from the individual IAs showing the ratio of the costs and benefits of regulation across government. Analysis of labour market regulations for the financial year 2008-09 (HM Government 2009) shows a ratio of total benefits to costs of around 1.8 – which suggests that they are welfare-enhancing overall.

The interactions between labour market flexibility and other markets

This report also looks at the interactions between LMF and a selection of other markets in the UK economy, to demonstrate that labour market policies cannot be viewed in isolation, but need to take into account the interaction between the labour market and other markets.

LMF and product market flexibility

Some macroeconomic cross-country studies look at the relationship between labour market performance and measures of *product* market flexibility (PMF) as well as LMF. PMF refers to the degree of competition between firms in the product market. OECD work on the relationship between LMF and PMF finds that low levels of PMF are adversely correlated with labour market performance, although the effects are not large. However, other work produces more mixed results. There are good reasons for thinking that *some* degree of regulation enhances performance – many product markets have features that are inherently imperfectly competitive.

LMF and transport

The provision of affordable and accessible public transport represents one of the most obvious areas of physical infrastructure investment that can improve the operation of the labour market. Transport infrastructure investment reduces travel costs and should make labour markets "thicker" and more efficient. The existence of 'excess' commuting, whereby high numbers of workers commute from place A to place B at the same time as there are workers commuting from place B to equivalent jobs in place A, casts doubt on the orthodox view of the labour market, which would tend to predict one-way commuting only.

LMF and migration

The extent of migration into and out of the labour market is obviously an important aspect of how flexible the labour market is, yet migration is often omitted from LMF discussions. Whereas the flexibility debate has tended to see the political right arguing for increased flexibility at all costs and the centre and left being more balanced, on migration the right tends to argue for stricter controls on immigration (i.e. *less* flexibility) whereas the centre and left are mostly more positive about immigration.

Net migration into the UK has increased substantially since the mid-1990s. Critics of increased migration argue that it reduces wage levels and employment prospects for workers already living in the UK, places increase pressure on infrastructure and public services, and undermines social cohesion. However, recent empirical evidence on the wage and employment effects of migration into the UK finds overwhelmingly that they are small or non-existent. However, the system for funding local public services currently lacks sufficient flexibility to respond quickly to changes in population size in an area, which can lead to pressure on public services if in-migration to an area increases. Recent research finds that migrants make a net contribution to the public purse (through taxation) and to service delivery (by offsetting 'skills gaps' in UK regional labour markets and doing key public service jobs).

Labour market flexibility, the business cycle, recession and possible depression

Do business cycle conditions affect the case for labour market flexibility? *A priori*, critics of the orthodox labour market story might have thought that the current economic crisis – a product of three decades of neoliberalism – would discredit orthodoxy for good and usher in a more progressive approach to economic policy, including labour market regulation. However, orthodox commentators have instead used the sheer severity of the current crisis to argue that we need *more* deregulation to decrease unemployment. The idea behind this argument is that national economies can "get away with" labour market regulation when macroeconomic performance is strong, but not when it is weak.

The vast majority of evidence surveyed by this report suggests that these concerns are misplaced and the UK economy does *not* need to deregulate further to ensure economic recovery (indeed, further deregulation could impede economic performance). However, policymakers *do* need to be careful about the design of unemployment benefits. Ideally, benefits should be high enough to ensure that families can survive during the downturn, but "activation conditions" – i.e. job-search requirements and active labour market policy – help ensure that long term unemployment remains as low as possible. If long-term unemployment does rise it is important for the unemployed to be kept in touch with the labour market rather than shifted onto other benefits (which happened to an extent in the 1980s and early 1990s in the UK).

Labour market regulation is often seen as an exclusively 'supply-side' phenomenon. Orthodox macroeconomic policy (as practised by the European Central Bank and IMF, for example) is that monetary policy (the setting of interest rates) should be run in accordance with an inflation target, and Keynesian activist fiscal policy is unnecessary and ineffective. The current economic crisis has severely challenged this view. When interest rates hit a 'zero lower bound' (as has happened in most industrialised countries), monetary policy becomes ineffective. Standard monetary policy is based around the NAIRU (Non Accelerating Inflation Rate of Unemployment) model. The NAIRU is defined as the level of unemployment consistent with stable inflation, and that demand side stimulus can reduce unemployment only in the short run before increasing inflation becomes a problem. But recent empirical evidence casts doubt on the NAIRU model – it is unstable and tends to follow changes in actual unemployment rather than the other way round.

Some progressive commentators now argue that the ECB is partially to blame for average unemployment being higher in Europe than the US because the ECB does not take employment levels into account when setting interest rates (unlike the US Federal Reserve) but targets only inflation. It is possible that a dual ECB target of price stability and full employment (such as the Fed uses) would result in better European unemployment performance in the future. Similar reasoning suggests that the Bank of England Monetary Policy Committee which sets interest rates in the UK could also consider adopting a dual target.

Orthodox macroeconomic models assume that if unemployment exists in labour market equilibrium it must be because real wages are *too high*. However, as Keynes pointed out in

his *General Theory* of 1936, it may also be possible for unemployment to exist when wages are *too low* – because of insufficient *aggregate demand* in the economy (of which wages are a key component). There is tentative evidence that this may currently be the case in Ireland, which is now caught in a 'deflationary spiral' with wages, prices and consumer demand falling. An Irish fiscal stimulus in the short run – combined with some wage restraint to restore competitiveness in the Eurozone over the longer term as the global recovery kicks in – might be a better option than current 'hairshirt' policies.

Based on the latest available data, the recession of 2007-09 is the most severe contraction of economic activity for the UK since the 1930s, surpassing the early 1980s and early 1990s recession. However, the UK labour market seems to be performing much better in the current recession than it did either in the early 1980s or early 1990s. The rise in unemployment in this recession is much smaller compared with the fall in output, and economic inactivity has not increased at all. Unemployment has not increased so much this time round because average hours worked are decreasing. Partly this may be because unions and firms are negotiating temporary short-time working arrangements as a response to the fall in demand for goods and services in the economy. To the extent that these agreements enable workers to stay in jobs with their accumulated skills and experience and return to full-time work as the economy recovers, they are preferable to mass redundancies. But it is too soon to say how sustainable this approach is. The data *do not* support the view that the good performance of the labour market in the current recession is due to deregulation, because in many ways the labour market is *more* regulated now than it was in the early 1990s.

Labour market regulation and "high road" firm strategies

In previous research in 2002 the TUC characterised UK firms' choices of competitive strategies in the marketplace as "high road" vs. "low road". A "high road" strategy for business success involves combining high value-added product strategies, high levels of training and investment, high productivity and wage levels, and good workforce terms and conditions. Orthodox economists would assume that employers are already maximising profits and so there is no reason to discuss policy strategies to shift them to the "high road" – this should happen automatically. But more realistic models of the labour market and firm behaviour allow for multiple equilibria, where many firms could be pursuing a "low road" strategy that delivers reasonable profits to the firm but is sub-optimal for the UK as a whole (because economies dominated by "low road" firms perform worse on key economic outcomes than "high road" economies).

Firms choose the "low road" for a number of reasons: because of lack of management skill and training, because it is the "quick, low cost option", due to corporate governance pressures for short-term profitability, and/or due to weak trade unions and employee organisation. In 2002 the TUC recommended changes to corporate governance law and the implementation of the European Directive on Information and Consultation rather than focusing on labour market regulation. But there is evidence that labour market regulation can play a role in encouraging employers to take the "high road", although it probably

requires a more co-ordinated institutional framework (based on sectoral agreements between firms over policies like training) than is currently the case in the UK.

Government skills strategy and the high road

Since 1997 much of the UK's skills strategy has reflected a 'human capital' or skills-driven model of business development, based on the ideas that improvements in the skills and qualifications base of the population can secure a high productivity economy. This approach was exemplified by the Leitch Review of Skills in 2006. However, since then policy has increasingly recognised the importance of demand for skills, and the first report from the UK Commission for Education and Skills (UKCES) which was established as a result of Leitch's recommendations, *Ambition 2002: World Class Skills and Jobs for the UK*, is more balanced, arguing that *both* the supply of skills and the demand for skills are important. The report finds evidence of a growing mismatch between the numbers of high skilled people and the number of jobs in the UK which require high skills, with increases in the supply of skilled workers outstripping the increase in the demand for skilled jobs (a pattern not seen in most other OECD countries). The report suggests this could lead to a future 'over-supply' or 'deficient demand' for high level skills.

Recent research on the wage premium for graduates also finds that while the overall wage return to degree level education remains high, some types of degrees are a lot less valuable than others, and there are an increasing number of 'overqualified' graduates in jobs which do not require graduate-level qualifications. The UKCES believes that this is largely due to the failure of employers to utilise graduate-level skills effectively. This analysis fits well with the TUC's "high-road"/"low-road" analysis of the problems that the UK faces in this area. To the extent that labour market regulations such as the National Minimum Wage, Train to Gain and the European Directive on Information and Consultation help 'nudge' employers towards a high road strategy, they are more important than ever, and may need to be supplemented with further measures such as stronger economic and business support, improved employee relations and personnel management policies and an effort to upgrade work organisation and job design.

Introduction

This report looks in detail at the relationship between labour market flexibility (LMF) and economic performance. It is designed to act as background material and further reading for the TUC ToUChstone pamphlet *The Red Tape Delusion* (Lansley and Reed, 2010). The pamphlet asks to what extent increases in the degree of flexibility (or, equivalently, reductions in the amount of regulation) in the UK labour market are essential for a strong recovery from the current economic crisis, or whether the UK labour market is already quite flexible enough as things stand, and policymakers instead need to focus on other policy priorities as the UK begins to recover from the most serious recession in seventy years.

The report aims to collate, summarise and analyse the evidence on the relationship between labour market flexibility (or conversely, labour market regulation) and economic performance in the UK and other developed economies. My aim is to establish, first, whether there *is* any relationship between LMF and economic performance. Second, if there is a relationship, does more regulation mean worse economic performance? Or can increased regulation *improve* economic performance in some circumstances?

Background

Not so long ago, labour market deregulation was seen as one of the main planks of good economic policy. Between the early 1980s and the mid-1990s, the orthodox economic policy stance known in common parlance as “neoliberalism” became the dominant view of policymakers in most developed economies, as part of a general shift in favour of market-oriented solutions to economic problems. This orthodoxy tended to equate high levels of labour market regulation with poor economic performance and deregulation with good performance. The OECD’s 1994 *Jobs Study* (OECD, 1994) reflected this neo-liberal *zeitgeist* to a large extent, stressing the role of LMF as an essential precondition of economic success for all developed economies.

At the same time that neoliberal orthodoxy was rising to dominance, the Conservative Government in the UK was pursuing a policy of deregulating the labour market. Details of this process of deregulation are given in Appendix 1, which lists all changes to labour

market regulation that have taken place in the UK since 1979. The Appendix shows that the period between 1979 and 1997 consisted mainly of deregulating measures. To the extent that additional labour market regulation took place under the Conservatives, it was largely a consequence of European Union directives (as shown in Appendix 2, which lists recent EU directives and the pieces of UK legislation that they gave rise to). This process meant that by 1997 when Labour came to power, the UK's labour market was lightly regulated by international standards – along with the US, New Zealand, Australia and Canada. The OECD *Jobs Study* praised the steps that the UK had taken to deregulate its labour market.

Since the late 1990s, however, the tide has begun to turn somewhat against neoliberal orthodoxy and deregulationary fervour, although plenty of both still abound in popular discourse. The partial retreat of the neoliberal agenda during the 2000s was examined in David Coats's influential 2006 report for the Work Foundation *Who's Afraid of Labour Market Flexibility?* (Coats, 2006), which argued that "recent research suggests that the standard account of why 'Anglo-Saxon' [i.e. deregulated] labour markets perform well is shot through with myths, half-truths and a cynical manipulation of the evidence." A growing body of evidence (which is also reviewed in detail in this report) suggested that different economies, with very different approaches to LMF, could produce equally good results, and that, while it was certainly possible for badly thought-out regulation to have harmful effects, the idea that there was some simple positive .relationship between the flexibility of the labour market and the good performance of the economy was simply not supported by the empirical evidence. For example, from 1997 onwards the UK Labour Government implemented a clear, if modest, increase in labour market regulation – the minimum wage, enhanced maternity and paternity rights, and the right to request flexible working, for example – without, as we shall demonstrate in this report, any obvious detriment to labour market performance. Again, details of this are given in Appendix 1.

The change in mood in some quarters away from free market fundamentalism and towards a more balanced approach was reflected in the OECD's update of its *Job Study* priorities in its 2006 *Employment Outlook* publication. In 2006 the OECD took a much more middle-of-the-road view, arguing that countries with very different amounts of 'flexibility' as defined by their 1994 framework had experienced equal levels of success in generating employment. By 2006, the OECD no longer backed deregulation as a labour market cure-all. Furthermore, it pointed out that there are drawbacks to flexibility; for example, the US

has a very deregulated labour market in many ways, and has performed relatively well on key labour market indicators such as unemployment and employment. But it also has some of the highest levels of inequality and poverty in the developed world, and since 2008 its unemployment rate has risen very sharply.

Until 2007, then, it seemed like the neoliberal economic agenda was in retreat – or at least not carrying all before it as had seemed the case in the mid-1990s. Moreover, one might have thought that the implosion of global credit markets and the ensuing economic crisis would drive the final nail into the coffin of the orthodox economic prescription for success.

Paradoxically however, the current economic crisis has actually presented an opportunity for supporters of labour market deregulation to make a comeback. The approach that has been popular among neoliberal commentators is to argue that more highly regulated labour markets can produce reasonable successes during periods of economic growth but are unable to cope effectively with severe shocks to the economic system – such as recessions. To give some recent examples of this line of argument:

- In November 2009 the British Chambers of Commerce wrote to Business Secretary Lord Mandelson calling for a three year moratorium on new employment legislation. The letter asks for "a period of stability to allow recent changes to 'bed in' and give employers the time to concentrate on running their businesses[1]."
- In November 2009 the Confederation of British Industry published the results of a survey of employers it had commissioned from the recruitment consultants Harvey Nash. The CBI's summary of the findings argued that "employers remain especially worried about the excessive burden of employment regulation." CBI Deputy Director-General John Cridland said that "employers remain deeply frustrated by the amount of paperwork and regulation they have to deal with." (CBI, 2009)
- In October 2009 Mark Littlewood, former head of media for the Liberal Democrats and now Director General of the Institute of Economic Affairs (from December 2009), published an article calling on an incoming Conservative Government to lower or scrap the minimum wage. The article claimed, "the full, and substantial, cost of Britain's minimum wage legislation is becoming increasingly plain to see. In times of plenty, the impact it had on pricing employees out of the labour market was

[1] "Business seeks freeze on labour laws", *Financial Times*, 20 November 2009. Online at http://www.ft.com/cms/s/0/bc788742-d573-11de-81ee-00144feabdc0.html

less dramatic. But in the depths of a recession, it acts as a real barrier in getting people back to work." (Littlewood, 2009)

These lines of argument are very similar to the reasoning which the OECD used to justify its deregulationist position in the 1994 *Jobs Study*, which appeared following the recessions of the early 1980s and early 1990s. The contention of the supporters of labour market deregulation is that the UK and other developed economies (except for maybe the US, which is already the most deregulated on most measures of labour market flexibility) need to deregulate their labour markets (even more than some of them have already done during the last thirty years) to ensure a strong economic recovery.

The problem for progressive commentators seeking to engage with proponents of further deregulation is that the sudden change in the economic climate we have experienced over the past couple of years means that even relatively recent studies of the relationship between labour market flexibility and economic performance, such as TUC (2004) and Coats (2006), are now out of date. There is an urgent need for a new overview of the literature which takes changed economic conditions into account. That is the main purpose of this report.

Methodology and Structure

There is a huge evidence base to draw on in examining the relationship between LMF and labour market performance. An immense amount has been written in the academic literature about the relationship between various dimensions of labour market flexibility (or 'rigidities', to use the opposite term favoured by many economists) and various aspects of labour market performance. The literature on this topic spans economics, industrial and employment relations, political science, management theory, sociology and social policy. Of these, the economics literature is perhaps the most extensive. This report will focus primarily on the economic evidence but will draw in evidence from other disciplines as and when appropriate and relevant.

The structure of the report is as follows. Chapter 1 looks at the way that LMF is defined, drawing on definitions from academics working in economics and other related disciplines, and the UK Government's official definitions. I look at the concept of flexibility both as an

abstract economic notion and as a more operational assessment of the state of the UK labour market. I discuss measurement issues here as well as definition. I start with a standard economist's view of the competitive labour market – which I term the "orthodox" view[2] but which could equally well be called the "neoliberal" view or perhaps the "neoclassical" view[3]. I then look at the implications of labour market regulation in the orthodox view – which delivers many unambiguous predictions of how the labour market should be regulated, but is for the most part an unreliable guide to the way labour markets actually behave in the real world. In response to this problem with the orthodox model I outline some more realistic alternatives and sketch out their implications for the desirability (or otherwise) of labour market flexibility.

Chapter 2 looks in detail at how "economic performance" should be defined, and what concepts of performance are relevant in assessing how labour market flexibilities or rigidities affect the economy.

Having studied the implications of economic theory and measurement in Chapters 1 and 2, the rest of the report attempts to apply the theories to real world evidence. Chapters 3, 4 and 5 assess recent empirical evidence on the links – whether causal or otherwise – between LMF and economic performance using data from the UK and other advanced industrialised countries. Chapter 3 outlines the different types of empirical evidence available and their strengths and weaknesses, and uses OECD data to produce some basic descriptive evidence of the relationship between economic outcomes like employment and unemployment, and labour market regulation measures like employment protection. Chapter 4 focuses on 'macroeconomic' evidence from descriptive statistics and econometric regressions which use data from several countries over time. Chapter 5 looks at 'micro' evidence from individual or firm-level data sets, most of which is concerned with the impact of specific reforms which increased or decreased regulation. For the most part, I look at the impact of each particular aspect of flexibility – e.g. minimum wages, employment protection etc. – separately, although I am also careful to point out the links between different policy areas. The empirical evidence that is used is as up-to-date as

[2] This term was inspired by David Howell's coining of the phrase "OECD-IMF orthodoxy" to describe the prescriptions for labour market reform recommended by the OECD and the IMF during the 1990s following the OECD's 1994. *Jobs Study* (Howell, 2005). See also Coats (2006).

[3] There is a problem with use of the adjective 'neoclassical' to describe the orthodox view of the labour market as many of the critiques of this view of the labour market are also grounded in (a more sophisticated understanding of) neoclassical economics, but this terminology is sometimes (mis)used in the economics profession. Hence I have avoided using 'neoclassical' as a synonym for 'orthodox' in this report.

possible although selected older studies are also reviewed and summarised particularly when they are especially valuable because the issue they cover has not been subsequently explored further. The aim in every case is to provide a balanced assessment of the evidence base while taking into consideration the quality and generalisability of the empirical work that has been done at both macro and micro levels.

Chapter 6 broadens the discussion out to look at the interplay between regulation and flexibility in the labour market and the extent of government intervention in other markets. I focus on three particular areas – product market regulation, transport and migration policy. The aim is to show that the question of how much labour market flexibility is optimal cannot be answered by looking at the labour market in isolation from the rest of the economy, but needs to take account of the interplay between the labour market and other parts of the economy.

Chapter 7 looks at the macroeconomic implications of LMF in the context of the current economic crisis. I look in particular at the implications of cutting wages and employment in recession, drawing on new evidence from badly affected industrialised countries such as Ireland, and older evidence from countries such as Germany which have suffered persistent unemployment problems over the last two decades.

Chapter 8 looks at labour market flexibility in the context of overall industrial policy. Drawing on evidence from the literature previously produced by economists and management theorists on the possibility of multiple equilibrium paths for businesses in the UK economy (the “high road”/”low road” distinction). I ask what this means for the policies being pursued by the Department for Business, Innovation and Skills (BIS) in the wake of the *New Industries, New Jobs* White Paper of April 2009. How can the UK ensure that the new industries and new jobs are high value-added, innovative and high skilled? What is the role of labour market flexibility, or alternatively labour market regulation, in the quest for the “high road”? How does skills policy fit together with labour market policy in policymakers’ attempts to ensure Britain is ready for the challenge of recovery from the economic crisis?

Finally, Chapter 9 draws overall conclusions. How much of a link is there between labour market flexibility and economic performance? Should the recession change our views of

the desirability of labour market flexibility? And how does labour market policy fit together with other policy areas in the search for a mix of policies that will deliver economic growth, environmental sustainability and social justice?

Chapter 1: What is Labour Market Flexibility?

For the general public 'Labour market flexibility' (hereafter referred to as LMF) is one of those economic 'buzzwords' (or phrases) – like 'globalisation', 'sustainable growth', and 'an end to boom and bust' which has been used so much by politicians – of every stripe – since 1997 (and indeed before) that its exact meaning has probably been forgotten. However, it is essential to agree on a clear definition of LMF if we are to evaluate properly its importance for economic outcomes. The first part of this chapter examines some formal definitions of LMF in an attempt to pin down what's covered by LMF and what isn't. The second part looks at what one might call, for want of a better word, the 'philosophy' behind LMF – or, more accurately, the orthodox belief that flexibility in the labour market is *a priori* a good thing, and inflexibility or rigidity an automatic 'bad'. I argue that an unswerving belief in the inherent benefits of labour market flexibility regardless of the empirical evidence reflects a political conviction rather than the outcome of hard-headed economic thought, and suggest more reasonable starting points for the economic analysis of labour markets.

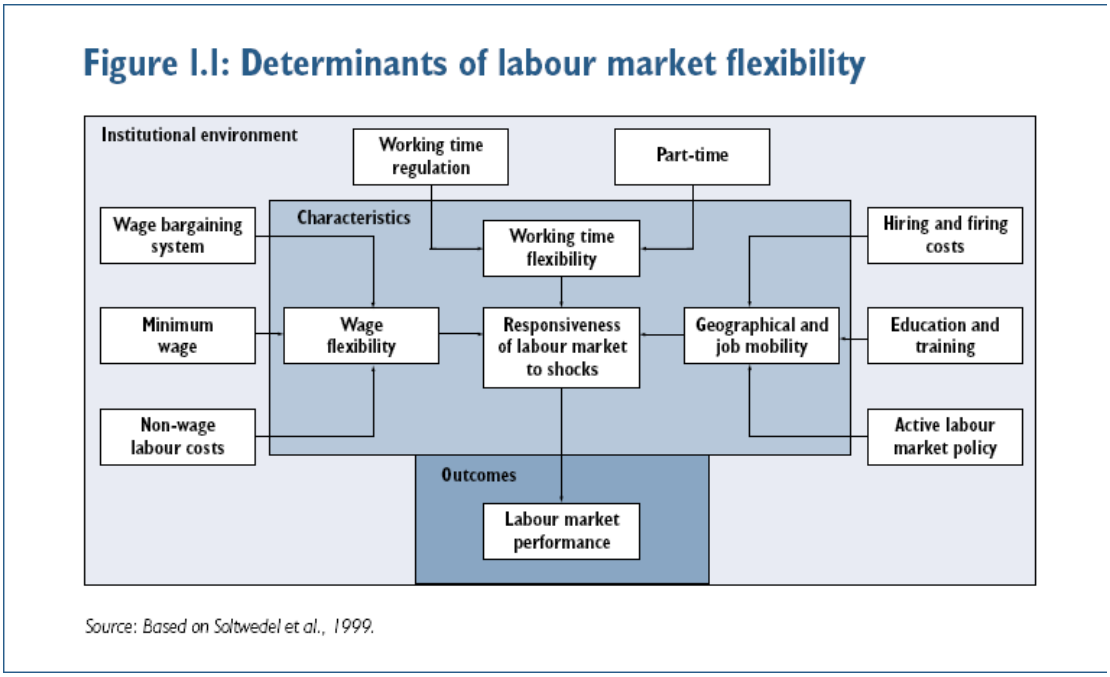
Analytical definitions of Labour Market Flexibility

This section develops a taxonomy of labour market flexibility. My starting point is research undertaken for HM Treasury's 2003 assessment of whether the conditions were right for the UK to enter the Euro (HM Treasury, 2003). Although the assessment is now a few years out of date, it is the most recent that has been undertaken, and subsequent publications from HMT confirm that their basic analytical stance has not changed since 2003 (for example the 2007 report *Productivity in the UK 7: Securing Long Term Prosperity* contains several references to the link between flexible labour markets and high productivity - see HMT/BERR, 2007).

The Treasury's headline assessment is that "a flexible and efficient labour market, combined with a stable macroeconomic environment, implies an economy that is fairer, more competitive and more productive. It also means an economy that is better able to respond to economic change." The Treasury identify three basic 'overall' definitions of LMF (HMT 2003, page 9):

1. Flexibility as the **speed with which the labour market can adjust in response to an economic shock.**
2. A flexible labour market as **one that exhibits a good equilibrium, i.e. a low structural unemployment rate.**
3. A flexible labour market as **one that has institutional features that allow wages and employment to adjust smoothly and freely to equate supply with demand.**

Figure 1.1, taken directly from HM Treasury (2003), gives HMT's stylised assessment of how the institutional environment (point 3 above) influences the characteristics of the labour market (point 1) which determine labour market performance (which encompasses point 2 above, plus other factors). Of course, the analysis is not restricted to the labour market – labour market performance will be an important determinant of the performance of the economy as a whole. I focus on the question of what economic outcomes should be included when analysing the impact of LMF in the next chapter.



Source: HM Treasury (2003)

The Treasury analysis identifies the following determinants of labour market flexibility (i.e. factors in the institutional environment that can contribute to, or prevent the existence of, a flexible labour market):

i) determinants of wage flexibility

This comprises:

1. the **wage bargaining system** (e.g. whether collective bargaining takes place in the workplace, whether there is centralised bargaining across industries or sectors, or the economy as a whole);
2. the existence and level of a **minimum wage**[4];
3. **non-wage labour costs –** for example the extent of payroll taxation.

ii) determinants of working time flexibility

These comprise:

4. **regulations on working time –** for example the EU working time directive;
5. the extent of **part-time and flexible working.**

iii) determinants of geographical and job mobility

These comprise:

[4] This heading could be broadened out to encompass other controls on wages which have existed in the past (e.g. the incomes policies of the 1960s and 1970s.)

6. **employment protection legislation –** i.e. restrictions on employers' ability to "hire and fire" employees;
7. **education and training;**
8. **active labour market policy –** government-funded programmes designed to get more unemployed (and in some cases inactive) people into work. The obvious example in a UK context since 1997 would be the various New Deals.

The Treasury list seems a useful starting point[5] but is not complete. We could certainly add the following factors:

9. **maternity and paternity leave** rights;
10. rights to a minimum number of **paid holidays;**
11. the **right to request flexible working;**
12. employment rights coverage of **part-time staff;**
13. employment rights coverage of **agency staff;**
14. **childcare** arrangements;
15. flexibility over **non-wage remuneration –** e.g. pension arrangements;
16. **trade union** rights – the right to belong to a union and the right to have a union recognised for bargaining purposes;
17. rights to **information and consultation** in the workplace;
18. **health and safety** related legislation;
19. **other wage related policies** – e.g. living wage campaigns, possible restrictions on high pay (e.g. bankers' bonuses);
20. **in-work benefits** and the financial incentives to work;
21. **illegal working** and the "informal economy";
22. freedom of entry into (and exit from) the UK – i.e. **immigration/emigration** and the labour market.

This gives a grand total of twenty-two possible determinants of labour market flexibility – some of which could still be subdivided further! Figure 1.2 shows how these might fit together into an expanded Treasury-style schema, where four broad factors determine the

[5] Although, it should be noted that the LMF *index* developed by HMT based on this schema was controversial. For example, the index gave a country a more flexible ranking the weaker its trade unions were (in terms of density and bargaining coverage). For example, this meant that Denmark was judged to be a have flexible labour market than Italy – something that would surprise advocates of the Danish 'flexicurity' approach which combines generous welfare benefits with limited employment protection. The Danish system is discussed in more detail later in this paper.

degree of flexibility in the labour market. In place of the three general dimensions of flexibility identified by the Treasury I have constructed a four-fold schema:

i) **wage flexibility –** how free wages are to adjust.
ii) **employment flexibility –** the extent to which workers are free to adjust employment, and to choose whether to work or not, and how many hours to work.
iii) **management flexibility–** the extent to which managers are free to manage the employment relationship, including the role and functions workers perform in the workplace, their shift patterns, and so on[6].
iv) **compositional flexibility –** the extent to which the composition of employment according to geographical location, industry, occupation, skill or nationality of worker is free to adjust.

These four dimensions of flexibility sit in the middle of the diagram, surrounded by three sets of determinants of flexibility. These are divided into factors which mainly help determine wage flexibility, those that mainly help determine compositional flexibility and those that mainly help determine employment and/or management flexibility[7].

[6] Of course, to a certain extent management flexibility can be considered the obverse of employment flexibility. However, it is worth including the two separately as later in this chapter under the subheading 'whose flexibility' I discuss how employment and management flexibility are sometimes complementary to each other rather than inevitably being opposed.

[7] In reality many of the dimensions of LMF listed here may operate through more than one channel – for example trade union rights might affect wage flexibility as well as employment or management flexibility. However, I have shown each determinant of flexibility as operating through one channel only, to keep Figure 1.2 more tidy than it would otherwise have been.

Figure 1.2. Schematic representation of the determinants and dimensions of labour market flexibility

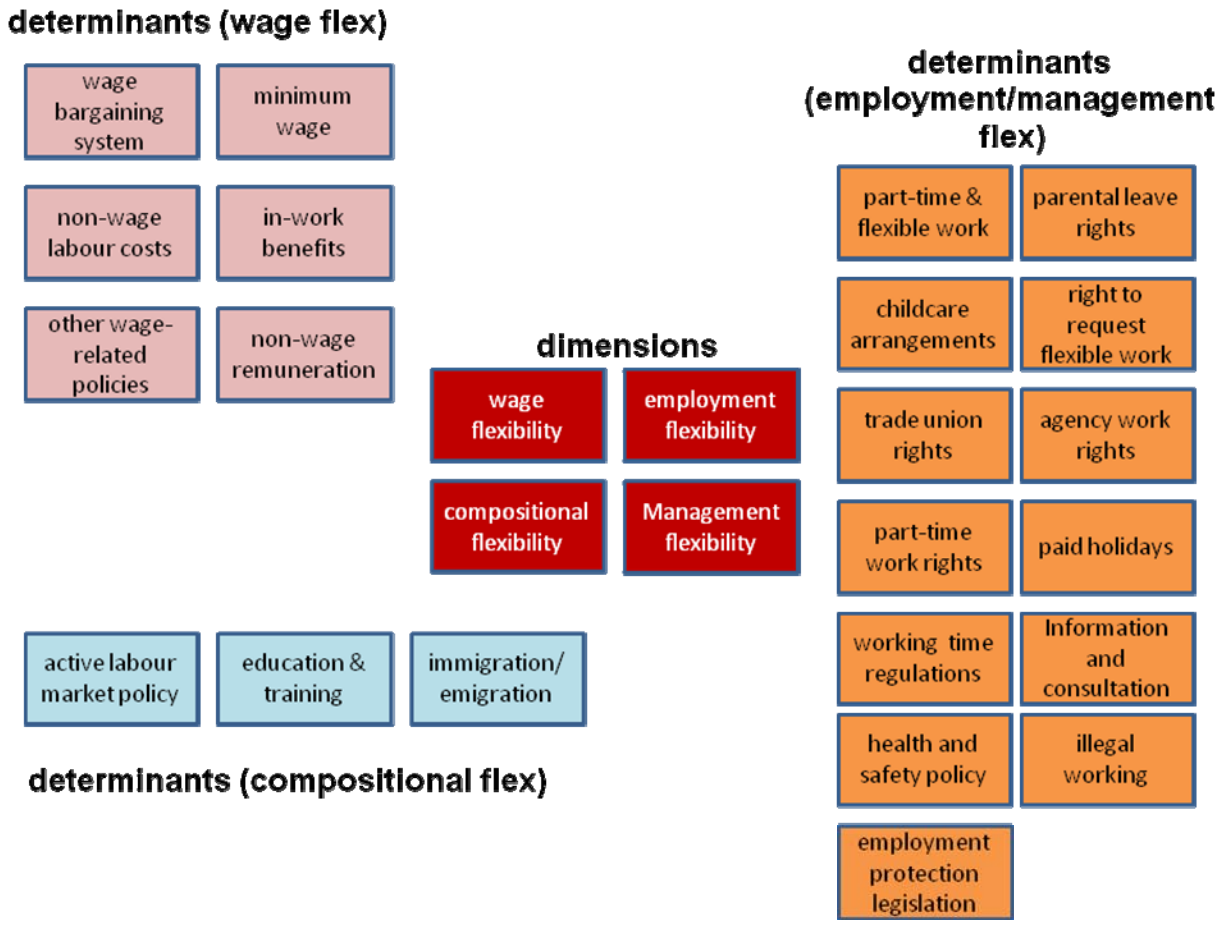


Figure 1.2 should not be seen as the 'perfect model' of how to look at flexibility. There are several ways to arrange this information, and alternative schematics may make more sense in some circumstances. To give but one good example, in work for the then Department of Trade and Industry in 2006 Vassilis Monastiriotis of the London School of Economics argued that LMF comprises three 'aggregate domains':

i) **the production function or institutional domain ('employment flexibility') –** this comprises all elements relating to the production process (e.g. working time, work content and the employment relationship
ii) the **labour costs domain ('wage flexibility') –** this comprises all aspects that relate to the determination of wage and non-wage labour costs, including trade union presence and recognition, the wage elasticity of unemployment and the composition of overall labour costs.
iii) Individual **labour supply flexibility –** e.g. worker mobility and skills acquisition.

Roughly speaking, these three domains map onto employment flexibility, wage flexibility and compositional flexibility in our schema, with employment flexibility and wage flexibility also mapping onto our 'management flexibility' criterion.

Economic theory and labour market flexibilities and rigidities

Labour market flexibility as defined in Figure 1.2 has several dimensions and there are a multitude of institutional factors which might promote or inhibit it. Popular media writers discussing LMF rarely manage – or even attempt – to convey the complexity of the subject matter. In this chapter I outline two views on how to assess LMF from the standpoint of economic *theory*. One is what I call the “orthodox” view (often known as the “neoliberal” view). Politically speaking, it is broadly associated with the right of the political spectrum (although with additional adherents in the centre and even left of centre). The other view is what I describe as the “progressive” view or “alternative” view – which is actually not a single view at all, but an umbrella or spectrum of views ranging from critiques of neoliberalism from mainstream economics at one end through to radical rejections of the entire framework of conventional economic analysis.

If both views can be characterised in a nutshell, broadly speaking adherents of the orthodox view would argue that flexibility is “a good thing” for the economy, and policies which reduce or prevent any aspect of flexibility are bad. Progressives take a more pragmatic approach: they argue that some regulations actually improve economic performance, and that individual labour market regulations need to be assessed on their own merits. Chapters 3 to 5 contain a full assessment of the empirical evidence on the impact of LMF on economic outcomes, but here I develop two stylised views of the labour market which are normally used as different lenses through which to view the evidence.

An obvious objection to the attempt to characterise different ideological views on flexibility at this stage would be that it is “unscientific”, and that flexibility should be measured objectively. Why not let the empirical results speak for themselves? In general I would say that to a large extent, the progressive camp does precisely this, whereas for the most part the neoliberal camp is unwilling to accept evidence that does not fit its preconceived ideas of how the world is, or should be. On the other hand, a lot of the empirical evidence is open to interpretation. Many economists and other commentators sincerely believe that

over-regulation of the labour market is the root cause of Europe's poor unemployment performance since the early 1990s, for example (for a classic accessible statement of this view, see Siebert 1997). Some academic economists take things to extremes; for example last year a paper was published in a leading economics journal in the US arguing that the reason that the US had longer average working hours and a larger service economy than continental European countries was that labour regulation and high taxes in Europe had made it more economic for European workers to provide services like cooking and cleaning at home rather than eating at restaurants or paying for cleaners (Rogerson 2008).

In fact, as Coats (2006), Howell (2005) and a host of other progressive commentators point out, even a quick eyeball cast over the data on national unemployment rates gives the lie to the statement "US low unemployment, Europe high unemployment." Several European states – for example Denmark, the Netherlands, Austria and Norway – have had unemployment rates persistently below the US since the 1950s. And European countries are a very long way from being uniform or harmonised on almost any aspect of labour market policy – unlike, for example, macroeconomic policy, where membership of the Euro dictates a common monetary policy for most of the EU. But the orthodox view – which is largely hostile to regulation – persists, fed by certain media outlets, international commentators of repute such as the OECD and the IMF (although the former has softened its stance quite a lot recently), business pressure groups and many leading British politicians – particularly Conservative, but also with leading adherents in the Labour and Liberal Democrat parties. Against such a wall of orthodoxy, it is often hard for the alternative view to be heard. But, as I outline in this chapter, the theory underlying the orthodox view of the labour market is, in its purest form, so extreme as to be hard to take seriously.

The orthodox view of labour market flexibility

In this section I outline the neo-liberal view of labour market flexibility in its purest form. There is a danger here of creating a "straw man" – at the extreme, the orthodox view does look like a caricature of the labour market which no reasonable person could subscribe to. However, although the assumptions underlying orthodoxy are mainly outlined as clearly as this, economic commentators of an orthodox frame of mind often argue for certain policies – normally including labour market deregulation – using this framework as an (often

unspoken) starting point. For their arguments to be watertight, it is often the case that something like the framework I outline below has to be true. The “straw man” is an all too real participant in current political debates.

The central assumption underlying the orthodox view of the labour market is that the labour market is characterised by *perfect competition*, or something very close to it. In perfect competition, the following facts about the labour market are true:

1. individual workers are paid according to the value of what they produce (in “economist-speak”, wages are equal to marginal product). Wages are determined by the value of skills (human capital) and other productivity enhancing characteristics (such as motivation) in the labour market. Any two workers with the same productivity earn the same wage.
2. Firms can hire as many workers as they want at the prevailing wage rate for a worker of given characteristics (i.e., to use the economists’ terminology, each firm faces a horizontal labour supply curve).
3. There are no frictions stopping workers from leaving their jobs (quitting) if employers attempt to pay them less than the value of what they produce (their “marginal product”).
4. Workers can move from one job to another costlessly.

These assumptions comprise the basic competitive model of the labour market which the neo-liberal school of thought has in its mind when making policy prescriptions[8].

Although the assumptions are fairly skeletal, they lead to strong conclusions about the desirability of labour market flexibility and the undesirability of regulation. In terms of the determinants of flexibility considered earlier, in the perfectly competitive model many of the regulations which define the UK’s current institutional environment (although not all) are either ineffectual or counterproductive, as follows:

- **constraints on wages –** whether minimum wages, industry-wide bargaining, or other mechanisms – will lead to increased unemployment to the extent that wages are set any higher than individual's marginal product – because firms will not

[8] There are other assumptions behind the competitive model (for example, that workers and firms are forward looking, have access to the totality of information about future events, and evaluate economic outcomes rationally) but these are not so important for the exposition here.

employ workers when it is not economically viable to do so. If wages are set any *lower* than individuals' marginal product in a firm, the workers quit because it is costless to move to another employer where they will be paid the value of their marginal product.

- **Regulations on working time** will reduce efficiency since there are no frictions in the labour market (by definition), and hence all workers are already working at their optimal number of hours (given the market wage).
- **Employment protection legislation** will introduce artificial frictions by making it more difficult for workers to move from one job to another, and making it more costly for firms to hire new workers. This is likely to reduce employment levels.
- **Active labour market policy** is unnecessary because workers can move into work costlessly if they so wish.
- **Unemployment benefits** reduce the incentive to work and hence make workers less likely to enter work, which will lead to increased unemployment.

However, most of the other kinds of labour market regulation considered earlier either have no obvious impact on labour market outcomes, or have positive impacts:

- **maternity and paternity leave** provisions are likely to be paid for by workers who take leave (as their average productivity over a period of time once the period of leave is taken into account) but have no other adverse effects.
- **Health and safety legislation** will reduce wages to the extent that it reduces productivity, but conversely may increase wages, if it reduces the number of accidents and hence increases average productivity.
- **Trade unions** are largely irrelevant in terms of wages in this model, as a unionised firm which tried to raise wages (without a corresponding increase in productivity) would simply result in the firm going out of business (as its profitability would reduce below the level of other firms in the industry and hence the firm would no longer be economically viable.)
- **Education and training** which improves individual worker productivity has a positive impact on wages, as wages directly reflect productivity in the perfectly competitive labour market model.

Obviously the perfectly competitive scenario laid out above is an absolute extreme case – for example, as the labour economist Alan Manning of the London School of Economics

has pointed out, an implication of the perfectly competitive model is that a firm which reduces its workers' hourly wage by an infinitesimally small amount (say one penny per hour) would be left with no workers, as all the workers would quit and go elsewhere. Few, if any, economists would agree with this kind of caricature of the labour market[9].

Nonetheless, it is worth setting out this extreme case of the perfectly competitive labour market model because the arguments and the 'worldview' associated with the competitive paradigm are often used by neoliberal economists and commentators to reject labour market regulation and promote labour market flexibility, regardless of the empirical evidence on the impact of LMF in many cases.

The progressive view(s)

The neoliberal view of labour markets is not without its fair share of critics, both inside and outside the mainstream economics profession. In this section I consider alternatives to the orthodox view, of which there are several. An important starting point for most – or maybe all – progressive economists is to engage seriously with institutional features of the labour market rather than automatically assuming that any real-world feature which doesn't fit the simple textbook model is an aberration. The default progressive argument would be that in most, if not all cases, these institutions evolved *for a legitimate* reason, in response to particular problems with labour markets, and so it is simply not legitimate to assert *a priori* that regulation is harmful. Nobel Laureate Robert Solow articulated this view well in a speech to the British academy in 1998:

"Every one of these regulations or restrictions [on the operation of the labour market] was intended to promote a desirable social purpose. Some may do so ineffectively or inefficiently. That is worth knowing; but the fact remains that wholesale elimination of these "rigidities" is neither desirable nor feasible." (Solow, 1998)

[9] Critics of this objection to the realism of the perfectly competitive model (e.g. Kuhn, 2004) sometimes argue that the model should be treated as describing the 'long run' – when factors of production (labour and capital) are free to vary – rather than the short run (when they are largely fixed). Their contention is that if firms reduce wages below the competitively determined level, workers wouldn't leave at first, but they would do over a period of time. However, this criticism ignores the fact that the perfectly competitive model is an even less realistic description of how the labour market – or other markets – work in the long run than it is in the short run. For example, it says nothing about the mechanism whereby technological innovations are embedded into firms' production systems.

As we will see in Chapters 4 and 5, the empirical evidence for the validity of the pure neoliberal view of the labour market is mixed, to say the least. In the introduction to a recent volume of empirical papers critiquing the neoliberal perspective on the labour market, the eminent labour economist Richard Freeman reflects on this:

"The evidence for the *Jobs Study* orthodoxy was and remains at best mixed. Many economists have known that the time-series and cross-country data on which some proponents of the view relied was of dubious value. Indeed, in various Employment Outlook analyses post-1994, OECD economists themselves made clearer the fragility of the empirical support for some of the orthodox claims. Other analysts, usually country specialists, have known that the simple flexibility story does not explain the good or poor performance of their national economies. How else to account for the success in employment of Scandinavian countries… [or] the success of the United States compared to economic near-clone, Canada?" (Freeman, 2005)

Note also that Freeman was writing in 2005, before the recent implosion of global financial markets and the worst recession since the Great Depression of the 1930s, an event which many of the proponents of the neoliberal view of the economy in general (not just the labour market) had assured us could not happen in countries like the United States and the UK, which have pursued a more deregulated path than most of the continental European economies. In the wake of the global economic crisis it is a lot harder to take the proponents of the neoliberal view seriously, although paradoxically, the high unemployment and general labour market dysfunctionality precipitated by the current recession gives neoliberals a renewed chance to argue that labour market deregulation is a more pressing case than ever. I return to this issue in detail in Chapter 7.

The remainder of this section looks at three different schools of progressive thought, all of which can be used to mount an effective challenge to orthodoxy.

Option 1: imperfect competition theories

In terms of their theoretical approach, economists who oppose the neoliberal characterisation of the labour market while remaining within a broadly neoclassical (mainstream) framework usually modify the assumptions of the orthodox model by

assuming *imperfect competition* rather than perfect competition. In recent years this position has been most clearly associated in the UK with Professor Alan Manning of LSE who coined the term “monopsony theory” to describe the approach.

This approach sticks with mainstream (“neoclassical”) economics by continuing to assume that individual behaviour is rational, forward-looking, and utility-maximising. However, it also assumes *imperfect competition* (i.e. that firms have some monopsony power)[10] rather than perfect competition, as in the orthodox approach. Table 1.1 below sets out the implications of an imperfectly competitive approach to the labour market, comparing them with the perfectly competitive model examined earlier. It is not the case that every single theoretical paper using an imperfectly competitive framework exploits every single one of these assumptions; rather, this table should be viewed as a set of ways in which imperfectly competitive models can deviate from the perfectly competitive model.

Table 1.1. Comparing the assumptions behind perfectly competitive and imperfectly competitive labour market theories

Perfect competition	**Imperfect competition (monopsony)**
Wages are equal to marginal product. Wages are determined by the value of skills (human capital) and other productivity enhancing characteristics (such as motivation) in the labour market. Any two workers with the same productivity earn the same wage.	Wages may diverge from marginal product, although they will still bear some relation to skills and other productivity enhancing characteristics. Two workers with the same productivity working for different firms (or even, in some cases, with the same firm) may earn quite different wages.
Firms can costlessly hire as many workers as they want at the going wage rate for a worker of given characteristics.	There are costs involved with hiring workers (e.g. recruitment, advertising).
Workers can move from one job to another costlessly	There are mobility costs associated with moving from job to job, so workers in a firm are “tied in” - to a greater or lesser extent – with that firm.
Human capital (skills) are transferable – i.e. they can be used in a variety of firms. This means that there are always jobs available in other firms which would pay the same wage as the job the worker is currently in.	Human capital may have firm-specific elements – i.e. skills which are specific to a given firm. For workers with firm-specific capital, wage offers in other firms will be *lower* – at least in the short run – than wage offers in the current firm.

10 In pure monopsony, there is just one firm which operates as the buyer of labour (equivalent to monopoly, where there is just one firm selling a product). Obviously this is an unrealistic assumption but the essential idea behind monopsony theories of the labour market is that firms have some degree of *market power* – either in the labour market, the product market, or both. For full details see Manning (2003a).

Workers have “perfect” information about the characteristics of firms and jobs. Firms have perfect information about workers.	Workers’ and firms’ information about each other is considerably less than perfect. Often, information about the quality of a job or the quality of a worker can only be obtained after the worker spends a certain period of time on the job.

As Manning (2006) explains, these changes in the assumptions about the way the labour market operates have a huge impact on economists' theoretical view on whether labour market regulation is a good idea or not. To return to some of the examples considered earlier in the analysis of the implications of a perfectly competitive labour market, in a labour market characterised by imperfect competition the outcomes may be very different[11]:

- **Minimum wages** can raise wages for workers who are being paid less than the value of what they produce, without increasing unemployment (indeed, in some cases they may actually *increase* employment over a certain range). This is because in the absence of minimum wage legislation firms can pay workers less than the value of what they produce *without* the worker finding it economically viable to leave for another job elsewhere
- Likewise, **wage bargaining** can raise wages for workers who are being paid less than the value of what they produce.
- **Regulations on working time** can provide a mechanism for stopping workers who face costs of leaving a job from being overworked in that job – effectively, forced to work more hours than they would like – by an employer.
- **Active labour market policy** can help reduce unemployment through reducing the cost (to each unemployed person) of finding work.
- **Unemployment benefits** can improve the efficiency of the labour market by subsidising costly job-search activity. This may provide better “matching” between firms and workers than in the case where workers have to fund job-search activity themselves. (see Burdett and Mortensen, 1998)
- **Trade unions** can help deal with grievances and issues relating to workplace environments where workers are “tied in” to jobs because moving is costly, and therefore workers would rather exercise “voice” rather than “exit” mechanisms (Hirschman, 1970). Some aspects of this role can also be performed by formal

11 See Manning (2003a) and Manning (2006) for more detailed theoretical analyses of all of these cases.

information and consultation procedures.

- **Health and safety legislation**, like regulations on working time, may stop workers who are "tied in" to jobs suffering from poor working conditions.
- As in the perfectly competitive labour market model, **education and training** tend to increase wages, although there is a question mark about the split of the returns between workers and firms, particularly where training generates firm-specific human capital (see Hashimoto, 1981, for example).

Clearly, assuming imperfect competition in labour markets - a relatively minor change to the economic assumptions we make about the structure of the labour market - generates completely different implications for what the impact of labour market regulation on efficiency and labour market performance might be. As Manning (2006) and Freeman (2005) point out, the imperfectly competitive framework does *not* imply that labour market regulation is *always* beneficial; for example, it is still possible for minimum wage laws to have an adverse impact on employment if they are set too high. However, the key message is that each piece of labour market regulation has to be assessed on its own merits. It is no longer possible to make a blanket statement that most, if not all, labour market regulation is harmful – which is something that proponents of the neoliberal model often do.

Option 2: multiple firm strategies

One underlying assumption of the perfectly competitive model is that in the absence of government intervention, the labour market – and indeed the economy as a whole – reaches a unique equilibrium state of optimal efficiency – where there is no 'slack' in the sense that it is impossible to make anyone in the economy better off without making someone else worse off[12].

The presence of features of the labour market that deviate from the pure competitive paradigm – what orthodox economists would call 'distortions' – calls this view into question. As far back as the 1960s it was established that, in an economy with two or more distortions[13], removing *some, but not all*, of the distortions does not necessarily move the

[12] The technical term for this is 'Pareto efficiency'.
[13] Note that the distortions can be in *any* market – e.g. product markets, the government sector, the financial sector, barriers to trade, and so on.

economy closer towards efficiency, but can actually make it *less* efficient, because the mathematical axioms which guarantee efficiency under perfectly competitive conditions do not generalise to more realistic economies which contain distortions[14]. This provides an additional reason why economists cannot just assume that labour market deregulation will have beneficial effects on the economy – it is an open question whether this will in fact be the case, and the question can only be settled by empirical investigation.

Taking this line of argument a step further, once we move away from the strict orthodox view of the labour market it is quite possible that there are *multiple* equilibria which the labour market can attain[15]. So, for example, one equilibrium might be characterised by a relatively compressed distribution of wages, whereas another might correspond to a much more unequal distribution of wages. Or there might be a whole series of equilibria at different levels of earnings inequality (or any other dimension of the labour market, such as the level of labour market regulation or the amount of training being undertaken by workers), each of which is locally stable, but all of which 'score' differently in terms of economic efficiency and equity.

This kind of analysis provides a clear theoretical rationale for models where the kind of economy a nation has is shaped by the decisions that decision-makers in the economy take. As production decisions are mainly taken by firms (or to be more precise, managers) in economies like the UK, these kinds of models normally focus on the alternative strategies available to firms to compete in the marketplace. For example, in response to the increased competitive pressures wrought by globalisation, firms can choose a number of strategies. Some of these may involve an improvement in workers' pay and conditions (e.g. investment in additional skills to increase worker quality); others may involve a deterioration (e.g. work intensification, longer hours and pay restraint.) The TUC (2002) characterised the choices available to firms as, broadly speaking, whether to take the "high road" (a high skills, high-quality, high value added strategy) or the "low road" (the opposite).

[14] The technical name for this discovery is 'second best theory'. The initial discovery was by Lipsey and Lancaster (1965).

[15] –Many non-orthodox economists would question whether the static concept of 'equilibrium' even makes sense compared with more dynamic approaches to modelling how the economy functions. Other sciences – for example physics - have moved on from what is essentially a 19th century notion of equilibrium (see Mirowski, 1989). However, important criticisms like this actually move us *even further away* from the orthodox economist's notion of unique equilibrium, so they are very much in the spirit of the argument presented here – just taking it on a stage further.

A clear implication of multiple-equilibrium models like this is that there is a possible role for government or organisations representing workers (such as trade unions or wider groups such as “living wage” campaigns) to move the economy towards a situation where circumstances whereby firms find the transition to a “high-road” strategy preferable to alternative low-road strategies. This could be done either by direct pressure on employers, or by creating public momentum for legislative and regulatory changes which incentivise employers to introduce “high-road” business strategies and working practices. I return to this issue in detail in Chapter 8.

Option 3: radical economic streams of thought

The imperfectly competitive model of labour markets retains the key features of mainstream, or “neoclassical” economics – in particular, forward-looking rational individual employees and employers with well-specified utility functions. This is a relatively small departure from the neoliberal labour market paradigm, and it is possible to go a lot further than this – as many non-mainstream economists do. *Debunking Economics* by the Australian economist Steve Keen (Keen, 2001) contains a good summary of radical objections to the perfectly competitive model of the labour market[16]. These include the criticisms that:

- the aggregate supply and demand curves for labour are not anywhere near as 'well-behaved' as neoclassical economists assume – there can be multiple equilibria of supply and demand, and reducing wages will not necessarily increase employment (as most economists would believe)
- when workers face organised or very powerful employers, the theory of 'bilateral monopoly' (Fellner, 1947) shows that workers will get paid less than the value of what they produce unless they also organise – for example, into trade unions (this conclusion also emerges from the imperfectly competitive neoclassical model above);
- demand and supply in the labour market are not independent, because changes in labour supply will affect the distribution of income, which itself affects the demand for goods and services, which in turn affects the demand for labour (Sraffa, 1960).

16 Keen's book is certainly not the first radical critique of labour economics and will certainly not be the last either, but it is probably the most readable and accessible example, so I have used it here.

Simplistic analysis of the labour market as a closed system (whether perfectly or imperfectly competitive) is therefore invalid[17];

- the basic vision of workers freely choosing between work and leisure is flawed. In reality, most people of working age do not have sufficient non-work incomes to be able to pick and choose whether to work or not (in the absence of income from the state such as unemployment benefits; and even then, in the UK for most workers Jobseekers Allowance is a small proportion of previous weekly earnings.) Thus, there is a natural constraint and 'lack of flexibility' about most working people's position; they have to find work reasonably quickly, or suffer extreme hardship. By positing the work decision as a free choice, the neoclassical paradigm ignores a hugely important aspect of the work decision.
- The perfectly competitive model of the firm is itself methodologically incoherent because it aggregates individual (firm-level) horizontal labour supply curves into an upward-sloping firm-level labour supply curve, which makes sense as a limiting assumption, but gives rise to logical inconsistencies if used as the basis for an actual model of the labour market. (Keen and Standish, 2006)

If these criticisms of the neoclassical model (some of which apply to the imperfectly competitive version as much as the perfectly competitive version) are correct, then economic theory gives essentially *no* prediction as to what the impact of labour market regulation on labour market performance might be. Once again, this doesn't automatically mean that any specific labour market regulation is always and everywhere a good idea. Rather, it means that it the question of whether a particular labour market regulation is good or bad for labour market performance can only be settled by empirical study.

Thus, in terms of their implications for how to assess the impact of labour market regulation, the imperfectly competitive version of neoclassical economics and the radical perspective of non-mainstream economics would proceed in much the same way – despite the fact that they rely on totally different theoretical foundations.[18]

17 *General equilibrium* analysis answers these objections by considering the labour and product markets as interrelated, but the simplifying assumptions needed to do this at a sufficient level of generality generate a host of new problems (Keen 2001, ch 8)

18 I should also mention another alternative school of thought here: the *evolutionary* tradition in economics, which replaces the concept of static equilibrium with an analysis of the economy as a system which evolves through time. (Nelson and Winter, 1982). In terms of how strongly it differs from the orthodox model, this school of thought is somewhere between the imperfectly competitive and radical approaches covered in this chapter. It has a lot in common with the multiple equilibrium models examined earlier.

The radical tradition in economics – which includes such exotica as Post-Keynesian, Sraffian and Marxian approaches – has been increasingly marginalised since the 1960s in academic economics departments both in the UK and abroad, but has been given a new lease of life by the almost complete failure of the orthodox economics profession to anticipate the implosion of financial markets and resulting severe economic recession of 2008-09. Certain radical economists – for example Steve Keen and the late Hyman Minsky (Minsky, 1986) had long predicted the "credit crunch" and resulting near-collapse of the global financial system. In the early 1970s, the emergence of "stagflation" - the combination of high unemployment and high inflation – discredited the prevailing "neoclassical-Keynesian synthesis" view of macroeconomics, which held that there was a stable trade-off between unemployment and inflation and led to the increasing dominance of the "new classical" approach to macroeconomics – which for the most part took a neoliberal perspective on the labour market. In a similar fashion, the current economic crisis has, in turn, discredited neoliberal finance theory and turned attention towards alternatives. One implication of this is that if the neoliberal economists and commentators have been wrong about the desirability of unfettered deregulation in financial markets, then they may also have been wrong about the desirability of deregulation in labour markets.

In fact, as Coats (2006) points out, the 'conventional wisdom' as exhibited by international economic and financial institutions like the OECD, World Bank and the International Monetary Fund had already moved closer to a moderate neoclassical view of the way the labour market works and away from the pure neoliberal (or close to neoliberal) view which characterised the OECD's 1994 *Jobs Study*, for example (OECD, 1994). As we shall see in Chapter 4, this development occurred largely because the neoliberal claims which the OECD wished to make about the correct approach to labour market regulation and flexibility simply were not supported by the empirical evidence.

Which progressive critique is the 'right' one?

The three critiques of orthodoxy have different, if related strengths. The imperfectly competitive variant of neoclassical labour market analysis, as exemplified by the work of Alan Manning, is useful for showing that even a slightly tweaked version of the conventional economic framework can deliver very different recommendations as to whether labour market regulation might be "a good thing" or not. In much of the analysis in Chapter 5 of this report, which looks specifically at microeconomic evidence on the effect

of individual types of labour market regulation, it is very useful to compare the predictions from the perfectly competitive and imperfectly competitive labour market models. I make substantial use of the imperfectly competitive framework in assessing empirical research of this type.

The wholesale rejection of the orthodox framework exemplified by Steve Keen and other radical economists is a more powerful instrument for tackling its deficiencies, but also a much blunter one. The main problem with rejecting neoclassical economics entirely is that we don't have any other model which is nearly as fully worked out to put in its place. This is for two reasons. One is across economics departments in the world as a whole, neoclassical economists are by far the dominant 'species' of economist and have been for several decades. This means that neoclassical economics has a huge advantage in terms of the time and effort that can be used to advance the discipline. The other main reason is that neoclassical economics – at least in its most simple, perfectly competitive form – is one of the few analytical frameworks which delivers straightforward, unambiguous answers to economic problems. How much regulation should there be in the labour market? The perfectly competitive framework gives the answer, "as little as possible." What level should wages be set at? The perfectly competitive framework says, "whatever level the market decides"... and so on. Of course, the contention of this report is that the answers which the orthodox model gives are mostly unambiguous at the expense of being correct, but this ability to give clear-cut predictions where other frameworks are equivocal goes a long way towards explaining the persistent attraction of the perfectly competitive paradigm to commentators and policymakers looking for straight answers to economic problems (despite the manifest limitations of the paradigm, as explained above.)

Because radical alternative theories aren't as well worked out as the current orthodoxy, this report compromises by pointing out particular areas where a completely alternative approach to economics might do a much better job of explaining what is actually going on than the neoclassical model – even in its more realistic imperfectly competitive variant. This is the case, for example, in Chapter 7 where we look at the interaction between macroeconomic policy and labour market flexibility in the context of the current recession.

The 'high road'/'low road' framework for analysing business strategies can fit into either a modified neoclassical economic framework or a more radical approach. We discuss this framework in detail in Chapter 8, but also refer to it where relevant in other sections.

To summarise, this report uses a mix of economic frameworks to analyse labour market flexibility – depending on which seems the most appropriate for the specific issue being discussed. The drawback of this approach is that it is more eclectic, and perhaps less cohesive, than making a critique of orthodox economic thinking from a single alternative standpoint. The advantage is that it allows us to show the variety of alternative approaches which exist, and show the overlaps between them (which are substantial, although far from total).

Whose flexibility? Comparing employee and employer visions of the flexible labour market

One important issue that is often insufficiently explored is from whose perspective – employers or employees – the labour market should be flexible. It is often assumed – particularly, but not exclusively, by commentators of a neoliberal persuasion – that flexibility and regulation are opposites; that a regulated labour market is an inflexible labour market. But in many (although not all) aspects of the employment relationship, employer and employee interests stand in opposition to one another; therefore, an initiative that increases flexibility for the employer may reduce it for the employee, and vice versa. Table 1.2 demonstrates this by listing several aspects of the terms and conditions of employment and assessing whether regulations increase or decrease flexibility, and for whom.

Table 1.2. Aspects of the employment relationship which give rise to maximum flexibility: employers and employees

Dimension of employment	Arrangements which maximise flexibility for **employer**	Arrangements which maximise flexibility for **employee**
Wage-setting	Employer sets wages unilaterally	Bargaining
Hours worked	Employer sets hours worked to fit into production pattern in most efficient way	Employee sets hours worked to fit around other commitments (e.g. family life, children, leisure time and holidays)

Employment protection legislation	Limited or non-existent	Desirable for reasons other than flexibility
Maternity/paternity leave rights	Limited	Sufficient to allow return to work after having children if the employee chooses
Health and safety legislation	Limited	Desirable for reasons other than flexibility
Temporary/agency working	Available	Available (if chosen voluntarily)
Illegal working	Available	Unclear
Immigration	Limited restrictions	Unclear

It is important to realise that Table 1.2 does not necessarily show what arrangements might be “best” for employees and employers in each case, or indeed what might be realistically achievable; just what arrangements are likely to be most flexible for each party in the employment relationship. Also, these are sweeping generalisations; different employees and employers will certainly have different views as to the desirability of different arrangements.

The most “flexible” labour market from an employers' point of view would be one where the terms and conditions of employment were set unilaterally by employers to maximise production efficiency – in other words, if workers were treated as just another input to production, like machinery or raw materials. Note that, even if the employers aiming to maximise profits had a free hand to organise production in this manner, that does not necessarily mean that they would do. As the recent review of employee engagement by the Department for Business, Industry and Skills (MacLeod and Clarke, 2009) points out, involving a workforce in decisions about the organisation and content of work is often an essential precondition for high-productivity, well-performing workplaces. It is unlikely that a workforce which is treated like an inanimate object and not engaged with or consulted in any way would be the best-performing workforce in most contexts. This is for the case both for employees in skilled workers. Nonetheless, this is the implication of “maximum flexibility” for employers to set terms and conditions.

Employers would also – presumably – be most flexible in the absence of legal constraints over how workers can be treated, whether these relate to paid holidays, leave rights or health and safety legislation (and indeed non-restrictions on the use of child labour). From

this perspective, the long hours, unsafe and dangerous conditions, and lack of holidays which characterised the early days of the industrial revolution in Great Britain in the late 18th and early 19th centuries (and which still characterise production in many “sweatshop factories” in developing countries today) provide maximum flexibility. Once again, it is most unlikely that productivity would be maximised in modern UK industry by a return to the working conditions of the industrial revolution, but here we are outlining the extreme case for the sake of argument.

A lack of barriers to employing migrant labour would also be the most flexible situation for employers to be in – as it would increase the pool of labour from which they could draw. (It would also, in the short run, provide a very low cost source of labour).

From the employee perspective, things look somewhat different. Flexibility in terms of conditions of employment would be maximised by the availability of work patterns which can fit around employees' other commitments – for example, their family lives, religious observance (if any), leisure activities and holidays. On wages, employees would presumably appreciate the freedom to bargain over wage levels, bonuses, pension arrangements and so on rather than having these unilaterally dictated by the employer. Generous provisions around maternity and paternity leave also enhance flexibility for workers who are planning to have children, although there may be knock-on effects on workloads and work organisation for employees who have to cover for staff who are on leave if employers do not make suitable alternative arrangements to cover workload.

Some aspects of labour market regulation – for example, health and safety legislation, and employment protection legislation – do not really relate to “flexibility” from an *employee* perspective as they impose restrictions on employers rather than employees. However, employees are likely to desire them for other reasons. An unsafe workplace is, on the face of it, not somewhere most of us would like to work. Similarly, to the extent that employment protection legislation increases job security and enhances fair treatment in the workplace, most employees are likely to be in favour of it.

The main point to take away from this discussion is that the neoliberal view that there is a diametric opposition between labour market flexibility and labour market regulation only makes sense seen from *an employer perspective* – and an unsophisticated 'low road' employer at that. From the *employee* perspective, regulation can actually *enhance* labour

market flexibility across several dimensions. Also, informed employers who are interested in maximising profitability by exploiting the full potential of their workforces are likely to take a more moderate and consensual view of work organisation rather than going “gung-ho” for labour market flexibility at any cost. Thirdly, it is not always the case that the interests of employees and employers with regard to flexibility are diametrically opposed to each other. For example, some may find agency work preferable to working as an permanent employee because of the additional flexibility that temporary agency placements offer – and this may fit in with employers’ desire for increased flexibility (although other workers may feel that the insecurity such flexibility leads to is not in their best interests).

Appreciating the difference in perspectives between employees and employers over flexibility is important because most of the empirical work shown in Chapters 4 and 5 uses measures of LMF that increase employer flexibility, but not necessarily in employee flexibility.

2. Defining economic performance

Just as the previous chapter looked in some detail at what constitutes labour market flexibility, this chapter at what constitutes "economic performance".

In an abstract sense, economists are interested in the extent and distribution of well-being – 'utility', to use the 19th century philosopher's term. However, well-being can't be measured directly in any obvious sense, so instead, empirical research in economics and other disciplines uses real-world variables which capture some of the important aspects of well-being. This chapter first considers several variables which are obvious indicators of labour market performance. After that I examine the relationship between the labour market and wider measures of economic performance (like output per head).

Labour market variables

Employment, unemployment and inactivity

The most commonly studied measures of labour market performance, particularly in studies that use aggregate national-level ("macro") data from different countries, are to do with labour market status – the number of people in employment, the number of unemployed work-seekers and the number of "economically inactive" people (i.e. the remainder – those neither employed nor unemployed)[19].

The unemployment rate is often used as a barometer for an economy's general health. . While we would expect there to be a certain number of unemployed work-seekers even in the best-functioning economies as the economy changes structure over time and resources are reallocated toward more productive industries ("frictional" unemployment), a high level of structural unemployment – particularly if a high proportion of unemployment is people who have been out for work for a long time (e.g. more than six months) – is definitely cause for concern.

[19] "economically inactive" should be taking as meaning inactive *in the labour market*, not necessarily in general life; many people in this category are full-time students, for example.

However, the headline unemployment rate is not the whole story – even if it is based on the internationally agreed International Labour Organisation (ILO) measure (which measures the number of non-working people actively seeking work rather than the number of benefit claimants, which will differ from one country to another because of the generosity of benefit systems). For one thing, long-term unemployment can cause unemployed people to stop seeking work and become economically inactive – either because their skills deteriorate and atrophy, or they become ill or disabled, or they simply become discouraged (Gregg and Tominey 2005). Secondly, many people entering the labour force go directly from inactivity to employment without being officially measured as actively seeking work (this is particularly the case with second earners in couples, for example) and so the employment and inactivity rates are just as important as the unemployment rate in measuring labour market performance. Thirdly, the aggregate employment rate tells us nothing about the number of hours being worked by each worker. As Howell (2005) points out, "the unemployment rate is a poor measure of the state of worker welfare and labour market efficiency. For instance, a highly developed labour market such as the US could be operating at nearly full employment […] despite the large numbers of adult active work seekers unable to find anything but part-time work at poverty level wages (as in the late 1990s). Thus, such an economy should not get the same score on labour market performance as a country with an identical unemployment rate but a lower percentage of poverty level wages, involuntary part-time and discouraged workers."

Earnings and productivity

Labour market earnings growth is obviously an important aspect of economic performance, given that approximately 53% of UK national income is wages (Lansley, 2009). Average earnings growth is often used as a key barometer of economic performance in macro-level comparisons across time or across countries. However, for microeconomic studies (which look at the effects of labour market reforms or other changes to the labour market on particular industries, firms or workers at the individual level) economists are normally more concerned with the impacts on *productivity* – i.e. output per worker.[20] This is because, once we move away from strictly orthodox

[20] Strictly speaking, output per worker is a measure of labour productivity. Measures of *capital* productivity (i.e. returns

assumptions about the structure of the labour market, the wages that workers receive may not correspond exactly to their productivity and it would be possible in some circumstances for a labour market reform to raise or lower wages without affecting productivity, or vice versa.

But there is a good case for being interested in both earnings *and* productivity as measures of economic performance – for different reasons. Earnings are a measure of employees' main source of income, whereas productivity is a measure of the efficiency with which labour is utilised in the production process. Both of these are important measures of how well an economy is performing.

The *distribution* of earnings is an important measure of economic performance in itself. Depending on our distributional preferences, we might prefer an economy with lower average earnings per head but a more equal distribution of earnings to one with higher average earnings per head but a more unequal distribution[21].

Subjective measures of job satisfaction and security

Employment status and wages have the advantage of being objectively measurable, and so have traditionally been the main focus of economic research on labour market outcomes. However, by themselves they tell us nothing about whether employees are happy or satisfied with the tasks and working conditions that their jobs entail. Researchers in other disciplines who are more comfortable with using subjective data on interviewees' reported feelings and attitudes (such as psychologists, sociologists and employment relations researchers) regularly make use of responses to questions regarding job satisfaction from the British Household Panel Survey, which asks employees whether they are satisfied in their jobs on an annual basis[22]. A related (although not identical) question asked in some surveys is whether employees feel *secure* in their job[23]. Comparison of

to capital investments) or *total factor* productivity (the increase in output corresponding to an increase in labour and capital together) are also relevant to economic performance, but the labour measure seems the most obvious one to use here.

[21] Most research on inequality of earnings is done using micro-data sets for countries and looking at differences over time (or within subgroups of the population, such as the gender gap between men and women), although there is some work which looks at the impact of labour market policies on wage structures within specific firms.

[22] Other surveys – for example BIS's Work Life Balance Survey – ask employees a wider selection of questions about aspects of their job – for example whether they are satisfied with the number of hours they are working.

[23] For example, the European Working Conditions Observatory's Working Conditions Surveys asks this question every five years for a sample of employees in all EU member states (Eurofound 2009).

responses to subjective questions like this can be problematic across different data sets (with different question wording) and across countries, but are normally assumed to be reasonably reliable across time within data sets.

Wider measures of economic well-being and their relationship to the labour market

As well as the direct impacts of labour market flexibility/rigidity on the labour market, researchers and commentators are also interested in the impacts on wider measures of economic performance.

Overall national income or **output** is sometimes used as a performance measure rather than labour productivity or wages. There is some logic to this, as changes to labour market regulation which affect labour market productivity could also have an impact on usage and efficiency of capital in the production process, and hence on output and profitability. Other production-related economic measures such as **investment, profitability, innovation** and **skills acquisition** (e.g. through workforce training) are also sometimes analysed as outcome measures in this context.

The **price level** is sometimes analysed as an economic outcome when looking at the possible knock-on effects of regulations that might affect wages and other production costs.

Subjective measures not specifically focused on employment, such as **happiness**, are also increasingly used by researchers as a proxy for well-being. Happiness data has been used by psychology researchers for decades (e.g. Easterlin 1974) but has recently become a focus of economics research (Oswald, 1997; Layard 2006). Other well-being measures which feature a mix of subjective and objective assessments, such as **health,** are often used.

One measure which is often featured in commentary on the effects of labour market regulation or deregulation on the labour market, but which is rarely analysed quantitatively, is **social justice** or **fairness**. This was a major driver of the popular movements behind the introduction of labour market regulations such as basic health and safety legislation,

and the right to form trade unions, in the 19th century in the UK and other industrialising countries, for example. In more recent times, the main justification for the introduction of the minimum wage by the Labour Government in 1999, and for the 'living wage' campaigns of recent years, is that it is not socially just for workers to be on a level of pay which is so low that they cannot meet basic minimum standards of living, even if that is the 'equilibrium' pay level in the labour market for workers with their levels of skill or in their occupations. This is a more fuzzy notion than most of the other outcomes we focus on in this report, but it is nonetheless important in explaining why some types of labour market regulation are popular with the general public (Horton and Gregory, 2009).

The impact of labour market regulations on **income inequality** is often studied. This is linked to, but not the same as, the effect of regulations on earnings inequality. Labour market regulation can affect the income distribution through several other channels. Firstly, out-of-work benefits (like Jobseekers Allowance) and in-work transfers like the Working Tax Credit affect incomes directly. Secondly, changes in the level of employment can alter the income distribution. Thirdly, to the extent that labour market reforms alter other outcomes in the production sector of the economy (e.g. profitability) they can affect the income distribution via the returns to capital as well as labour. It is important to bear in mind the distributional affects of labour market policies, as even in the event that a particular policy is found to have a negative impact on economic efficiency, policymakers might still wish to support it on equity or social justice grounds. Orthodox economists argue that there is a trade-off between equity and efficiency in the economy in general. The idea behind this is that left to its own devices, the unbridled free market delivers optimum efficiency[24] - but it may deliver a distribution of income which is seen as too unequal to be socially unacceptable. Thus there is a case for redistribution through the tax and benefit system, provided that policymakers accept the trade-off of lower efficiency for more equity. In general, this report does not accept *a priori* that such a trade-off must always exist – because the initial premise that the unbridled free market delivers maximum efficiency is itself wrong. It is quite possible (although by no means definite) that reforms which reduce inequality could also increase efficiency.

Given that the attempt to limit global emissions of greenhouse gases below a level which

[24] the orthodox economist's definition of efficiency is *Pareto efficiency*, which refers to a situation where it is impossible to make anyone in the economy better off without making someone else worse off. Pareto efficiency thus says nothing about the fairness or equity of the distribution of resources in the economy. It would be theoretically possible to have a Pareto-efficient economy where one person owned all the resources in the economy and everyone else owned nothing!

would cause catastrophic climate change looks set to be one of the major policy issues of the 21st century, measures of **environmental** quality and environmental outcomes are an increasingly important feature of economic evaluation. However, research on the impact of the production sector of the economy on the environment has focused more on the impact of firms' production decisions than the impact of labour market flexibility or rigidity.

An important overall point to make about empirical work looking at the impact of labour market flexibility or regulation on wider economic outcomes is that these wider outcomes will inevitably be more 'distant' from specific labour market conditions than are outcomes which are more directly linked to the labour market (for example unemployment and economic inactivity rates). For example, a whole host of economic and non-economic factors could affect the level of innovation in the economy, which makes it harder to isolate the effect of labour market conditions relative to other factors – particularly when looking at cross-country evidence. This should be borne in mind when assessing the empirical evidence on the impacts of labour market flexibility in Chapters 4 and 5.

3. Introduction to empirical evidence on labour market performance

In general, empirical studies of the impact of LMF on labour market performance can be categorised according to the **type of data** they use:

1. **Descriptive evidence**, which analyses measures of labour market performance and LMF data graphically.
2. **Quantitative macroeconomic studies** using cross-country data (or occasionally, area-level data within a single country).
3. **Quantitative microeconomic studies** using data on individual workers or firms (usually within one country).
4. **Qualitative microeconomic studies** using data on individual workers or firms.

In addition, studies can be categorised according to the **aspects of labour market flexibility** (or the institutional factors contributing to labour market flexibility) that they look at:

a. **Overall labour market flexibility** (often using some kind of composite measure).
b. A **particular type of flexibility** which comprises a number of specific regulatory measures (e.g. employment protection legislation).
c. A **single regulatory measure** (e.g. the minimum wage).

Thirdly, studies can be categorised according to the particular **economic outcome** variable they use from unemployment and inactivity to subjective variables like happiness and job satisfaction. For labour market regulations which are directly related to earnings, earnings growth and/or inequality is an obvious indicator to use as well as employment. There is also a reasonably-sized literature which looks at the impact of LMF on inequality of incomes in different countries. Environmental measures – either workplace environment or wider environmental factors - are the least-well studied outcome variables.

This section of the report is divided into three parts. The remainder of this chapter looks at descriptive evidence on labour market performance over time. Chapter 4 looks at the

evidence from macro studies – which tend to consider the impact of *several dimensions of flexibility at once*. Chapter 5 looks at microeconomic studies – both quantitative and qualitative.

Descriptive evidence on the relationship between labour market flexibility and economic performance

I begin this review of the evidence by graphing some measures of labour market performance and labour market flexibility to see if there are any obvious relationships between the two. Statisticians and econometricians are normally wary of using simple correlations or cross-tabulations between two variables rather than regression analysis, simply because they do not control for any other differences between the units of observation (countries in this case) which might affect the outcome variable, whereas regression analysis is specifically designed to do precisely that.

As an example of why the descriptive approach can be misleading, consider Ireland, whose unemployment rate (as a percentage of the working age population) which was below the OECD average for most of the 2000s. However, in 2008 and 2009 Ireland's unemployment rate increased massively as a result of its heavy exposure to the financial and economic crisis which caused a wave of banking nationalisations and bail-outs in the autumn of 2008. Ireland's unemployment rate went from less than 5 percent in 2007 to over 12 percent in 2009. Any analysis of the determinants of unemployment which does not control for business cycle factors (such as the rate of growth of Gross Domestic Product in a country) will find it very hard to explain what happened to Irish unemployment over the last two years. Its key indicators of labour market flexibility – employment protection, union density and bargaining coverage, etc. – hardly changed between 2007 and 2009. Yet, two-way descriptive scatterplots or cross-tabulations of an aspect of labour market flexibility against an aspect of labour market performance do not control for any other factors which might help determine labour market outcomes.

Despite this obvious flaw, two-way analyses using scatterplots are nonetheless a useful starting point as they provide a feel for what these measures look like, where the stronger and weaker performing labour markets and the strongly and weakly regulated countries

are, and how the measures are changing over time. But also, cross-tabulations are regularly used by commentators and researchers to back their views of the association between LMF and labour market performance. For example, the OECD's 2006 *Employment Outlook* publication has a chapter on labour market flexibility which features a large number of two-way scatterplot graphs. Thus, it is important to assess how robust evidence of this type is. Does it derive any relationships between measures of labour market flexibility and labour market performance which can be unambiguously interpreted as evidence that highly-regulated labour markets perform badly (or vice versa?)

Basic evidence on labour market performance

This section provides some graphs of the economic performance indicators which are most commonly used in analyses of this type – unemployment rates and employment rates. Before graphing unemployment or employment against measures of labour market flexibility, I first focus on them in isolation. Table 3.1 shows unemployment rates for twenty-two OECD countries (those for which consistently defined unemployment information was available for the years 1990, 1999 and 2009). The first column shows the unemployment rate as a percentage of the working age population. The second column shows the 'rank' of the country – the lowest unemployment countries are ranked highest. Columns 3 and 4 do the same thing for 1999, and columns 5 and 6 for 2009. The countries are ranked in order of unemployment rate in 1990, from lowest to highest.

Table 3.1 shows considerable variation in unemployment rates in each of the years featured, and also a lot of movement in the unemployment 'rankings' over time. While Spain has the highest unemployment of any of the countries featured in all three years, by 2009 the lowest unemployment rate in the OECD belonged to Norway, which was not far above middle-ranking on this measure in 1990. Countries which significantly improved their unemployment performance relative to the average between 1990 and 2009 included the Netherlands, New Zealand, Denmark and Italy, while those whose unemployment performance worsened appreciably included Sweden, Finland, Portugal and the United States. Ireland exhibits a 'hump-shaped' performance record, whereby its unemployment was relatively high in 1990, relatively low in 1999, and then high again in 2009. The UK's performance is close to the average in each period.

Table 3.1. Unemployment rates and rankings for selected OECD countries, 1990-2009

	Unemployment rate (% of population aged 15-64)					
Country	**1990**	**rank**	**1999**	**rank**	**2009**	**rank**
Luxembourg	1.6	1	2.4	1	6.3	8
Sweden	1.8	2	7.2	13	8.7	15=
Japan	2.2	3	4.9	6	5.2	5
Korea	2.5	4	6.6	10	3.9	3
Finland	3.1	5	10.2	18	8.3	13
Germany	4.9	6=	8.5	16	7.7	11
Portugal	4.9	6=	4.6	5	9.3	18=
Norway	5.4	8	3.2	2	3.1	1
United States	5.7	9	4.3	4	9.2	17
United Kingdom	6.8	10	6.0	9	7	9
Australia	7.0	11	7.0	12	5.7	6
Greece	7.2	12	12.0	21	8.7	15=
Belgium	7.3	13	8.7	17	8.1	12
Netherlands	7.4	14	3.5	3	3.2	2
New Zealand	7.9	15	6.9	11	5	4
Turkey	8.2	16=	7.9	15	12.5	21
Canada	8.2	16=	7.6	14	8.4	14
Denmark	8.5	18	5.2	7	5.9	7
France	9.2	19	11.8	20	9.3	18=
Italy	11.5	20	11.5	19	7.4	10
Ireland	13.3	21	5.8	8	11.9	20
Spain	16.1	22	15.7	22	17.9	22
OECD average	**6.3**		**6.7**		**8.2**	

Source: OECD Main Economic Indicators. Data for 2009 are for second quarter (or first quarter if second quarter was not available)

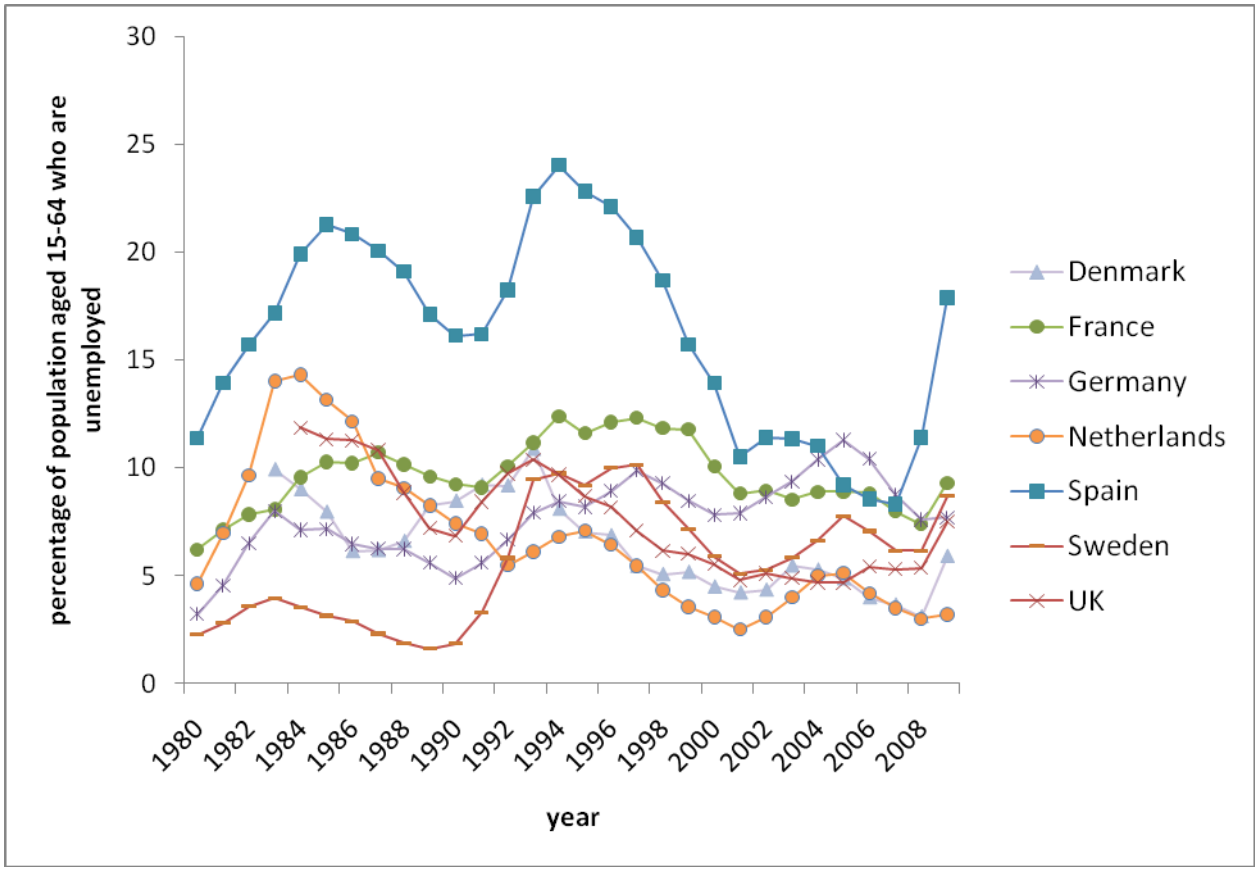
To provide a clearer picture of the dynamics of unemployment from year to year over a

longer time period, Figure 3.1 presents unemployment rates from 1980 to 2009 (or for as much of the time period as consistent figures are available) for a selection of twelve OECD countries, in two panels: European countries (including the UK) in panel (a) and non-European countries in panel (b). The data on unemployment (as with all the data in this section) are taken from the OECD's *Main Economic Indicators* webpage[25]. The number of countries has been limited to twelve to make the graphs more readable. Figure 3.1 shows that Spain is a clear outlier, with much higher unemployment than most other OECD countries for most of the sample period (until 2005-08 when it is much closer to the average, but it then shoots up again in 2009 following the recession). The early 1980s and the early 1990s see some upward trend in most of the unemployment rates in the OECD, reflecting global recessions in each period. The period between 2002 and 2007 sees falling unemployment rates in most OECD countries, coinciding with a boom period of fast growth in consumption. The dispersion in rates of unemployment falls markedly at this time. This period comes to an abrupt halt in 2008-09 as the global recession takes hold, and most unemployment rates start to climb again. Reflecting the findings of Table 3.1, the two panels of Figure 3.1 show that there is a large amount of movement in individual countries' unemployment rates going on over the three decades featured; it is certainly not the case that the ranking of unemployment rates across countries is preserved in any way at all over this period.

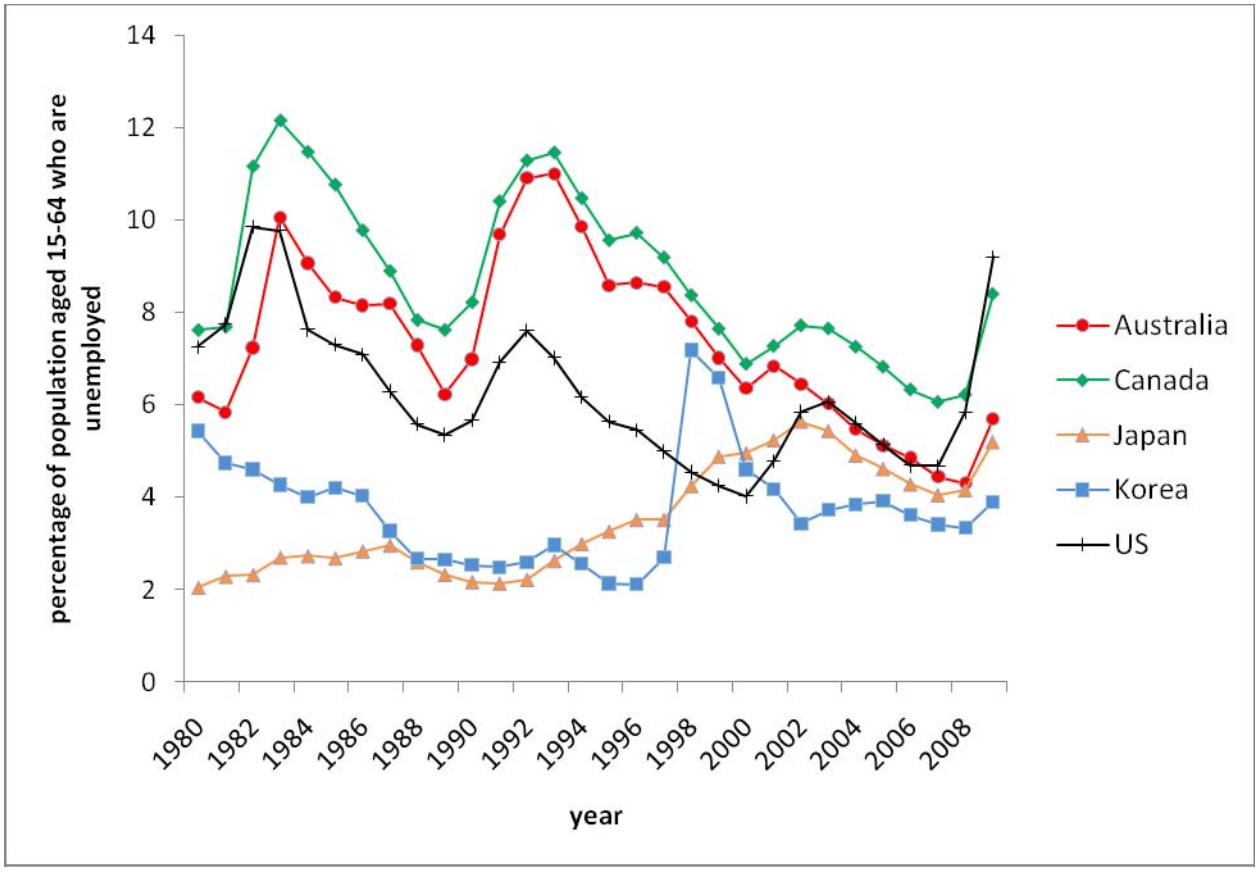
[25] See http://www.oecd.org/document/54/0,3343,en_2649_33715_15569334_1_1_1_1,00.html. Accessed December 2009.

Figure 3.1. Unemployment rates in selected OECD countries 1980-2009

(a) European countries



(b) Other countries



Source: OECD Main Economic Indicators

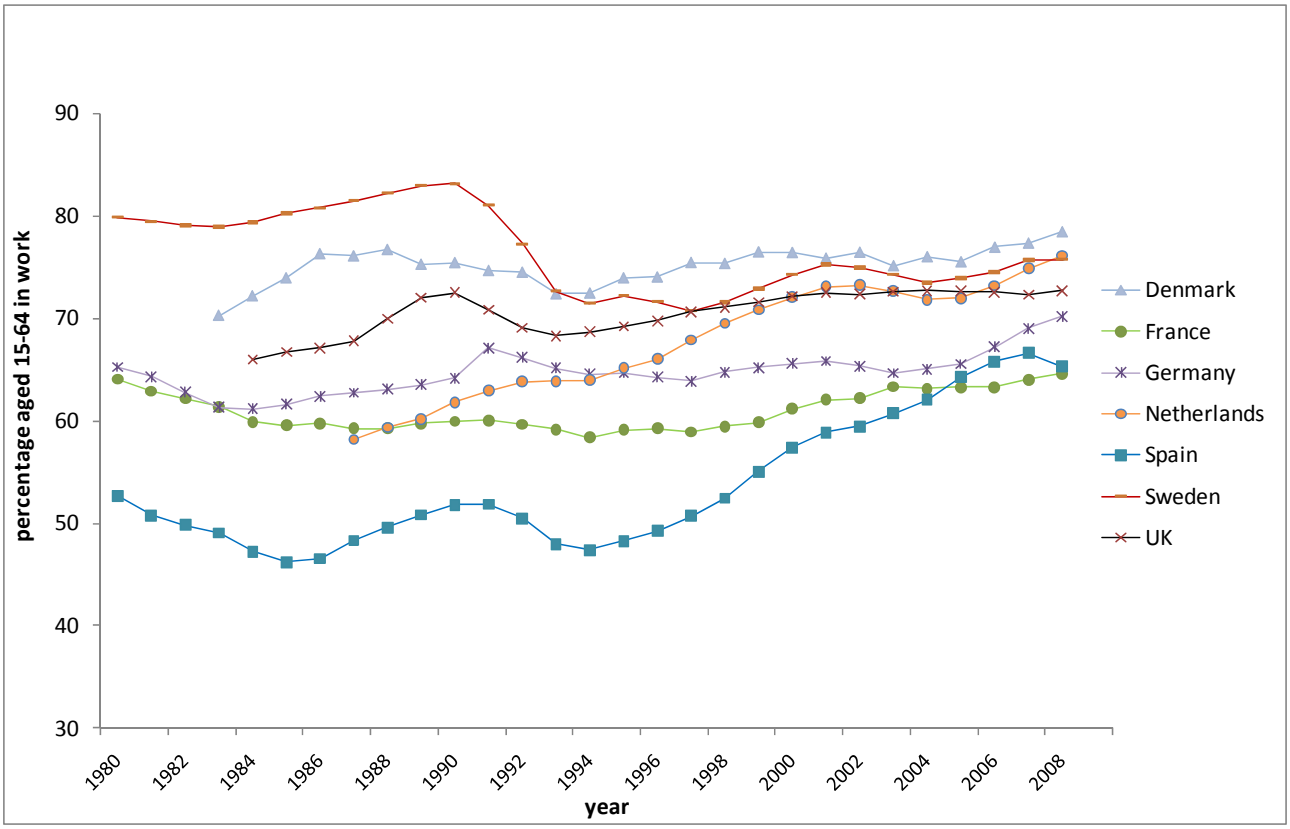
Unemployment is, of course, only one measure of labour market performance – albeit an important measure. Figure 3.2 shows the *employment* rate (for working age people as a whole) between 1980 and 2009, for the same group of countries as shown in Figure 3.1.

Figure 3.2 shows a little more convergence between countries in employment rates over the 1980s, 1990s and 2000s than was the case with unemployment. However, much of this was driven by two outlying countries – Sweden with particularly high employment rates until the early 1990s, and Spain with particularly low employment rates until the 2000s. By the end of the period, Denmark has the highest employment rate of any of the countries featured, and Korea the lowest. There has been a slight upward shift in average OECD employment over the last twenty-five years (from around 63 percent of the working age population in 1984 to around 66.5 percent in 2008).

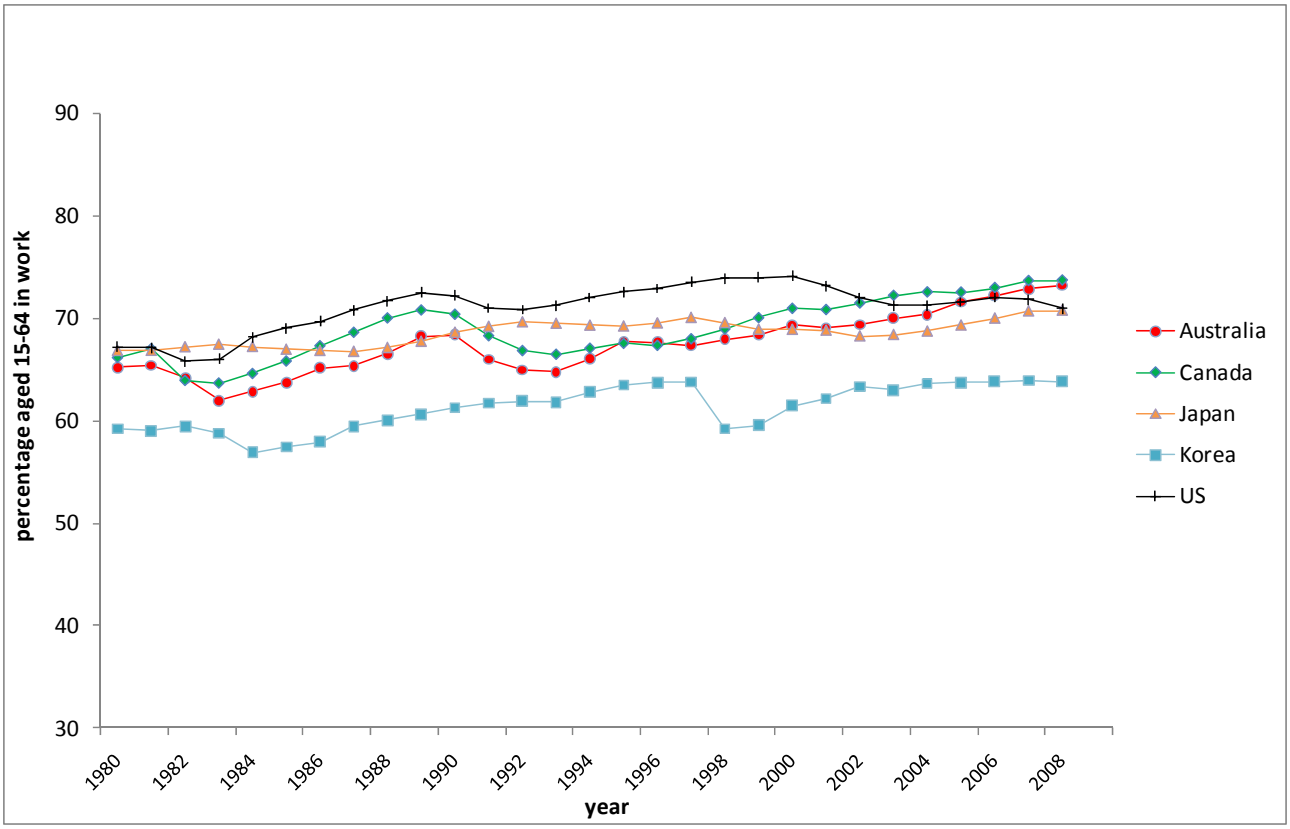
These employment patterns look very different for men and women. Figures 3.3 and 3.4 present employment rates defined in the same way as in Figure 3.2, but for men and women separately.

Figure 3.2. Employment rates in selected OECD countries 1980-2008

(a) European countries



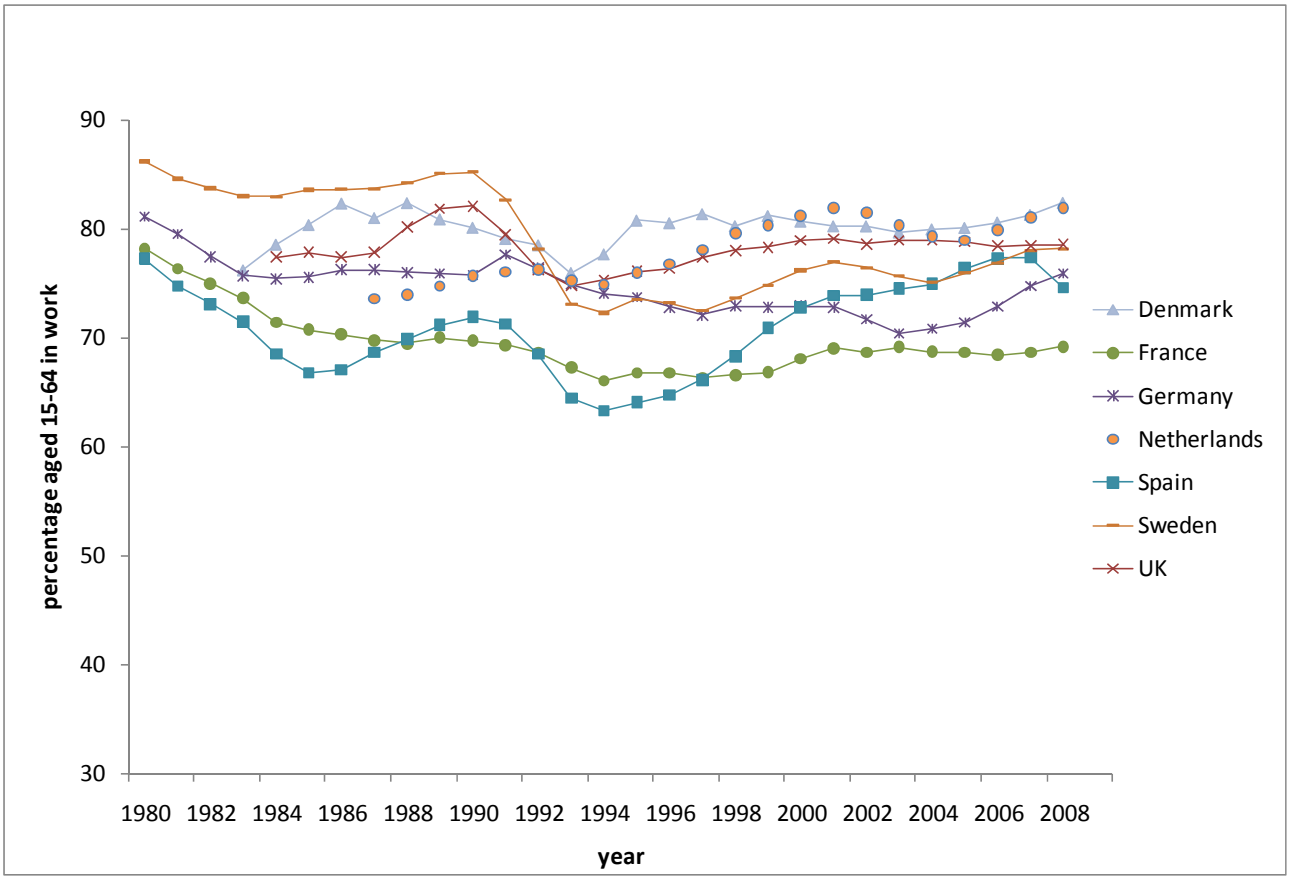
(b) Other countries



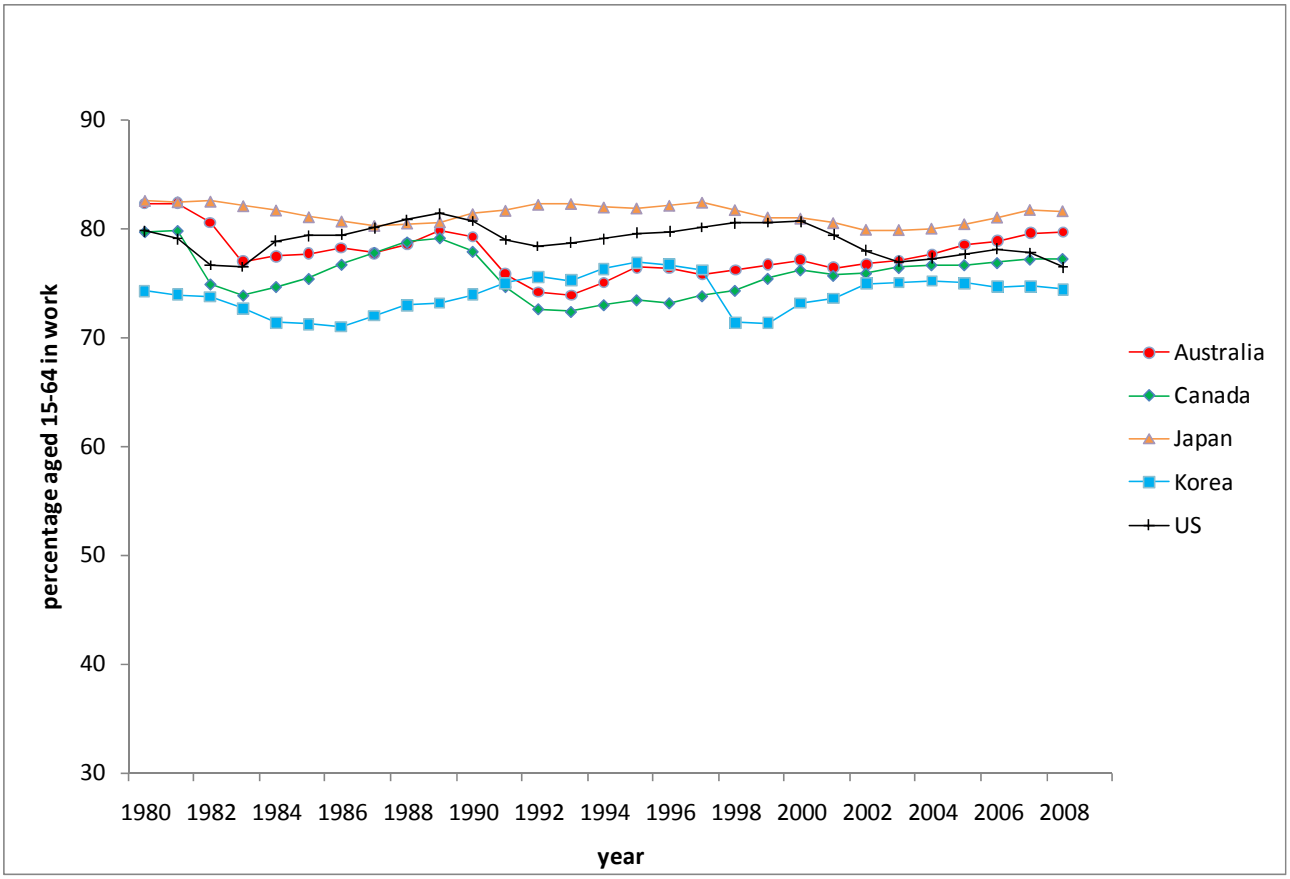
Source: OECD Main Economic Indicators

Figure 3.3. Male employment rates in selected OECD courtiers 1980-2008

(a) European countries



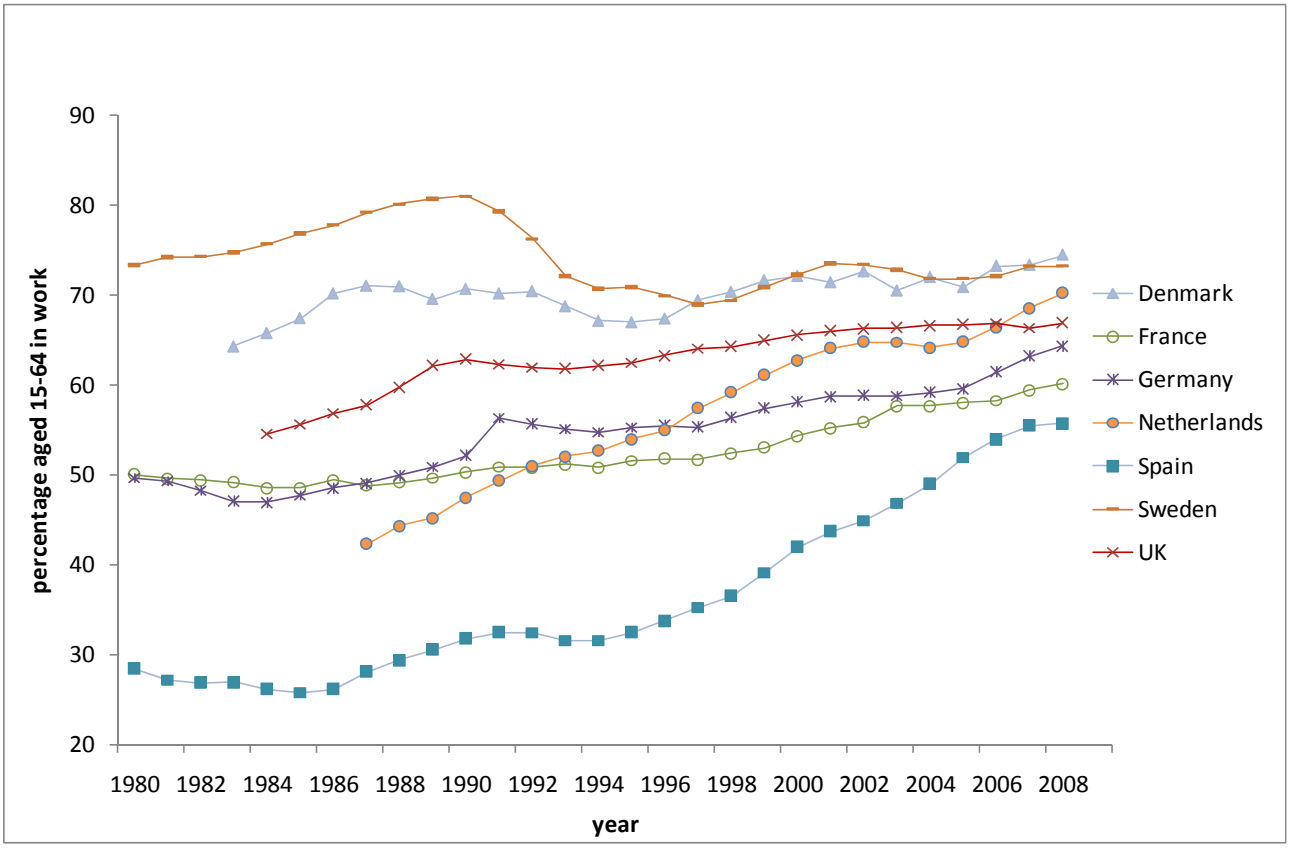
(b) Non-European countries



Source: OECD Main Economic Indicators

Figure 3.4. Female employment rates in selected OECD courtiers 1980-2008

(a) European countries



(b) Non-European countries

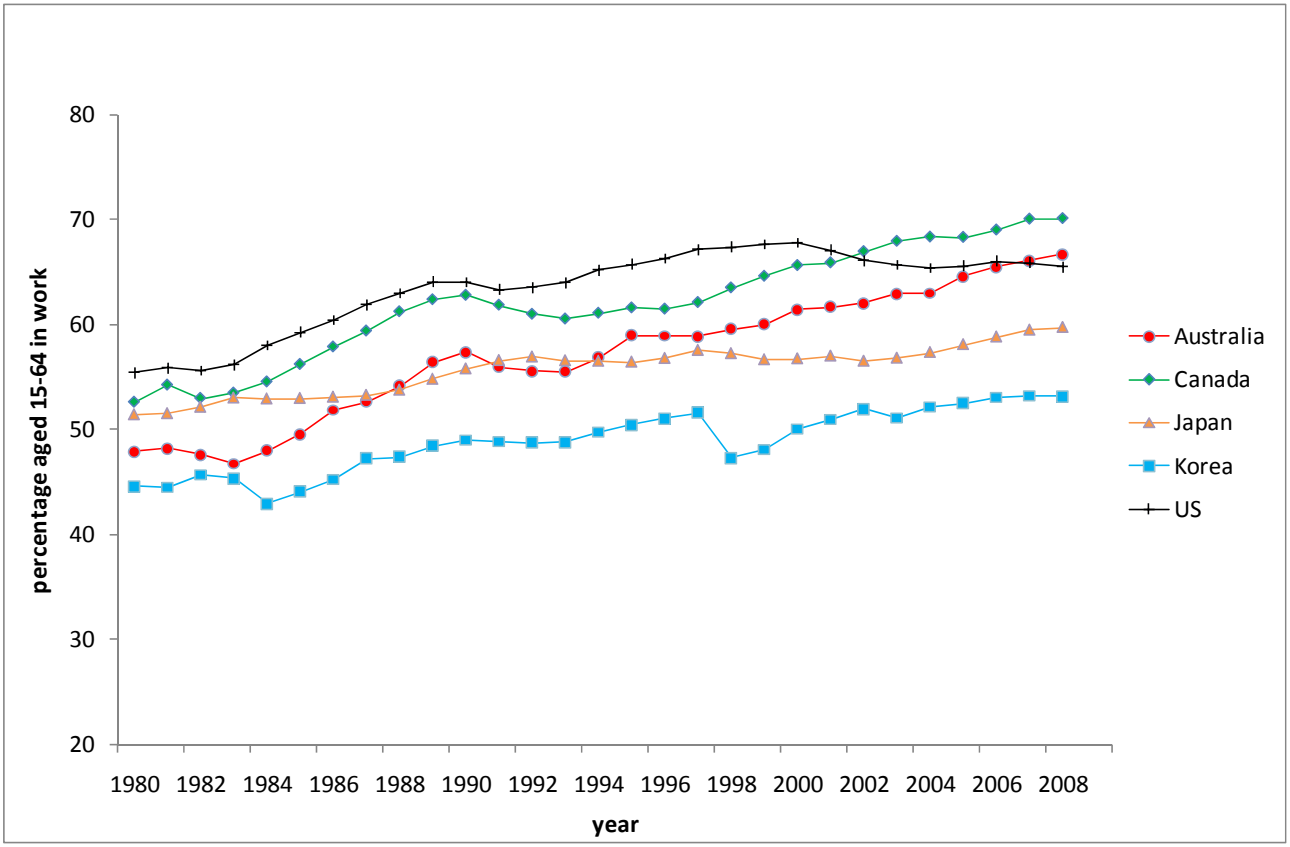


Figure 3.3 shows that the limited increase in average OECD employment rates over the period 1980 to 2008 was driven by increases in female employment rather than male employment. If anything, average male employment rates fell slightly in the early 1980s recession and have never fully recovered. Over the 2000s, France has had the lowest rate of male employment at around 70 percent, with the Netherlands and Japan having the highest recent rates, at around 80 percent. The UK's male employment rate in the 2000s is above average at between 75 and 80 percent.

Figure 3.4 shows a very different pattern, as one might expect given the different role that women – particularly mothers – play in different European labour forces (see Azmat *et al* 2006). In the 1980s, the female employment rate varied hugely in OECD countries, from around 30 percent in Spain to between 70 and 80 percent in Sweden and just under 70 percent in Denmark and Finland. Since around 1990, there has been some convergence towards a female employment rate of between 50 and 70 percent. By the 2000s, the UK's female employment rate is above average at around 65 percent. Sweden and Denmark still had the highest female employment rates in 2008 but the Netherlands and Canada were very close to them. Meanwhile, Spain has experienced a massive increase in female employment since the mid 1990s.

These figures show that patterns of unemployment and employment "performance" over time for different countries are complex. In the next section, we compare this labour market performance data with data on two commonly used measures of labour market flexibility to see if any clear patterns emerge.

Graphing labour market performance against labour market flexibility

Employment protection measures

The extent of *employment protection* in an economy – to use an informal definition, how easy it is for employers to fire workers – is one of the most commonly used measures of labour market regulation. There are many dimensions to employment protection including:

1. Regulations governing the initiation of the dismissal process, such as notification and consultation requirements
2. Notice periods and severance pay, which typically vary by tenure of the employee

3. Difficulty of dismissal (e.g. the circumstances in which it is possible to dismiss workers)
4. Additional costs for collective dismissal of groups of workers (e.g. plant closure) over and above the costs of dismissing individual workers
5. Regulation of fixed-term and temporary contracts
6. Requirements covering agency workers (e.g. whether they have rights to holiday pay, whether they have to receive the same pay and conditions as equivalent permanent workers in the firm hiring them).
7. The strictness with which employment legislation as laid down in the statute book of the country in question is actually enforced by the judicial process (e.g. courts, industrial tribunals, etc.)

It is standard practice in simple descriptive statistical work (and macroeconomic regression models) to combine these many dimensions of employment protection (EP) into a single indicator or *index.* The most commonly used index is maintained by the OECD, who recently updated the methodology they use to construct the index (Venn, 2009). The current OECD EP index is made up from three sub-indices (which cover points 1 to 3, 4, and 5 to 6 above respectively), adjusted to take account of point 7. The index is expressed as a numerical value ranging from zero (no EP whatsoever) to 6 (extremely high regulation). Table 3.2 below shows the value of the OECD's EP indicator for a selection of OECD countries, comparing 1990 with 2008[26]. The right hand column shows the change in the index between 1990 and 2008.

[26] The 1990 value for the index is derived using the old-style OECD methodology as the OECD has not produced retrospective data for the new index methodology introduced in 2007. However, as Venn (2009) shows, the exact choice of OECD index makes very little difference to country rankings. This does mean that the decrease in the average value of the index between 1990 and 2008 does not necessarily mean that the average level of employment protection in the OECD economies actually went down over time, as the definition of the index changed.

Table 3.2. Employment protection in selected OECD countries, 1990-2008

	OECD employment protection index				Change,
Country	**1990**	**rank**	**2008**	**rank**	**1990-2008**
United States	0.21	1	0.85	1	+0.64
United Kingdom	0.60	2	1.09	3	+0.49
Canada	0.75	3	1.02	2	+0.27
New Zealand	0.86	4	1.16	4	+0.30
Ireland	0.93	5	1.39	6	+0.46
Australia	0.94	6	1.38	5	+0.44
Switzerland	1.14	7	1.77	8	+0.63
Hungary	1.27	8	2.11	11	+0.84
Poland	1.40	9	2.41	15=	+1.01
Japan	1.84	10	1.73	7	-0.11
Austria	2.21	11	2.41	15=	+0.20
Finland	2.33	12	2.29	14	-0.03
Denmark	2.40	13	1.91	9	-0.49
Netherlands	2.73	14	2.23	13	-0.50
Korea	2.74	15	2.13	12	-0.61
Norway	2.90	16	2.65	20	-0.25
France	2.98	17	3.00	22	+0.02
Mexico	3.13	18	3.23	24	+0.10
Belgium	3.15	19	2.61	18	-0.54
Germany	3.17	20	2.63	19	-0.54
Sweden	3.49	20	2.06	10	-0.53
Greece	3.50	21	2.97	21	-0.53
Italy	3.57	22	2.58	17	-0.99
Turkey	3.76	23	3.46	25	-0.30
Spain	3.82	24	3.11	24	-0.71
Portugal	4.10	25	3.05	23	-1.05
average	**2.30**		**2.20**		**-0.10**

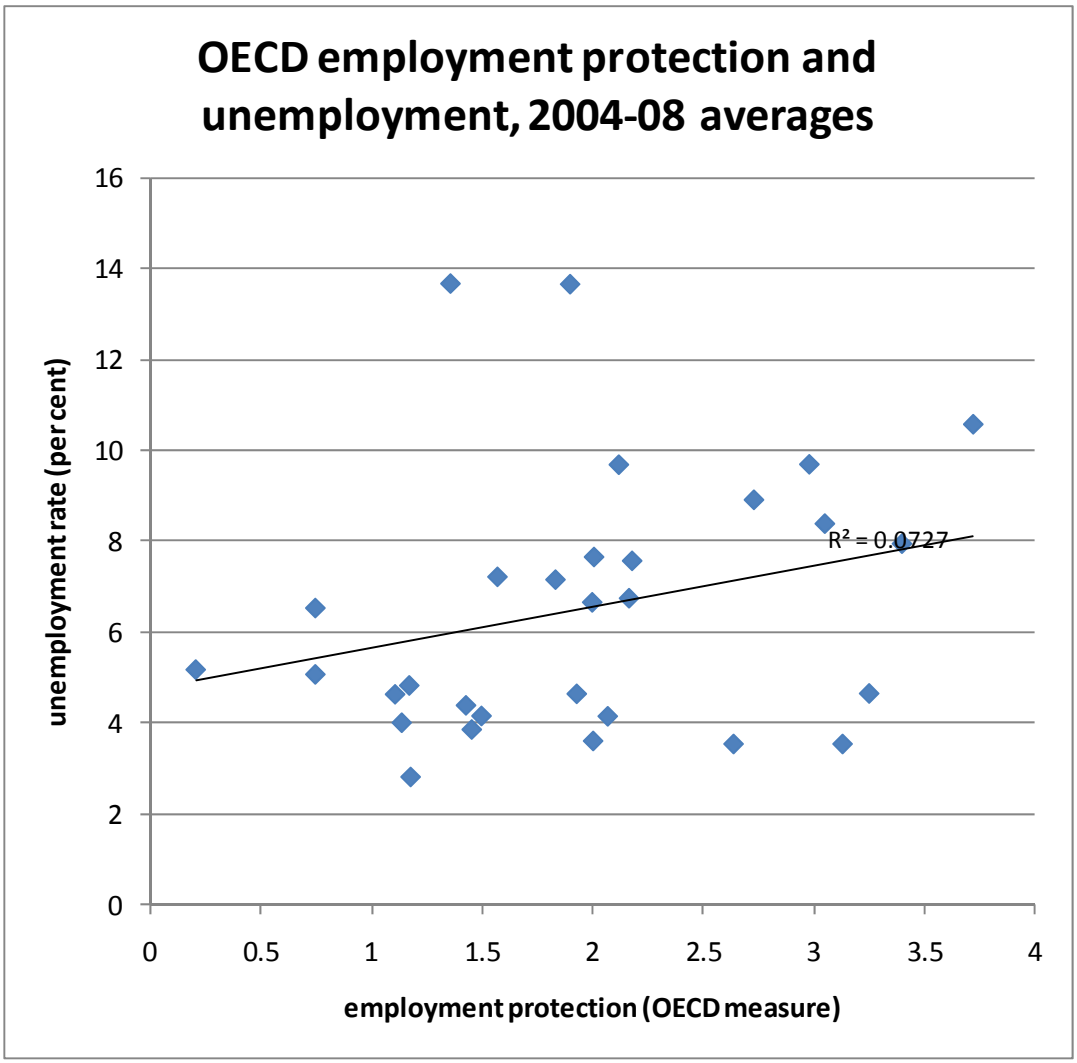
Source: OECD Main Economic Indicators

Table 3.2 shows smaller changes in most countries' ranking on employment protection between 1990 and 2008 than we saw for the unemployment rankings in Table 3.1. The only countries to change their rankings by more than five places between 1990 and 2009 were Poland (which underwent a transition from a planned economy to a market economy over the period) and Mexico (where the EP index only changed by 0.1 over the period). In general there has been convergence towards the average level of EP over the 1990s and 2000s, with most of the countries with the lowest EP increasing it and most of the

countries with the highest level of EP reducing it. It is interesting to note that the UK was the second most lightly-regulated economy on the OECD measure in 1990 (after the US), and only the third most lightly-regulated economy in 2008 (after the US and Canada). As stressed in the introduction to this report, the UK's labour market is relatively lightly regulated by international standards.

The simplest descriptive analysis of the relation between employment protection and labour market performance involves a two-way 'scatterplot' of the two variables against each other. Figure 3.5 shows this for the 26 countries shown in the table above. Because unemployment is cyclically sensitive to the choice of year, I graph average unemployment over the five years 2004 to 2008 against average EP over the same time period.

Figure 3.5



Source: OECD Main Economic Indicators

Each country is one point on the figure (the individual countries have not been labelled, to keep the figure uncluttered). To analyse whether the relationship between EP and unemployment is positive or negative, I have added a linear regression 'trend line' or 'line of best fit' to the picture. This line is the best (straight line) estimate of the relationship between EP and unemployment rates[27].

The line shows a positive relationship, but we this should not be taken as evidence that increases in employment protection cause higher unemployment. This is for four reasons. Firstly, the line itself explains very little of the variation in the points on the graph. The extent of the variation measured by the graph is given by the 'R-squared' statistic, which is around 0.07. For any two-way scatter graph like this, the R-squared statistic can range between 0 and 1. A value of 1 would mean that the points in the graph lined up in a straight line, whereas a value of zero would mean that the points were in a 'cloud', with no obvious relationship whatsoever between employment protection and unemployment. A value of 0.07 is much closer to zero (i.e. no relationship) than to one (i.e. a strong relationship).

Secondly, even to the slight extent that there is a correlation between employment protection and unemployment, two-way analyses like this are subject to the limitation that no other control variables are included in the analysis. To the extent that other variables are correlated with either unemployment or EP, we could be picking up the effects of these variables rather than a true causal effect of EP on unemployment (this is the well-known problem of 'omitted variable bias'.

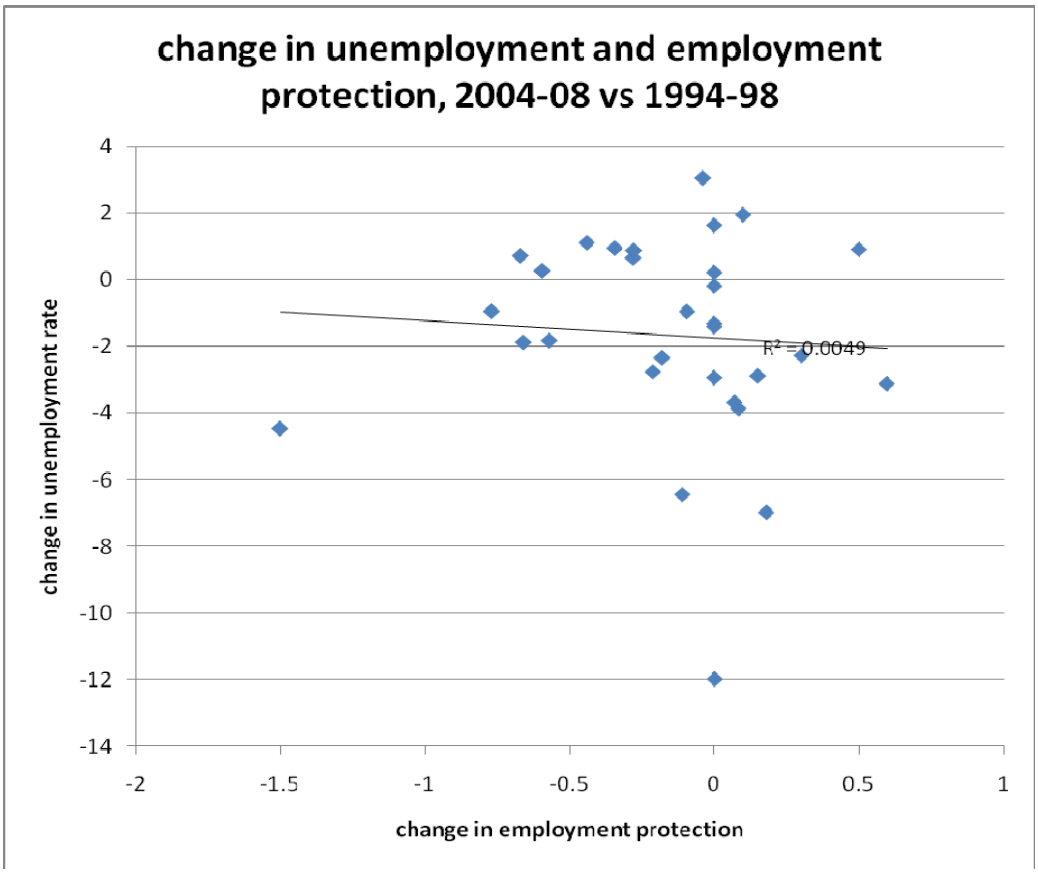
Thirdly, we have no way of establishing the *direction* of causality using analyses like these. For all we know, it could be that increases in unemployment lead to increases in employment protection rather than the other way round.

Fourthly, both measures are aggregates which conceal a lot of variation in different countries' labour markets. Some countries have very different unemployment rates for men and women, or for people of different ages. Employment protection can vary across – and within – each of the seven dimensions listed earlier in this section, meaning that any aggregate measure fails to capture the detailed differences between different countries in how employment protection policies are implemented.

[27] Technically, the line is chosen to minimises the sum of squared deviations of each point from the line.

It is impossible to address most of these issues within the constraints of the scatterplot framework. There is, however, one simple refinement we can make. If we graph the *change* in employment protection between two periods – say between 1994-98 and 2004-08 – against the change in unemployment over the same two periods, this may be a more useful way to assess whether *changes* in employment protection (i.e. reforms which deregulated the labour market by relaxing employment protection) were associated with reduced unemployment. This is a key contention of the orthodox view of the way the labour market operates. Figure 3.6 shows a graph of the change in the OECD employment protection measure against the change in unemployment for the OECD countries in this analysis.

Figure 3.6



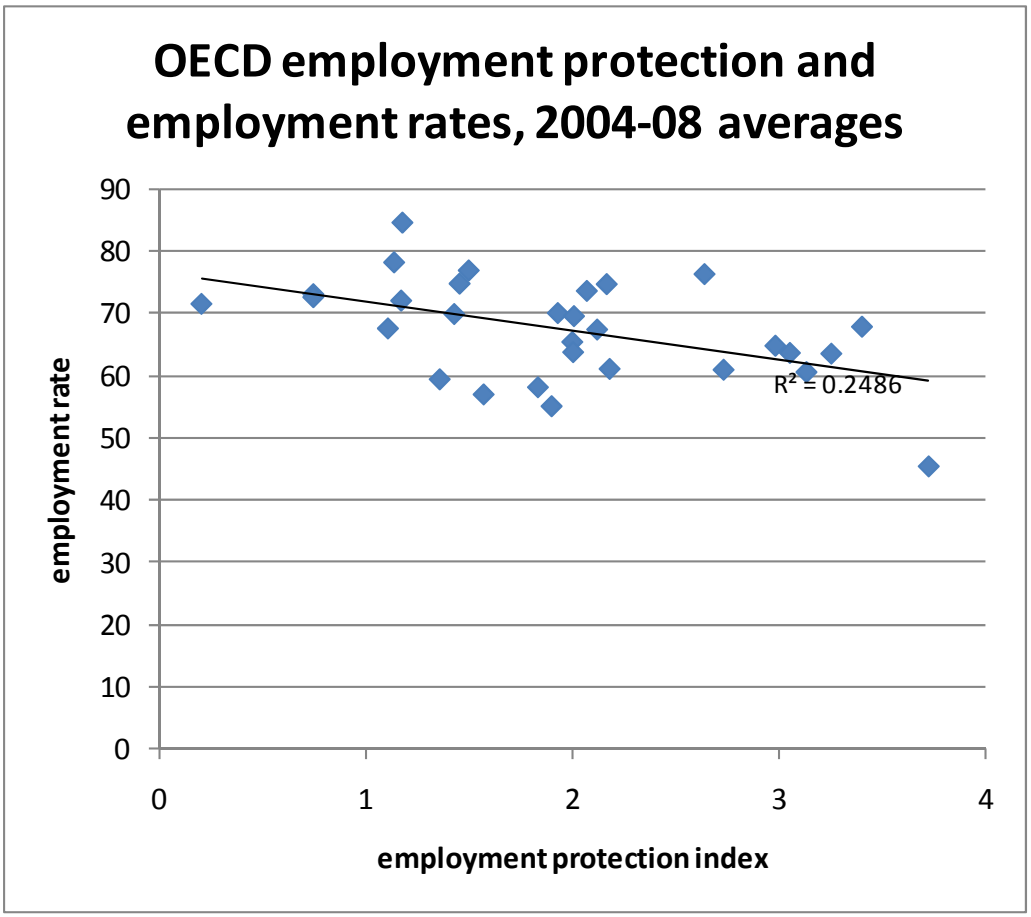
Source: OECD Main Economic Indicators

With an R-squared statistic of less than 0.01, there is no significant statistical relationship between the change in employment protection and the change in unemployment rate between the two time periods. The line of best fit slopes downwards slightly, which would imply that an increase in employment protection decreases unemployment. But the

relationship is too weak to set any store by. Figure 3.6 shows one of the pitfalls of the descriptive approach to analysing labour market performance; a simple change in the way the statistician uses the variables in question (i.e. taking differences rather than levels) can have a huge impact on the conclusions drawn from the data[28].

What about if we use employment, rather than unemployment, as the measure of labour market performance? The results are shown in Figure 3.7 and 3.8

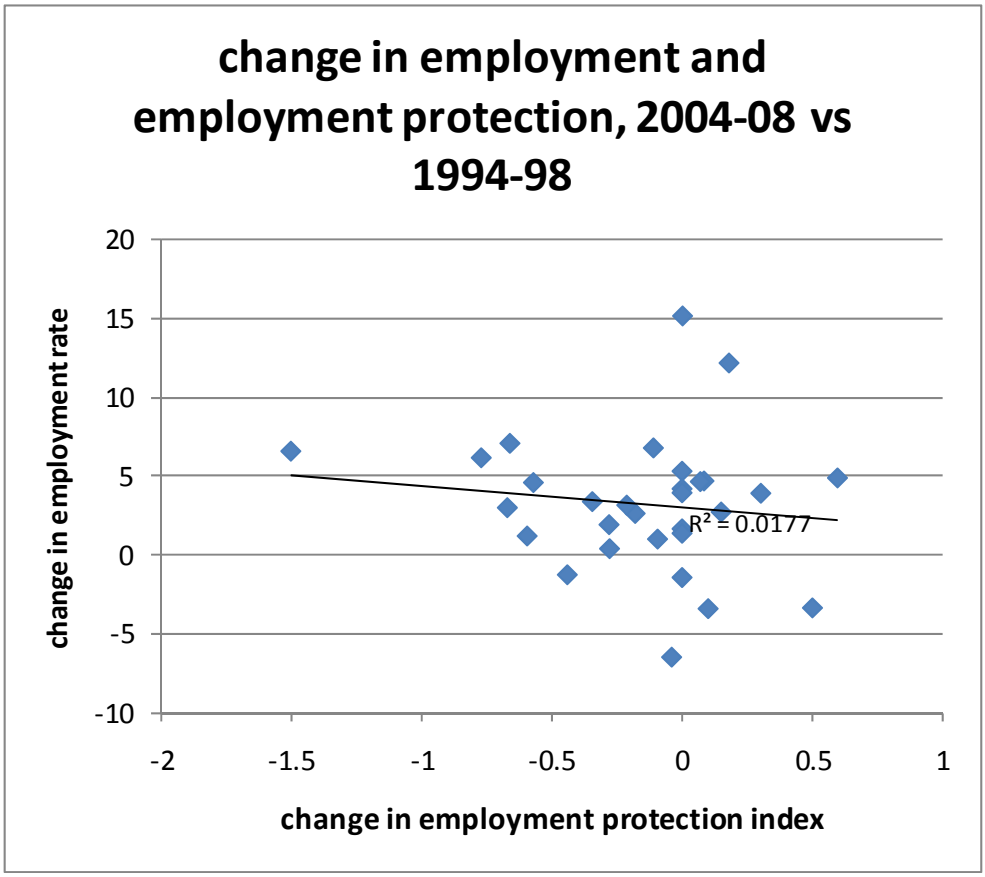
Figure 3.7



Source: OECD Main Economic Indicators

[28] If we change the measurement of the unemployment variable so that it measures only *long-term* unemployment (the proportion of 15-64 year olds unemployed for 12 months or more), the results change very little. Full results are not presented here for space reasons, but are available from the author on request.

Figure 3.8



Source: OECD Main Economic Indicators

Figure 3.7 shows a negative relation between the level of employment protection and the level of employment compared with the positive relationship found in the case of unemployment in Figure 3.5, implying that countries with more employment protection have slightly lower employment levels. However, if Turkey (the point on the lower right hand corner of the graph) is excluded, the line of best fit is a lot flatter and the R-squared drops from 0.24 to about 0.13. Hence, the relationship does not appear very robust to 'outliers' in the data. Figure 3.8 also shows a negative relationship between changes in EP and changes in employment, but as with Figure 3.6 the regression line explains very little of the variation in the data – the R-squared is less than 2 percent.

Trade union density

The other measure of labour market (in)flexibility I examine in this section is trade union density (the percentage of employees who are members of a trade union)[29]. This is much

[29] Note that trade union density is not necessarily a good indicator of trade union *influence*, which may be the most important factor in determining the effect that trade unions have on labour markets. For example, France has very a

easier to measure than employment protection, being a simple index. Table 3.3 shows the countries ranked on this measure, from highest to lowest union density in 1990, and their rankings in 2007. The right hand column shows the change in union density from 1990 to 2007.

Table 3.3

	Trade union density (%)				Change (% pts)
Country	**1990**	**rank**	**2007[30]**	**rank**	**1990-2007**
Iceland	92.1	1	88.6	1	-2.5
Sweden	80.0	2	70.8	2	-1.8
Denmark	75.3	3	69.1	3	-6.2
Finland	72.5	4	70.3	4	-2.2
Norway	58.5	5	53.7	5	-4.8
Ireland	56.7	6	31.7	9=	-25.0
Poland	54.8	7	14.4	22	-40.4
Belgium	53.9	8	52.9	6	-1.0
New Zealand	48.8	9	22.0	14	-22.8
Luxembourg	47	10	41.8	7	-5.2
Austria	46.9	11	31.7	9=	-15.2
Australia	40	12	18.5	19	-21.5
United Kingdom	39.3	13	28	12	-11.3
Italy	38.8	14	33.3	8	-5.5
Greece	37.5	15	23	13	-14.5
Canada	32.9	16	29.4	11	-3.5
Germany	31.2	17	19.9	15	-11.3
Portugal	27.5	18	18.7	18	-8.8
Japan	25.4	19	18.3	20	-7.1
Netherlands	24.3	20	19.8	16	-4.5
Switzerland	22.7	21	19	17	-3.7
Turkey	19.2	22	8.3	25	-10.9
Korea	17.2	23	10	24	-7.2
United States	15.5	24	11.6	23	-3.9
Spain	12.5	25	14.6	21	+2.1
France	10.3	26	7.8	26	-2.5
average	**41.6**		**31.8**		**-9.8**

Source: OECD Main Economic Indicators

Table 3 shows that union density decreased by an average of ten percentage points over

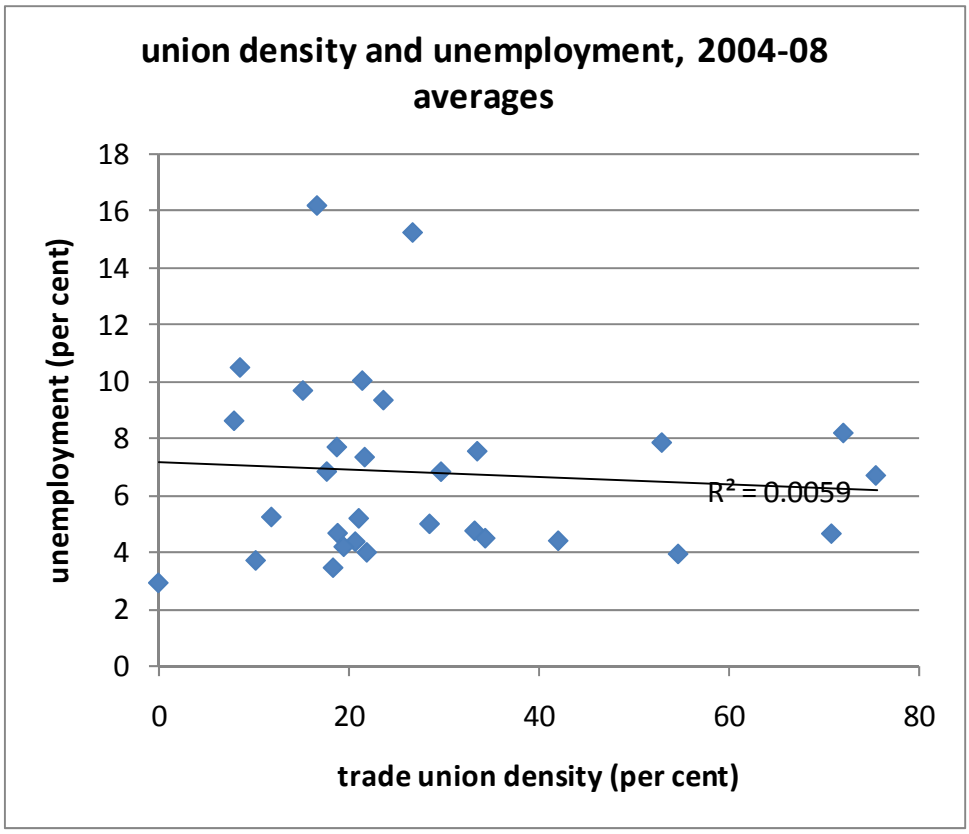
much more significant role for trade unions than its (relatively low) trade union density figure would suggest, because unions negotiate collective agreements over wages in many industries which affect a large proportion of the non-unionised workforce as well as the unionised workforce.

[30] Or most recent available year.

the period 1990 to 2007. The only OECD country to experience an increase in union density over the time period was Spain. However, in some countries union density was more or less constant (e.g. Finland, Belgium) whereas other countries saw falls of 20 percentage points or more (e.g. Australia, New Zealand, Ireland, Poland). The UK's fall in union density, from 39 percent to 28 percent, over the time period is about average.

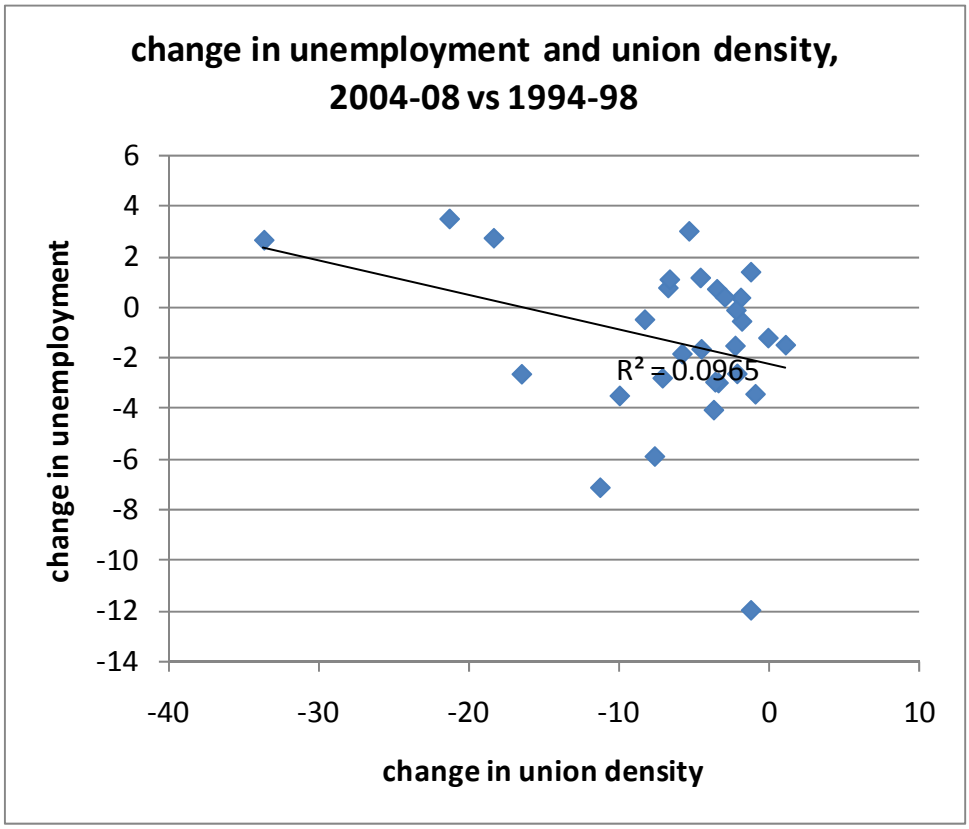
Does union density show a more robust correlation with unemployment than did employment protection? Figure 3.9 shows the correlation between the level of union density and the level of unemployment (in the years 2003 to 2007), while Figure 3.10 shows the correlation between the change in union density and the change in unemployment over the same time period.

Figure 3.9



Source: OECD Main Economic Indicators

Figure 3.10



Source: OECD Main Economic Indicators

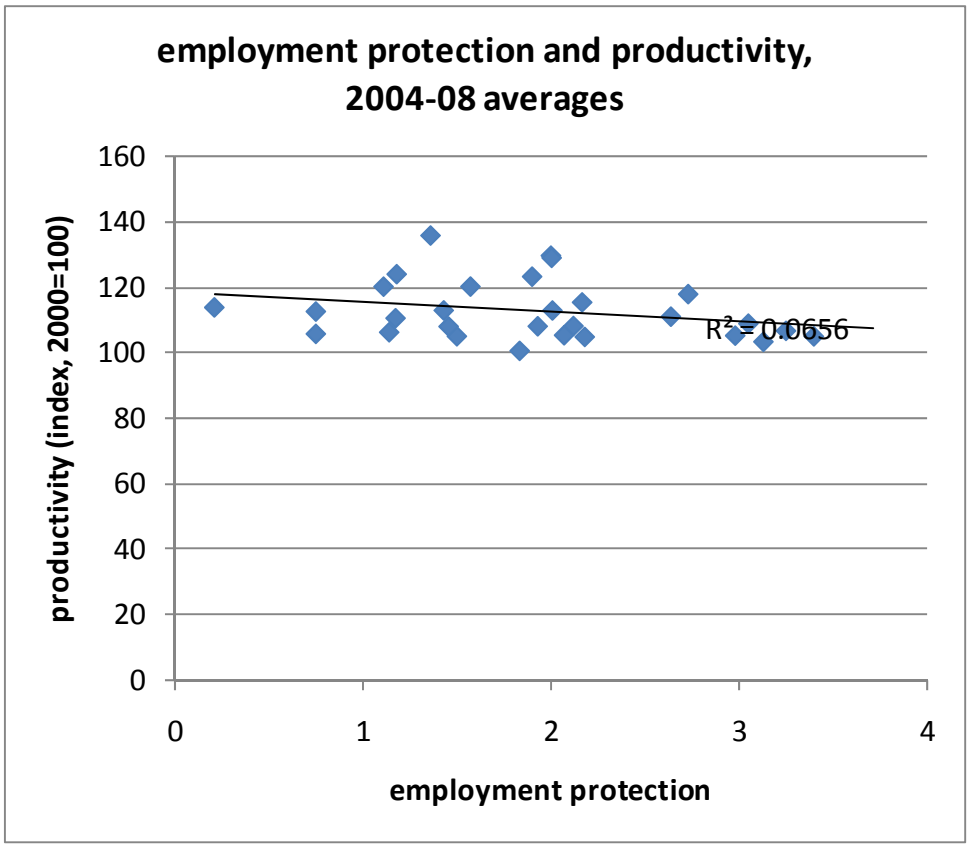
Figures 3.9 and 3.10 suggest that there is very little relationship between union density and unemployment, looking at either levels or changes of the two variables. In Figure 3.9 the R-squared of the graph is less than 0.01 and even in Figure 3.10, which shows a slight negative relationship changes between unemployment and union density, the R-squared is less than 0.1. Also, the result in Figure 3.10 is partially driven by Spain (which had a huge decrease in unemployment with almost no change in union density over the period) and the Czech Republic (which had a massive decrease in union density and a small rise in unemployment, but which may be very unrepresentative, as it was a transition economy over the 1990s). But is certainly true to say that there is no obvious support for the orthodox view of unions as an impediment to the efficient functioning of the labour market in these graphs.

Using productivity as an alternative measure of labour market performance

Finally in this section, I return to employment protection as a measure of labour market regulation but graph it against a different measure of labour market performance – *productivity*, measured as Gross Value Added (GVA) per worker. Figure 3.11 shows the

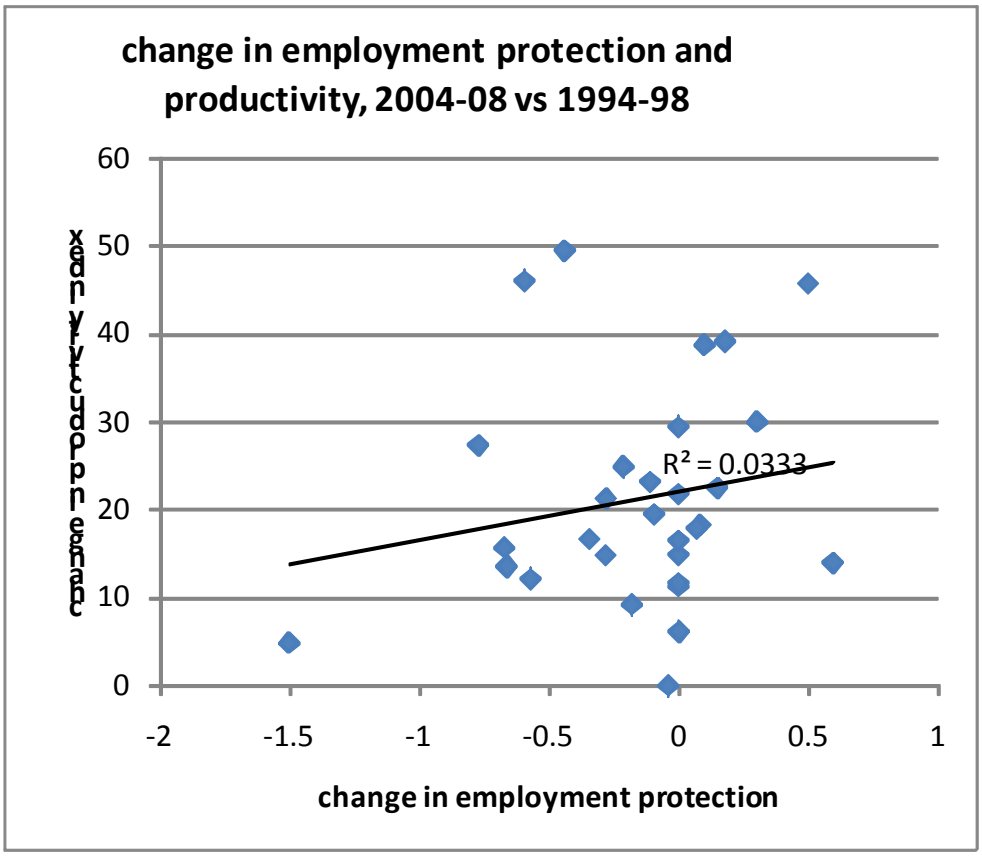
relationship between the two variables in levels, and Figure 3.12 shows the relationship between the change in the variables over the 1990s to the 2000s. However, it should be noted that the measure of productivity used here is an index measure, taking 2000 as a level of 100. So, the average productivity over the period 2004-08 is actually the average *growth in productivity between 2000 and 2004-08* rather than the relative levels of productivity in each country in 2004-08. Hence if anything, Figure 3.11 is graphing the rate of change of productivity against the level of employment protection. This is actually quite a useful exercise, as some economic theorists believe that employment protection reduces productivity growth in the economy by slowing down the movement of labour to more productive uses (as it is more difficult for employers to get rid of less productive workers) – see, for example, Caballero and Hammour (1998).

Figure 3.11



Source: OECD Main Economic Indicators

Figure 3.12



Source: OECD Main Economic Indicators

Again, the proportion of the variation in the data which is explained by the best-fit lines in these graphs is tiny – in Figure 3.11 the R-squared is less than 0.07, whereas in Figure 3.12 it is around 0.03. From these results it is impossible to make any general claim about the relationship between employment protection and productivity – just as with the other variables covered in this section.

Summary of descriptive evidence

The descriptive evidence analysed in this chapter shows, in general, that there is no strong overall pattern of support for the orthodox view that labour market regulation – or increases in labour market regulation – have an adverse impact on employment, unemployment or productivity. It is certainly possible to find specifications where the slope of the 'line of best fit' supports orthodox intuition, but it is equally possible to find specifications where the slope goes in the opposite direction. Given the limitations of the

two-way tabulation or scatterplot technique as an empirical strategy, it would be very rash to rely on these descriptive techniques as any kind of guide to policy. Indeed, it is perhaps puzzling why organisations such as the OECD include diagrams of this type in their publications at all, given their potential to mislead casual readers. They are only really useful for presenting the raw data on economic outcomes or labour market regulation in uni-dimensional form (as shown in Table 3.1 or Figure 3.1 for example) as this gives a useful indication of what the distribution of economic outcomes and of regulatory strictness across countries looks like, which is a good starting point for analysis. However, anything more than this is pushing past the limits of what descriptive methods can reliably offer. Hence the next chapter moves on to an examination of results using econometric methods which can handle more than two variables at once.

4. Macroeconomic studies of the impact of labour market flexibility on economic performance

Macroeconomic studies of the impact of labour market flexibility on economic performance are nearly always based on *cross-country panel* data sets (usually over a period of at least 10 to 15 years, sometimes a lot longer). Models of the following form are estimated using regression techniques with the general format of:

$$y_{c,t} = f(LMF_{c,t}, X_{c,t}, C_c, T_t) + \varepsilon_c$$

Where:

$y_{c,t}$ is the outcome variable for country *c* at time *t*

$LMF_{c,t}$ is a vector (i.e. a set) of 'labour market flexibility' or rigidity measures

$X_{c,t}$ is a vector of control variables, i.e. demographic structure, macroeconomic variables, product market features, etc.

C_c is a set of country-specific 'fixed effects'

T_t is a set of time effects (e.g. a time trend)

ε is an error term, corresponding to the proportion of the variation in *y* that can't be explained by any of the other regressors.

Because the macroeconomic approach has certain important limitations I discuss these first *before* examining any of the empirical evidence. It is important to be clear about what this approach can do and what it can't do.

Drawbacks of the macro approach

Variable measurement

Variables in these regressions are often poorly **measured**. The outcome variables (usually aggregate measures of the labour market like employment or unemployment, wider

measures like productivity or more abstract factors like happiness) are relatively straightforward although there are issues to do with concepts like unemployment[31]. Institutional variables are harder to measure. A good example is the extent of employment protection, which, as we saw in the previous chapter has several dimensions from the notice period employers have to give before firing someone to how much discretion courts or employment tribunals have. A macro-regression approach attempts to collapse all this rich information about each country's institutional arrangements down to one variable. While the OECD puts considerable effort into designing a consistent employment protection index across different countries[32], *any* single indicator inevitably 'throws away' a lot of information about cross-country differences in institutional arrangements – information which might contain vital clues about the best-functioning arrangements.

Similarly, unemployment benefit systems have a number of important factors which characterise them: how long unemployment assistance is paid for, what level it is paid at, whether it is paid at different levels for different family types, how strictly the work-search requirements are enforced, how the unemployment system interfaces with any active labour market policies that might be available, and so on. Again, standard OECD practice is to measure the generosity of unemployment benefits using just two variables – the average duration of unemployment benefits in a country, and the replacement rate (ratio of benefits to some average measure of in-work incomes). Once again, this collapses a large amount of information into a single metric.

Most of the other institutional variables which are used suffer from the same problem – using a single index number to capture variation across a range of different dimensions. For example:

– Union density is a very crude measure of union bargaining power. So are alternative measures of union strength, such as the extent of coverage of collective bargaining agreements across the economy.
– The degree of co-ordination and centralisation of wage bargaining are both concepts which are very difficult to summarise reliably in single index numbers.

[31] For example, Howell (2005) reports that one of the reasons for the measured unemployment rate being so high in Spain is that there are a lot of casually employed people – particularly men – of working age who would be classified as employed in many other countries but who report themselves as unemployed because they see that as the best description of their labour market status – they are mainly preoccupied with searching for permanent jobs. This doesn't explain all of the additional unemployment in Spain compared with other European countries but it accounts for some of the difference.

[32] See Venn (2009) for details of how the OECD has recently updated its employment protection measures to ensure greater reliability.

– The operation of active labour market policies (ALMPs – i.e. schemes which offer assistance with retraining or job search for unemployed workers) is often proxied by the total proportion of Gross Domestic Product spent on the schemes. But as Chapter 5 of this report shows, it is certain features of the way the schemes are designed, as much as the total amount spent, which determine their effectiveness. For example, Greenberg and Cebulla (2008) find that schemes which promote entry into work do better, in general, than those which promote training "off the job". There is no obvious way that a single index number can capture this subtlety.
– The 'tax wedge', a measure of the amount of direct tax which workers in a given country pay on their gross earnings, presents difficulties for several reasons. Firstly, most countries have *progressive* tax systems where the marginal tax rate is higher for workers on higher earnings than for those on lower earnings. This makes it impossible to produce a single figure for the tax wedge which covers all groups of workers, so some sort of average figure has to be used. But this is inherently an approximation and means that tax systems with very different marginal rate schedules could be included in the regression as having the same tax wedge. Secondly, employer taxes which are 'incident' on workers (i.e. where the worker ends up paying the tax through lower wages rather than, for example, shareholders paying through lower profits) should be included in the tax wedge measure, but rarely are. Thirdly, indirect taxes (e.g. VAT) are rarely included in the tax wedge measure – despite the fact that they reduce the effective purchasing power of workers' wages in the same way that direct taxes do – just through a different mechanism (making goods and services more expensive rather than lowering take-home pay).

Inferring causality

It is difficult to establish **causality** running from labour market institutions to economic outcomes (rather than the other way round) in a macro regression. Strictly speaking, in a 'classical' (i.e. idealised) regression framework of the form

$$y_{c,t} = Z_{c,t} + \varepsilon_c$$

the only circumstance under which correlations in *y* (the outcome variables) and *Z* (the explanatory variables) can be interpreted unambiguously as a causal effect is if the *Z*

variables are (a) *exogenous* (i.e. determined 'outside the regression system') and are exhaustive – i.e. they are the *only* factors which affect *y*.

Clearly, in the case of macro regressions linking labour market institutions to economic outcomes, neither of these conditions is satisfied. All labour market institutions are at some level the outcome of social – or at least governmental – choices, and it is entirely possible that a change in an economic outcome could cause a change in a labour market institution, rather than the other way round. For example an increase in unemployment could cause a state to devote more resources to active labour market policy, which could produce a negative correlation between ALMP spending and unemployment in a macro regression. But it would be completely wrong to infer from this that ALMPs caused higher unemployment[33].

Also, economic outcomes are the product of many other factors other than labour market institutions. The structure of product markets, the level of innovation, aggregate demand factors, volatility in the economy, shocks caused by natural factors (e.g. earthquakes), consumer tastes and cultural factors could all play a role, to give a far from exhaustive list. It is impossible to control for all these factors (and the possible interactions between them) in a regression of this type. The assumption behind the regression approach is that factors not included in the regression variables are subsumed into the error term of the regression, ε_c. However, for the estimates from the regression to be valid and unbiased, there must be no systematic relationship between the omitted factors and the variables actually included in the regression. In practice, researchers are unlikely to know for sure whether this is the case or not. However, to the extent that the omitted factors do not vary over time, estimating the equation using 'differences' – i.e. using *changes over time* in *y* and *Z* – helps improve the reliability of the estimates. Also, provided that the *most important* factors affecting *y* are included, analysts can have some degree of confidence in the regression results. However, it is usually impossible to eliminate 'omitted variable bias' completely.

For some of the variables typically included in macro regressions of this type, the 'omitted

33 There are various econometric techniques which attempt to get around the causality problem. One class of techniques uses timing variation between Z and Y to establish causality – the idea being that if Z happened before Y then Z caused Y. The other uses the variation in a third variable (or set of variables) W which affects Z but not Y and uses W as "instrumental variable(s)" for Z. Both these techniques have value but they are far from foolproof in the context of regressions of this type.

variable' problem is particularly obvious. For example, a 'tax wedge' variable is often included to proxy the overall tax burden on labour. But researchers estimating this type of model rarely, if ever, include variables corresponding to the type of public investments that taxation might be used to pay for – despite the fact that there is strong evidence that some types of public spending improve labour market performance and other aspects of economic performance. For example, in Chapter 6 of this report we examine evidence showing that public spending on transport infrastructure is positively associated with labour productivity. It is an open question whether the potential positive effects of infrastructure investments funded by taxation are large enough to affect labour market outcomes in regressions of this type. But if they were large enough, they could create a *positive* association between the tax wedge and labour market outcomes – which would fly in the face of the orthodox assumption that high taxation is deleterious to labour market performance.

Studies looking at the effects of LMF on unemployment

The most common type of macro-study looks at the relationship between various aspects of labour market flexibility and unemployment (or in some cases employment or activity levels) across countries. While there have been dozens of these studies over the past two decades, to keep this section manageable I focus on a recent study from 2005 which includes a survey of studies from the previous decade, and then a number of more recent studies which break new ground in this area.

Baker, Glyn, Howell and Schmitt (2005)

The study by Baker *et al* combines a survey of previous studies of the effects of labour market institutions on unemployment rates, which is then supplemented by the authors' own analysis over a slightly longer time period. It is easiest to summarise the results from their own study and the discussed studies in a table and then make some overall comments on the results. We have included only studies published since 2000 to keep the

results as up to date as possible.

A summary of the results is presented in Table 3.1 below. The first eight rows of the table give the main results regarding correlations (or lack of correlation) between the institutional factors and unemployment rates. So, for example, in the paper by Belot and van Ours (2002), a one-unit increase in the EP index is associated on average with an increase of 0.87 percentage points in the unemployment rate of a country, controlling for other factors. The middle part of the table, under the heading ‘interactions’, shows whether interactions between macroeconomic variables (e.g. the growth rate of output) and the institutions, and between the institutions themselves (e.g. a variable for the presence of active labour market policies *and* co-ordinated bargaining systems) are included. Including the interaction terms, or not, makes little difference to the actual results. The final three rows show whether additional controls for individual countries, time effects or country-specific trend variables are included. Once again, the precise set of time and country controls included makes little difference to the results.

Table 2.1. The impact of labour market institutions on unemployment – studies since 2000: results surveyed by Baker et al (2005)

Institutions	Belot and van Ours 2002	Nickell et al 2002	Blanchard and Wolfers 2000	Bertola et al 2001	Baker et al 2005
Employment protection index (1 unit increase)	0.87	4.45	0.24	0.2	-0.32
UB replacement ratio (+10 pp)	0.1	1.24	0.7	No effect	No effect
UB duration (+ 1 year)	Not included	0.88	1.27	1.43	No effect
ALMP (+ 10pp)	No effect	Not included	No effect	No effect	No effect
Union density (+10 pp)	-1.06	No effect	0.84	No effect	No effect
Union coverage (+10 pp)	-0.7	Not included	No effect	No effect	No effect
Bargaining co-ordination +1 unit	Not included	-11.64	-1.13	-1.11	-7.04
Taxes +10pp	1.79	1.69	0.91	0.97	No effect
interactions					
Institutions with macro factors	No	No	yes	yes	Yes
Institutions with institutions	Yes	Yes	no	no	Yes
Fixed effects					
Country	Yes	Yes	yes	yes	Yes
Time	Yes	Yes	no	no	Yes
Country trend	No	Yes	no	no	No
Sample period	1960-95	1961-92	1960-95	1970-96	1980-99

Notes: pp = percentage points

The main points to note about the results are the following:

- the only variables which have a consistent correlation with unemployment rates one way or the other in all the studies surveyed here are the presence of a co-ordinated bargaining system[34] between unions and employers (which is associated with reduced unemployment) and the tax "wedge"[35] (which is associated with increased levels of unemployment).

[34] The degree of co-ordination between unions and employers in the wage bargaining process is defined here using a dataset created by Professor Stephen Nickell and colleagues – an updated version of the measure used in Nickell et al (2002). This measures co-ordination on a scale 1 to 3, with higher values indicating that employers and unions are more co-ordinated on a national basis.

[35] The definition of the tax "wedge" used in this paper comes from the OECD, who define it as "the sum of personal income tax and employee plus employer social security contributions together with any payroll tax less cash transfers, expressed as a percentage of labour costs." Basically it is a measure of the direct tax burden on employees. See http://stats.oecd.org/glossary/detail.asp?ID=7273

- In the case of bargaining co-ordination, the impact of co-ordination (if causality does run from co-ordination to unemployment rather than the other way round, which is impossible to say for sure) varies wildly according to which regression is used – from around a 1 percentage point decrease in unemployment in Bertola et al (2001) to over 10 points in Nickell et al (2001). On average this is the strongest effect measured in the regressions.
- The tax wedge variable has a relatively minor impact on employment. A 10 percentage point increase in the direct tax burden on employees– a huge increase – is only associated with a 1 percentage point increase in unemployment. Given the difficulties with the measurement of the tax wedge outlined earlier, this is perhaps not surprising.
- The employment protection (EPL) and unemployment duration variables are significant and positively correlated with unemployment in *most* of the listed papers. However, again the effects are small; for example in Blanchard and Wolfers (2000) and Bertola et al (2001), a 1-unit increase in EPL (a large increase, given that the OECD use a 5-point scale to measure the maximum extent of variation and most countries are between 1 and 3) is associated with less than a 0.3 percentage point increase in unemployment. In the Baker *et al* study (the most recent in this subsection), increased EPL is actually associated with *reduced* unemployment – again the magnitude of the effect is small.
- The amount of spending on active labour market policies (ALMPs) – e.g. job training and job search programmes for unemployed workers or inactive people of working age – has no significant correlation with aggregate unemployment in any of the papers included here[36] (although the analyses don't consider variations in the design of ALMPs).
- In most cases the equations are estimated over a very long period – from the 1960s to the 1990s. Labour markets and the global economy underwent sweeping changes over this period and, while all the studies control for cyclical variations in the economy, it is probably implausible to expect that the structural relationships between individual labour market policies and the unemployment rate remained unchanged over time. For example, the content and administration of active labour market policies in 2000 was very different from the equivalent policies in 1960 in most industrialised countries.

[36] This result should *not* be taken as implying that ALMPs are ineffective across the board – as I show in Chapter 5, there is evidence from microeconomic studies that at least some of them have effects.

- The time periods used are quite out of date even considering that the studies are several years old now. None of them feature any data from the 21st century. A few more recent studies do contain more recent data (see below), but in general there is a publication lag of a few years.
- For the most part, the results are not very robust to the inclusion of interaction terms (with macro factors, or of institutions with each other) in the regressions. For example, in Blanchard and Wolfers (2000), an alternative specification of the regression which includes a time-varying interaction with the replacement rate variable results in the employment protection, tax wedge and union density variables all becoming insignificant. Belot and van Ours (2002)'s analysis also suffers particularly from parameter instability in the regressions depending on specification.

Overall, it is difficult to dispute the conclusions of Baker *et al* (2005) when assessing this evidence that:

"Our results suggest a yawning gap between the confidence with which the case for labour market deregulation has been asserted and the evidence that the regulating institutions are the culprits. It is even less evident that further weakening of social and collective protections for workers will have significant positive impacts on employment prospects. The effects of various kinds of deregulation on unemployment are very hard to determine and may be quite negligible." (Baker *et al* , 2005, p 108)

In other words, the strength of the collected evidence in these papers – which is the type of evidence that influenced the OECD *Jobs Study* and similar publications by the IMF – simply does not support the straightforward orthodox conclusions that the OECD and IMF drew in the 1990s. At best it offers limited support for the notion that employment protection and the tax wedge have a small positive correlation with the unemployment rate, controlling for other factors. The strongest result is that more co-ordinated wage bargaining systems are associated with *lower* levels of unemployment – an argument which runs completely counter to orthodox labour market prescriptions, and which was ignored completely by the OECD in the 1990s. While the OECD has since acknowledged that bargaining co-ordination might play a role in reducing unemployment, it still does not communicate this message as loudly or effectively as it should do if it were taking a consistent view of the evidence, such as it is.

Basselini and Duval (2006)

This is the most recent OECD study on the impacts of labour market regulation on economic outcomes using a macro cross-country framework. It is especially useful for our purposes as it includes separate equations for the impact of labour market regulations on *employment* rates as well as unemployment rates. This is particularly important because unemployment rates are only one aspect of labour market performance. As shown in Chapter 4, countries differ in the rates of employment of working age people – particularly women – more than they do in their unemployment rates, in percentage terms. Basselini and Duval also extend the sample of data used into the 2000s (as far as 2002).

Basselini and Duval find that the tax 'wedge' has a statistically significant relationship to unemployment; a 10 percentage increase in the direct tax burden on employees is associated with unemployment being 2.5 percentage points higher. This is a somewhat larger correlation than found in Table 2.1 above. “High and long-lasting” unemployment benefits are positively correlated with unemployment, while heavy *product* market regulation[37] (not featured in our list of labour market flexibility dimensions in the previous chapter because it is not strictly speaking a labour market characteristic, but included in some macro papers) is associated with increased unemployment. Highly centralised and/or co-ordinated wage bargaining systems are associated with reduced unemployment (as in Table 1 above).

One useful innovation of this paper is that it breaks down active labour market policies (ALMPs) into different types of policy (e.g. training, subsidised jobs, etc.), which is not done by most of the previous papers. The results show that publicly funded training programmes has a significant association with lower unemployment; other types of active labour market policy (e.g. job creation schemes or publicly subsidised employment) do not have any consistent correlation with the level of unemployment. As we show in detail in Chapter 5, these results are likely to be due to variations in the design and implementation of ALMPs, which can produce poor results if not well-designed (but which can be effective if designed properly).

[37] The ‘product market’ referred to here is the market(s) for consumer goods and services. For details of the way the OECD measures product market regulation see OECD (2009a).

In terms of the determinants of *employment*, the findings mostly mirror the results for unemployment. Higher aggregate tax rates and more generous unemployment benefits are associated with lower employment rates. For other variables the coefficients are rather different. Union density is *positively* correlated with employment rates, particularly for prime-age men – something that the orthodox model of the labour market would not predict. Co-ordination and centralisation of bargaining, product market regulation and employment protection legislation have no particular correlation with employment rates.

An interesting finding on the employment side is that the level of public subsidy for childcare has a positive correlation with rates of employment for mothers. Similar macroeconomic work looking specifically at women by Genre et al (2005) for the European Central Bank finds that the extent of maternity leave provisions in a country is positively associated with female employment levels. Again, it is not clear which way the causality runs here. Is it the case that good childcare or maternity leave provision increases female participation in the labour market, or do high female employment rates create pressure for childcare and maternity leave provisions to be upgraded? The microeconomic evidence in the next section casts more light on this issue.

There is some evidence that macroeconomic shocks (e.g. recessions) may be amplified by high unemployment benefits but dampened by highly centralised and/or co-ordinated wage bargaining systems. Also, a high rate of home ownership seems to be correlated with an increased unemployment impact of shocks. This conclusion is supported by microeconometric evidence for the UK from Battu, Ma and Phimister (2008) who use the British Household Panel Survey to analyse the effects of housing tenure on individual job durations and unemployment durations and find that being a homeowner reduces the likelihood of an unemployed person moving areas to search for new work compared with being a renter, conditional on other factors.

Amable, Demmou and Gatti (2007)

This recent paper extends the time series from 1980 to 2004 using 18 countries. Amable *et al* use a newly developed econometric estimator to improve the reliability of their regression estimates, and estimate separate equations for the determinants of unemployment, employment *and inactivity*, but otherwise the methodology here is similar

to that of earlier studies. They also include variables to capture correlations between the labour market and other features of the economy – product market regulation, whether the central bank in each country is independent, and the ratio of total financial assets to GDP for each country.

The main results are that the replacement rate[38] and union density have a significant positive impact on joblessness, whereas employment protection legislation and coordinated bargaining have a negative impact; the finding on employment protection is in contrast to most other studies. In the employment equation, both higher product market regulation and an independent central bank appear to be negatively correlated with employment. The authors suggest that the negative result for central bank independence may be because independent central banks are more committed to lowering inflation which can result in higher unemployment, as increases in interest rates reduce demand in the economy which increases unemployment. This is an issue which we return to in Chapter 7 of this report. When the sample of unemployed is broken up into subgroups, unemployed men aged 15 to 24 and 55 to 65 (i.e. at both ends of the working age distribution) seem to be more sensitive to labour market institutions and the business cycle than other groups.

In the inactivity equation, employment protection legislation seems to be related to *less* inactivity, while high product market regulation *increases* inactivity – two results which are somewhat at odds with the orthodox view of the labour market. Bargaining co-ordination has no impact on inactivity. (We analyse the relationship between product market regulation and labour market flexibility in more detail in Chapter 6).

This study shows that the results from running macro regression equations with employment (or inactivity) as the dependent variable can look very different from the unemployment equations examined in most of the literature. In the authors' own words:

[38] The replacement rate is defined as the ratio of out-of-work income to in-work income, either for a representative person or family (say a person who would be entitled to unemployment benefits if out of work, and would be on the average full-time wage if in work) or for some average out-of-work income and average in-work income across the working age population (or some sub-category of the working age population). The idea behind this concept is that the higher the replacement rate, the lower the incentive to work – because there is less of a financial gain to being in work. Of course, this measure does not take account of any conditions attached to benefits (e.g. needing to be actively seeking work), which have led some commentators to question its usefulness. Nonetheless, the concept remains in widespread use in the macro-regression literature. The particular definition of the replacement rate used in Amable *et al*'s paper is sourced from Allan and Scruggs (2004).

"The influence of institutional arrangements is actually far more complex than implied in most theoretical models and policy agendas. Notably, the results appear more complex than what is stressed by the "new orthodoxy view". We do not generally confirm the superiority in terms of employment performance of systems founded on deregulation."

The effects of labour market flexibility on wider economic outcomes

The bulk of the macro-regression evidence considers the impact of labour market flexibility on labour market outcomes. There are however some papers which consider wider economic outcomes – for example, productivity, or more abstract well-being measures such as happiness. (I should stress that the results discussed below are aggregate measures for the national economy; I cover micro-studies of the impact of flexibility on measures such as productivity, innovation and job satisfaction later on in this chapter).

Storm and Naastepad (2007) use macro-regression to look at the determinants of *productivity growth* rather than unemployment or employment. Defenders of the orthodox view of labour markets would assert that labour market regulations reduce productivity growth because they reduce the rate at which resources are reallocated in the economy from less productive to more productive firms. But the literature on this subject in economic theory is inconclusive, and like most results in labour economics, sensitive to the particular assumptions that are made[39]. (We return to this issue in more depth in Chapter 6).

In this regression, a technique known as factor analysis is used to collapse various

39 Theoretical contributions suggesting that labour market regulation will reduce the incentive to innovate by firms in the economy include Malcolmson (1997) and Flanagan (1999) who argue that organised labour has an incentive to 'hold up' innovative firms and demand higher wages once the firm has made 'sunk' (i.e. irreversible) investments – which reduces the firm's incentive to make the investments in the first place. Bartelsmann et al (2003) argue that labour market regulation may restrict the degree to which firms are able to experiment in finding the best combination of technological and organisational structure following the uncertain outcome of innovative investments. On the other hand, co-ordination of bargaining across the economy may reduce the severity of the 'hold-up' problem across the economy (Haucap and Wey, 2004). By driving inefficient firms who can't afford the 'going rate' for labour off the market, national wage-setting may expedite structure change (Agell and Lommermud, 1993). It is also possible that labour market regulation may affect productivity through its impact on worker motivation and effort, through (for example) fairness and commitment theories of 'gift exchange' (Akerlof, 1982); promotion of investment in workers by firms through firm-specific human capital (Auer et al, 2005) and promoting workers' own investments in training (Kleinknecht et al, 2006). Labour market regulation to exploit these potential positive effects (rather than just leaving workers and firms to contract with each other by themselves) may be required because labour needs to be able to enforce the commitments of firms to long-term employment and productivity gain sharing – which requires an employment relations system which offers legal protection to workers' rights.

aspects of labour market regulation (employment protection, minimum wages, legal entitlements to holidays and leave, etc.) into a single index of labour market regulation (the “LMR index”). This is, of course, an “index of indices” and so is doubly subject to the criticisms about collapsing too much information into one number that were mentioned at the start of this section. Using this index, Storm and Naastepad find a *positive* relationship between LMR and productivity growth. Breaking labour market regulation down into separate components, they find that the strongest positive association is between employment protection and productivity growth. Again this flies in the face of the orthodox view. However, as with most of the other results reported in this section, the results are not particularly large in size.

Sharkh (2008) uses a 'cluster analysis' which groups different countries according to the strength of (a) employment protection legislation, (b) union strength and collective bargaining coverage and (c) 'social protection' – the generosity and coverage of their unemployment insurance, and looks at several dimensions of economic performance at once – labour market outcomes, productivity, inequality and poverty. Countries are grouped as follows:

- An 'Anglo-Saxon flexible labour market' cluster of countries consisting of New Zealand, the UK, the US and Canada. These countries feature relatively low employment protection and union power and a low-to-moderate degree of social protection.
- The 'European flexible labour market category: Belgium, Greece, Switzerland and Ireland – rather like the Anglo-Saxon cluster but with slightly more protection and regulation on all three dimensions.
- ‘Flexicurity` - Finland, the Czech Republic and Denmark with relatively high levels of social protection, and moderate levels of employment protection and union strength.
- the 'corporate continental triple secure' category, - Spain, Germany, Italy, Portugal, Poland, Norway, Sweden, France and the Netherlands – with high scores on all three indices.

Sharkh's results show that of the developed countries in the study, the 'flexicurity' countries seem to perform best on most of the outcome measures, with lower inequality and poverty, high growth and relatively low unemployment. However the differences in the cluster averages on each outcome measure are small.

Finally, DiTella and McCulloch (2008) make a contribution to the emerging literature on *happiness* as a measure of social well-being (see Layard, 2006 for example) by analysing data from the Eurobarometer survey of social attitudes and its US equivalent, the General Social Survey, with an analysis of 400,000 individual data responses on the determinants of happiness in twelve OECD countries between 1975 and 1997[40]. (The cross country regressions for the determinants of happiness include national income but also a number of other factors (e.g. labour market variables). The results show that being unemployed oneself has a strong negative correlation with happiness (as one might expect), but on top of this, the aggregate unemployment *rate* in a country has a negative association with happiness. A one percentage point rise in a country's unemployment rate has the same degree of negative correlation with happiness as a drop in GDP of around 6%. Controlling for the unemployment rate, income and individual employment status, more generous unemployment benefits are associated with increased happiness. Hours worked also have a significant negative correlation with happiness. The magnitude of the parameter estimates suggests that a 1% increase in working hours would have to be compensated by a 2.4% rise in GDP per capita to keep national average happiness at the same level. There is also a slight negative correlation between the level of income inequality and happiness in each country, controlling for other factors.

Alternative measures of labour market flexibility in macro research

A recent paper by Vassilis Monastiriotis of the LSE European Institute (Monastiriotis, 2006) is worth examining in some detail as it takes a completely different approach to measuring labour market flexibility at the macro level. Monastiriotis argues that:

(1) the measures of flexibility used in the traditional macro empirical work examined so far in this chapter are not an accurate reflection of the actual degree of flexibility in each national economy; and
(2) due to the cross-country focus of conventional macro research, an implicit assumption is introduced that the unemployment relationship is the same across the sample countries and that within-country differences in unemployment performance and labour market flexibility are small. In fact, differences *within*

40 Although this survey uses microeconomic survey data I have placed it in the macro evidence section because the way the data are analysed have a lot more in common with the studies in this section than those in the micro section.)

countries are often more pronounced than differences across countries (for example, in spring 2009 working age unemployment rates in England ranged from 1.7% in East Devon to 14.8% in Sandwell in the West Midlands).[41]

In place of the cross-country data sets used in all the other papers examined in this chapter, Monastiriotis uses data for a single country – the UK – broken down according to standard administrative regions (e.g. North West England, Yorkshire and the Humber, etc.) He constructs indicators of labour market flexibility using the typology of the 'flexible firm' as identified by the work organisation theorists Atkinson and Meager in the 1980s as a starting point (Atkinson and Meager, 1986). His aim is to "adopt a view that sees flexibility as a set of observable labour market outcomes, represented by the extent to which flexible employment arrangements are identifiable in a labour market." The flexibility measures are based on data on the extent to which various flexible working arrangements – for example, irregular hours, temporary contracts, paid and unpaid leave, minimum standards, trade union bargaining, multi-tasking, team working, sub-contracting, outsourcing, childcare provision, qualifications and training provision, and so on) are used based on the responses of employees in the UK Labour Force Survey from 1985 to 2004. These are then aggregated into four flexibility measures, based on Atkinson and Meager's distinction between 'internal' and 'external' workforces, and 'functional' and 'numerical' processes:

- **internal functional** flexibility (e.g. multi-tasking)
- **internal numerical** flexibility (e.g. shift patterns, use of overtime)
- **external functional** flexibility (e.g. out-sourcing, sub-contracting)
- **external numerical** flexibility (e.g. temporary workers, part-timers)

Analysis of these four aggregate measures shows that flexibility in the UK economy increased between the mid-1980s and mid-1990s but has been declining since the mid-1990s. This fits with the conclusion of the report of the House of Commons Select Committee on Trade and Industry (2005) on labour market flexibility but runs counter to the view of HM Treasury (2003) which was that UK labour market flexibility had carried on increasing from 1997 onwards.

Monastiriotis's empirical analysis of the impact of the various dimensions of flexibility on UK unemployment involves regressing regional unemployment levels on the flexibility

[41] Source: NOMIS.

measures with controls for regional fixed effects, time-specific macro effects, productivity changes and inflation effects. The results suggest that overall, flexibility has a *positive* association with unemployment – contrary to the predictions of the orthodox economic model. This result persists even after an "instrumental variables" procedure is used to correct for possible reverse causality. Flexibility also appears to increase unemployment *persistence* (the extent to which macroeconomic "shocks" which increase unemployment – e.g. recessions – have effects which persist over a number of years). The different aspects of flexibility appear to have different impacts: for example internal functional flexibility is associated with higher unemployment, whereas internal numerical flexibility is associated with lower unemployment.

The conclusions from this (so far) unique approach to research on flexibility using aggregate data seem, if anything, to strengthen the overall impression emerging from cross-country macro research that it is very difficult to substantiate the orthodox view of a strong link between increased labour market flexibility and better economic performance.

Conclusions from the macro evidence

Overall, as many commentators including Baker *et al* (2005), Freeman (2005) and Coats (2006) have pointed out, the aggregate macro evidence for the orthodox proposition that labour market regulation has a negative impact on economic performance is mixed, at best. The strongest result – that co-ordinated bargaining is associated with reduced unemployment – runs directly counter to the orthodox prospectus. Based on this result, the OECD and IMF should be recommending that countries where collective bargaining is weak or non-existent – like the US, Britain and Australia – should be reforming their labour market to establish co-ordinated bargaining institutions. Of course, such a recommendation is noticeably absent from the packages of largely orthodox recommendations that supra-national economic organisations produce on a regular basis.

The only two robust findings from the macro evidence that could be taken as limited evidence in favour of the orthodox model are that the size of the tax 'wedge' and the generosity of the unemployment benefit system are correlated with higher unemployment.

However, it is important to note that these macroeconomic studies take a one-sided view of the tax system, because they do not take account of what the tax receipts are spent on. Publicly-funded investment in infrastructure, for example, can *improve* economic performance. To give a more specific example, Chapter 6 of this report looks at the relationship between labour market flexibility and transport policy and cites evidence showing that investment in public transport can reduce travel times and travel costs, thus improving the functioning of the labour market. As regards the generosity of unemployment benefits, the microeconomic evidence examined in Chapter 5 shows that high benefit levels are *not* a disincentive to work when adequate conditionality (e.g. job search requirements as a condition of receipt of benefit) are built into the system. Also, in both cases, the average estimates of the effects are rather small. Finally, both the tax wedge and unemployment generosity are measured very simplistically in these regressions.

Moreover, it seems that the results from the macro regressions are not very robust either to the precise set of variables included in the regressions (for example, whether interactions of variables, macroeconomic factors, country-specific fixed effects or time trends are used), or which particular measure of labour market performance is used. For example, the results for regressions where unemployment is the dependent variable are not simply the opposite of regressions where *employment* is the dependent variable, but actually look very different.

Because of the methodological and data-related deficiencies of the macro regression approach, it is likely that micro-level evidence on the impact of labour market regulation is likely to be more useful. This is the subject of the next chapter.

5. Micro-level evidence

Micro-level studies are in many ways preferable to macroeconomic evidence on the determinants of labour market flexibility. Whereas macro-studies suffer from ambiguities regarding aggregation and simplification of variables into indices, and the difficulty of ever establishing a causal link between labour market rigidities and economic performance, micro-level studies have the advantage of being to control for other factors which might affect labour market outcomes in a much more systematic fashion. This makes the results much more robust. For example, it is easier – although by no means completely straightforward – to establish causality running from policies to labour market performance, rather than vice versa.

The flip-side of this increased accuracy in isolating (as far as is possible) the causal impact of individual dimensions of labour market flexibility on labour market performance is that the results from micro studies are not individually generalisable. Each relates to a specific time and place and a specific policy, and it is necessary to collect many studies together to reach systematic conclusions about 'what works' in policy terms. However, a certain category of empirical studies known as 'meta-studies' do this in a formal way, by collating information from individual micro-level studies into a systematic review of the evidence. Where relevant meta-studies have been conducted, we refer to them in this chapter.

The other issue with micro-studies is that for the most part they focus on the impact of one particular policy – for example, the minimum wage, changes to the generosity of Jobseekers Allowance, or the introduction of the Information and Consultation Directive in 2005. This means that they can't normally be used to assess how different policies interact with one another (which was a strength of the macro studies). Thus, in this chapter we discuss micro-studies according to which dimension of policy or labour market flexibility they pertain to, rather than which economic outcome they pertain to. Most of the studies featured here look at some dimension of labour market performance (e.g. employment or unemployment, job satisfaction, etc.) as the outcomes, although there are exceptions (for example, some studies look at the impact on innovation at firm level).

In this chapter, we focus on quantitative studies, backed up by qualitative research in cases where the qualitative research reveals important results which are not covered by

the quantitative studies, or in some cases, where only qualitative evidence is available. In every case, we try to combine the most recent available evidence for the UK with evidence from other countries (where this shows interesting comparisons or gives evidence on features of labour market flexibility or rigidity which are absent from the current UK policy scene.)

Minimum Wages

The prediction from the orthodox labour market framework is that a minimum wage will either have no effect on the labour market whatsoever (if set at a level below what the lowest-paid worker in the labour market is paid) or will reduce employment (if set above this level). In this view, the higher the minimum wage is, the higher unemployment will be.

Alternative views based on imperfect competition in the labour market (e.g. Manning 2003a) suggest that it is quite possible that many workers are being paid less than the value of what they produce and in this situation, it is possible for a minimum wage to raise wages without having any adverse effect on employment. In fact, in certain models there may be a *positive* impact on employment (Card and Kreuger, 1995). There is a certain critical level above which we would expect to encounter adverse employment effects, but it is an empirical question as to where that level is. Also, the rate of an effective minimum wage may need to be differentiated in this view: certain workers with lower than average productivity (for example, young workers) may need to have a lower rate to avoid adverse employment effects. In the UK, the Low Pay Commission, which sets the level of the National Minimum Wage, sets lower rates for workers under 22 years of age.

Kaufman (2009) suggests that there is an additional rationale for minimum wages that goes beyond arguments about the structure of the labour market. This is the *inequality of bargaining power* between workers and employers[42]. Bargaining inequality arises partly

[42] Kaufman also outlines a second rationale for a minimum wage based on the *social cost of labour.* The idea behind this is that labour, like other inputs into production, requires some minimum ongoing expenditure to be 'maintained' (e.g. food, shelter, payments into old-age assistance schemes, healthcare and childcare costs. The idea, based on the work of Sidney and Beatrice Webb (Webb 1912) is that labour's inequality of bargaining power results into wages in low-wage labour markets being so low that some workers are unable to meet these basic needs – in other words, they cannot secure a 'living' wage. Kaufman argues that the 'social cost of labour' argument is the most important rationale for a minimum wage in a competitive labour market setting, but as this argument itself relies on the inequality of bargaining power between workers and firms (which pushes wages so low that workers cannot meet their maintenance costs), I have highlighted the bargaining inequality issue here.

from the fact that labour is a perishable good which cannot be inventoried like most other production goods. Most workers' bargaining power in employment negotiations is limited by the fact that they cannot afford to live for long without working – in other words they are likely to have 'shallower pockets' than employers. This is particularly the case for workers on very low wages who are unlikely to be able to save large amounts. Also, in countries with relatively weak employment protection, unskilled workers are easier to substitute with alternative sources of labour in the event of industrial action (because employers do not need to spend a lot on training up new workers if act to dismiss employees who are on strike).

Hence, the particular conditions of low-wage labour markets tilt bargaining power in favour of employers and results in low-wage workers having to accept lower average wages than they would do if bargaining strength of employers and workers were equal. I read this as a rationalisation of imperfect competition in labour markets using other supporting arguments; certainly the policy conclusions which follow – that a minimum wage can be effective at raising wages without harming employment in some circumstances – seem to back up the arguments that Manning and other theorists derive from the standard perfect competition framework. But Kaufman's argument is wider than this; like Keen (2001) whose radical analysis was discussed in chapter 1, effectively he is saying that the assumptions of the orthodox perfectly competitive view of the labour market are simply inappropriate – too simplistic – for real-world analysis.

Theory, then, suggests that the employment impact of a minimum wage is an open question. What does the empirical evidence suggest? The debate has swung wildly between defenders and opponents of minimum wages ever since 1995, when two eminent American labour economists, David Card and Alan Krueger, produced results from micro-studies on US data[43] which seemed to overturn the standard orthodoxy, showing that the best estimate of the effects of the minimum wage on US employment using micro-data from the 1980s and early 1990s was zero (Card and Kreuger, 1995). This conclusion has since been challenged: Neumark and Wascher (2007) argued, based on a meta-analysis of findings from micro-studies in the US and other countries, that there *is* a significant negative impact of increases in the minimum wage on employment, averaging across all

43 In the US there is a national (federal) minimum wage but each individual state can choose to set a state-level minimum wage in excess of the national minimum. Most of the US studies are based on “difference-in-differences” estimates which look at the change in employment levels in a state or states where the minimum wage was increased and compare this with the change in employment levels in a state or state where the minimum wage was held constant. Often, the studies look at matched workplaces in each state (for example, fast food outlets).

studies.

However, more recent analysis by Doucouliagos and Stanley (2009) using a meta-study of 1,474 empirical estimates of the effect of minimum wages on employment from 64 studies using US data finds that the results of Neumark and Wascher – at least for the US – are entirely driven by *publication bias*. This is the tendency, well-documented in empirical academic publications in a host of subjects, for empirical research which produces an outcome of an intervention or policy significantly different from zero to be more "interesting", and hence more likely to be published, than research which shows no effects of the policy or intervention (Sackett, 1979). In a minimum wage context, this gives two implications:

1. studies which find a negative impact of minimum wages on employment are more likely to be published that studies which find no effects.
2. Where researchers conduct an empirical study which produces several different results[44], there is a tendency to focus on the results which are statistically significant and different from zero, as this will make the paper more likely to be published (publication being the immediate objective of most researchers).

Once publication bias is controlled for using appropriate statistical techniques[45], the estimated average effect of minimum wages on employment from the meta-analysis is almost exactly zero. While Doucouglias and Stanley do not consider evidence from countries other than the US whereas Neumark and Wascher (2007) do, it is likely that publication bias operates in the same fashion for minimum wage research on data outside the US as it does within the US, given that researchers outside the US are mainly aiming to publish in the same prestigious journals as researchers in the US. Thus it is likely (though unproven) that Doucouglias and Stanley's results generalise to minimum wages in other countries.

44 Most empirical research, whether based on macro or micro data, produces several different estimates of the impact of the policy intervention being studied. The reason is that there are many different specifications that can be used for a regression (in terms of which variables are included and which are left out, the sample period, the particular econometric estimation technique used, etc.)

45 The techniques are based around the idea that in the absence of publication bias, the probability distribution of the estimated effects of a policy should follow a symmetric distribution around the average. If the estimated effects are asymmetrically distributed (as is the case for the minimum wage studies examined by Doucouglias and Stanley) then it is clear evidence of publication bias, and the 'real' average effect has to be estimated from the 'truncated' distribution.

In a UK context, the Low Pay Commission regularly commissions empirical work on the labour market effects of the UK's National Minimum Wage (NMW). The latest research report by Dickens, Riley and Wilkinson (2009) uses data from the UK Labour Force Survey (LFS) and the Annual Survey of Hours and Earnings (ASHE), and local area-level data to examine the impact of rises in the NMW between 2001 and 2006 on the wage distribution and on UK employment and unemployment. In terms of wage impacts, Dickens *at al* find little evidence of 'spillover' or 'knock-on' impacts on wages further up the wage distribution[46] – the effects of the minimum wage are mainly confined to the lowest paid 10 percent or so of wage-earners. The impacts on employment are mixed, but small. There is some evidence of reductions in hours for adult men resulting from upratings of the NMW in 2001 and 2003, but these are small in magnitude. In general there is no statistically significant evidence of reductions in employment or increases in unemployment arising from the uprating of the minimum wage in the UK. This is consistent with earlier evidence on the initial introduction of NMW which found no employment or unemployment effects. Draca, Machin and van Reenen (2006) present evidence from firm-level data before and after the minimum wage was first introduced in 1999 which suggests that the minimum wage increased wages at the expense of profitability for firms based in industries which employed a particularly high share of low-paid workers. This is some evidence in favour of the argument that, in the absence of a minimum wage, workers are paid less than the value of what they produce, and that the minimum wage stops this happening (at least for workers at the bottom of the wage distribution) by placing a floor under wages.

In summary, once publication bias is corrected for there is no evidence of adverse effects of minimum wages on the labour market in the United States (where the most research on this topic has been done). And in the UK, there is no evidence of adverse effects either. Given that we know from studies of the UK and US earnings distribution that the minimum wage does seem to set an actual wage floor, rather than being set below levels at which it would actually bite, the absence of a measurable employment effect presents a real challenge to the orthodox view of labour markets and is considerable *prima facie* evidence in favour of some alternative model – whether it be a conventional imperfect competition model of the firm's wage-setting decisions, more complex arguments based around inequality of bargaining power along the lines of Kaufman (2009), or something more

46 Prior to the introduction of the NMW in 1999 there was some concern that it would prompt knock-on wage increases for workers further up the wage distribution in a bid to maintain differentials between the lowest paid workers and those slightly further up the distribution. However, this does not seem to have happened (for earlier evidence see Dickens and Manning (2004).

radical altogether. That said, policymakers need to be careful not to be reckless with increases in the minimum wage. Even in alternative models, there remains *some* level above which minimum wages are likely to cause unemployment.

Employment protection legislation

In the economics and industrial relations literature, the term 'employment protection' normally refers to policies which reduce the ease with which firms can get rid of workers – for example unfair dismissal legislation, statutory redundancy pay provisions, and so on. Based on the OECD's employment protection index, the UK has relatively weak employment protection compared with most other industrialised countries. Employment protection provisions were loosened during the 1980s and 1990s under the Conservative Government, with some modest re-regulation under Labour (see Appendix 1). It is also worth noting that over most of this period, different provisions applied to temporary and agency workers, who were more lightly regulated than full-time non-agency workers in the UK.

Most of the theoretical work on employment protection legislation (EPL) in the economics literature predicts that EPL will reduce the extent of job flows in the economy. This is because it assumes that EPL reduces the rate of job losses in the economy (by making it more difficult for firms to get rid of workers) but also reduces the rate of job creation. The main rationale for this is that employers will be less likely to hire new workers if they face restrictions on being able to terminate their employment in the future.

However, the theoretical literature is split on whether employment protection is good for the economy (in terms of its impact on economic outcomes like employment, productivity and innovation) or not. In models which assume an orthodox perfectly competitive view of the labour market, EPL, like most other regulations, impedes the 'ideal' operation of the market and therefore reduces efficiency. However, in more realistic models there are countervailing effects:

- on the negative side, some models predict that EPL will lead to more 'shirking' by workers because firing workers is more difficult (Galdon-Sanchez and Guell, 2003),

and may create a barrier between a core workforce of employed, well-protected 'insiders' and a casually employed or unemployed periphery of 'outsiders' (Lindbeck and Snower, 2001). There may also be reductions in productivity growth and/or innovation if EPL impedes employment shifts from less productive to more productive sectors and/or firms over time (Caballero and Hammour 1998, MacLeod 2005).

- On the positive side, many 'job-search' models of the labour market suggest that the optimal level of EPL for economic efficiency is greater than zero because reduction in the risk of being fired acts as an insurance mechanism for workers (e.g. Fella, 2007). Similarly, severance pay is a (partial) insurance against the risk of being made unemployed, particularly in countries where unemployment benefits are low (Pissarides, 2004). EPL can also *increase* productivity and/or innovation in an economy where specific human-capital investments are important, but firms are vulnerable to economic shocks (Estevez-Abe *et al*, 2001).

Because of the complexity of labour market modelling once we deviate from the strict assumption of perfect competition in the labour market, the theoretical literature offers little guidance by itself on what the impact of EPL on labour market outcomes should be. And as we saw in the previous chapter, macroeconomic studies of the impact of EPL generate ambiguous results; for example, in terms of the effect of EPL on unemployment, some studies produce a positive effect, some a negative effect, and some no effect at all. Some of the macro evidence on job *flows* suggests that EPL reduces job creation and job destruction rates (see for example, Gomez-Salvador *et al* (2004), Wolfers (2005), Haltiwanger *et al* (2006)) but other studies find no overall relationship (e.g. Nickell and Layard 1999)[47]. In any case, the rate of flows between jobs is not necessarily an economic outcome variable that policymakers are worried about in itself; rather, they are interested in what the rate of job turnover means for economic well-being measures like employment, productivity and job satisfaction. And for this, micro-level evidence is more useful.

At the micro level, the evidence is once again mixed. The micro-level studies mainly exploit policy changes in the strictness of employment protection legislation which affect

47 The available micro-level evidence on the impact of EPL on job flows is also mixed. Bauer *et al* (2007) and Boeri and Jimeno (2005) find no measurable overall effect on job reallocation using micro-data for Germany and Spain respectively. Conversely, Miccio and Pages (2004) find that EPL slows down job reallocation, using data from the manufacturing sectors of 18 countries from the 1980s and 1990s.

some firms but not others, or compare micro-data sets in more than one country, to identify specific effects of EPL (if any) on economic outcomes. Van der Wiel (2009) examines the relation between employment protection and wage levels using Dutch panel data and finds that EPL appears to have a *positive* effects on wages. This could be due to encouragement of specific human capital formation (e.g. skill acquisition), or due to "rent creation[48]" arising from EPL making the labour market less competitive – unfortunately with the data available it is not possible to know for sure.

Gangl (2003) looks at the impact of EPL on job mobility among recent entrants to European labour markets using a special one-off module on transitions from school to work from the 2000 European LFS for 11 European countries. He finds that, as predicted by most of the theoretical literature, job and status mobility rates are negatively related to stricter EPL. However EPL has more complex effects on youth labour markets. Importantly, the empirical analysis shows a positive effect of EPL on occupational attainment of young workers in entrants' initial jobs, and by about 5 years after leaving the educational system. Overall, the impact of EPL on skills acquisition is positive in this study despite the fact that EPL reduces upward job mobility.

Kugler and Pica (2008), using data from Italy, find that a reform which increased employment protection (firing costs) for small Italian forms had an offsetting effect on accessions and separations, and thus left overall levels of employment unchanged.

Marinescu (2009) presents evidence from the 1999 British reform which reduced the qualifying period for redundancy and unfair dismissal provisions from 2 years to 1 year. She finds that the reform reduces the probability of *leaving* employment for the workers with tenure of between 1 and 2 years relative to workers with more than 2 years' tenure. The most convincing explanation for this is that the reform induced employers to spend more on recruitment to find workers who were better matched to their jobs (and thus, less likely to be candidates for firing). Bauer et al (2007) produce very similar results from a similar reform using German data.

[48] In economics, a 'rent' refers to a payment to a firm, worker or other 'economic agent' in excess of what the economic agent would receive in a situation of perfect competition in the economy (see Chapter 1). 'Rent creation' refers to a process by which firms or workers create distortions which move the economy away from perfect competition and towards imperfect competition, thus giving rise to the existence of 'rents'. Of course, this process assumes the correctness of the orthodox paradigm whose validity is explicitly brought into question by the theoretical and empirical economics covered in this report.

With regards to productivity and innovation, most of the available evidence is based on cross-country studies (although sometimes augmented by micro-data). Bartelsman and Hinloopen (2005) find that EPL has a negative effect on investments in information and communications technology (ICT) using data for 20 OECD countries between 1991 and 2000. However, Belot et al (2007) find that the relationship between EPL and productivity growth is non-linear. Very low levels of employment protection *reduce* growth because they reduce the incentive for workers to acquire job-specific human capital. Thus, up to a point EPL is productivity-enhancing. However, high levels of EPL raise wages and thus lower profitability (and hence investment), which reduces productivity growth. Scarpetta and Tressel (2004) find similar results to Belot *et al*.

The message from the literature on the effects of EPL on job satisfaction and job security is mixed. Green and Tsitsianis (2005) use micro-data from the UK and Germany for the 1980s and 1990s to look at the determinants of job satisfaction. While changes in the working environment (such as declining task discretion, which we return to later in this chapter) seem to have an impact on job satisfaction, changes in the strictness of EPL – and measures of job security – show no significant correlation with job satisfaction. Research using European panel micro-data on the relationship between the degree of employment protection and employees' own perception of job security by Clark and Postel-Visnay (2009) show that in the public sector, levels of job security are higher, but show no correlation with changes in EPL. In the private sector, job security is *negatively* correlated with the degree of employment protection. This is, on the face of it, a strange result, since if the link is causal it implies that strengthening employment protection makes workers feel *less* secure! Wasmer (2006) suggests a possible mechanism by which this result might be rationalised; if firms are prevented from firing particular workers then they may exploit other channels to induce the workers to quit – for example, harsher worker monitoring, a worse working environment, and perhaps even harassment. Wassmer uses data from a panel of Canadian individuals and finds positive links between employment protection and some dimensions of individual stress, and weaker but positive links between employment protection and depression. If this hypothesis (which has to be viewed as preliminary for now until more empirical work on this topic is carried out) is correct, then it suggests an important role for trade unions in counteracting this kind of pressure on individuals from employers in the workplace.

Another important result that comes through in some (but not all) of the microeconomic

literature, particularly in Europe, is that reducing the level of employment protection for temporary workers compared with permanent workers can result in a boom in the temporary worker sector but without increasing overall employment (see for example Dolado *et al* (2002) and Guell and Pertrongolo (2007) for Spain, and Autor and Houseman (2005) for the US). However Zijl (2005), using data for the Netherlands, finds that greater availability of temporary jobs *does* result in reduced unemployment spells.

In summary, the overall evidence on the impact of employment protection legislation is mixed. The most robust result from the literature overall is that strong employment protection reduces the extent of job flows and job reallocation between different sectors of the economy. This could potentially be a bad thing, if productivity increases are largely driven by reallocation of workers and investment from low-productivity to high-productivity sectors rather than by improvements in productivity within sectors[49]. However, if alternative jobs in expanding sectors offer better productivity (and hence, hopefully higher salaries) to the jobs which employees are currently located in, one might think that this *in itself* should provide a good reason to move – provided that mobility costs are not too high. However, there are also good theoretical reasons for believing that a certain degree of employment protection may help preserve jobs where specific human capital is an important determinant of productivity – particularly when the macroeconomic environment is as volatile as it is at the moment.

The fact that there are a number of different possible mechanisms by which employment protection might affect employment, unemployment and productivity means that it is unsurprising that the empirical evidence base does not deliver unambiguous results. One thing we can say for sure, however, is that according to the OECD EP index examined in Chapter 3, the UK already has one of the lowest levels of employment protection of any developed country. Hence it is, on the face of it, unlikely that a substantial reduction in EP *starting from the level we are at now* would deliver drastically enhanced labour market performance. Given that some of the theoretical literature suggests that EP has positive impacts on productivity at low levels which turn negative at high levels, it could just as

[49] The evidence on this issue is mixed. Disney, Haskel and Heden (2003) using UK data at the firm level between 1980 and 1992, find that 'external restructuring' (the process by which less efficient establishments exit and more efficient establishments enter and increase market share) accounted for around 50% of labour productivity growth over this period. However, Maudos, Pastor and Serrano (2008) analyse the causes of the productivity gap between the US and EU using the EU-KLEMS database of firms and find that the acceleration in the growth of labour productivity in the US since the mid-1990s is explained by greater productivity growth within individual industries, rather than reallocation of inputs between sectors.

easily be the case that reducing EP from where we are now actually reduces productivity.

"Family-friendly" policies: childcare subsidy and provision, maternity and paternity leave, and flexible working

This section looks at a set of policies which aim to regulate the labour market in such a way as to make work more compatible with having – and looking after – children. As explained in Chapter 1, whether such measures count as increasing 'flexibility' in the labour market depends on whose perspective you take. Broadly speaking, these measures increase flexibility for workers with children while reducing flexibility for employers.

There is a good deal of empirical evidence on the labour market effects of childcare, rather less about the impact of maternity leave, and almost none about the impact of paternity leave (although there is a larger literature about the impact of parental leave on child outcomes and parental health, which I will also cover.) There is a good deal of survey evidence on take-up of the right to request flexible working, although its impact on wider economic outcomes (if any) is still largely unknown. Below I consider each area of family friendly work practices in turn.

Childcare subsidy and provisions

The promotion of access to childcare for working families has been an important element in Labour's aim to increase the overall working-age employment rate in the economy to a target level of 80%, by moving more lone parents and couples with children into work[50]. The Working Families Tax Credit (introduced in 1999) and the Child Tax Credit (introduced in 2003) both included support for childcare expenditure for low-income working families, and the ambitious Ten Year Childcare Strategy launched in 2004 (HMT/DES/DWP/DTI, 2004) announced medium-term plans for a number of extensions to current state support for childcare provision. While it is not clear where the additional funding to actualise the Ten Year Childcare Strategy will come from in the current public finances squeeze, there is a reasonable amount of evidence from the economics and social policy literature that

[50] Data from ONS shows that after falling from around 75% to 71% in the early 1990s recession, the working age employment rate began to increase from 1995 onwards, reaching a peak of 74.9% in the first quarter of 2005. Since then it has declined to 72.5% in the third quarter of 2009, largely because of the recession.

childcare subsidies targeted on working families have a positive impact on the labour supply decisions of mothers – whether lone parents or in couples. In the UK, Paull, Taylor and Duncan (2001), Jenkins and Simons (2001) and Viitanen (2006) find that the introduction and subsequent extension of childcare subsidies in the UK tax credit system had significant positive effects on female employment. Viitanen's estimates suggest that the elasticity[51] of mothers' labour force participation with respect to the price of childcare is around -0.14. This implies that lowering the price of childcare by 10 per cent would increase the employment rate of working age mothers by about 1.4 percentage points. This is a relatively small effect, but it is statistically significant. Lefebvre and Merrigan (2008) produce similar evidence from Canada for the introduction of a provincial childcare subsidy in Quebec had a large and statistically significant impact on the labour supply of mothers with pre-school children. Baker, Gruber and Milligan (2008) produce similar results with Canadian data from elsewhere in the country.

Results from Nordic countries which have extended childcare subsidies mostly show no statistically significant effects on mothers' employment, but this seems to be because the childcare subsidies in those cases are available to mothers *in or out* of work, whereas in the UK they are available only to working mothers (Kosonen 2009 for Finland; Lundin *et al* 2008 for Sweden; Schone et al 2004 for Norway).

The result that childcare subsidies for working mothers increase female employment is not surprising from a theoretical perspective (whether in the orthodox model or alternative models), as the net cost of entering work is reduced. Obviously the subsidy has to be paid for – presumably out of increased taxation.[52] However, there is no evidence that increases in taxation have an adverse impact on aggregate economic efficiency (see Dophin, 2009, for example).

To summarise, we can say with some confidence (based on the existing literature) that childcare subsidies boost employment. They also assist women's re-entry into the labour market after having children; later in this chapter I examine the negative impact that

[51] 'elasticity' is a technical term in economics for the responsiveness of a quantity demanded or supplied to a change in price. If a good or service is 'demand-elastic', a certain percentage change in the price leads to a relatively large change in the quantity of that good or service demanded. Conversely, for a 'demand-inelastic' good or service the quantity bought changes relatively little if the price changes.

52 Although there is good evidence that subsidies for childcare for working mothers lead to an increase in employment, it is unlikely that the resulting increase in government tax receipts – and reduction in expenditure on out-of-work benefits – will enable the reforms to be "self-financing" once the impact of additional in-work subsidy is taken into account. See, for example, Giles and Duncan (1996).

childbirth has on subsequent wages in detail, but suffice to say at this point that there is strong evidence that subsided childcare has a role to play as part of a package to reduce the pay gap between men and women.

Parental leave legislation

Labour has made several extensions to mothers' rights to statutory maternity leave and maternity pay since coming to power in 1997, and also limited improvements to paternity leave (although the UK's current statutory paternity leave entitlement remains one of the smallest in Europe, at two weeks)[53]. In general, employer organisations have been more opposed to extensions of parental leave rights than childcare, because of perceptions that parental leave imposes an additional cost burden on businesses – either due to the cost of having to cover for the person on leave, and the temporary disruption for the business.

In terms of economic theory, the orthodox view of the labour market would suggest that in the short run, parental leave costs are shifted on to employees via lower net wages – in other words, the effects of parental leave are similar to the effects of paid holidays. In more complex models, where there is imperfect competition in the labour market and potential scope for bargaining, the effects of parental leave are less clear. There are also other channels through which parental leave could affect employment and productivity:

- on the negative side, long periods of parental leave might be disruptive to the business if it causes working patterns to have to be rearranged for the duration of the leave – which is especially likely to be the case in small firms.. Thus, there might be a negative productivity impact.
- On the other hand, to the extent that parental leave allows a mother or father to return to the same job – rather than having to leave the labour market and return to another job, it could result in an increase in productivity compared with a situation where no parental leave scheme is available. This is particularly the case if firm-specific human capital is an important element of job skills.

The empirical evidence on the impact of parental leave relates mostly to maternity leave.

53 However, in September 2009 the UK Government announced plans to introduce additional paternity leave for fathers of children due on or after 3 April 2011.

The balance of empirical evidence[54] suggests that:

- paid maternity leave increases the time that women spend out of the labour market immediately after giving birth (i.e. during the leave period);
- paid maternity leave increases the likelihood of women returning to employment after the leave period runs out;
- paid maternity leave increases the likelihood of returning to the same job – i.e. it improves worker retention;
- paid maternity leave has much bigger effects than unpaid maternity leave – largely because women are much less likely to take unpaid maternity leave;
- maternity leave has positive impacts on child health (measured by birthweight) and a negative correlation with infant mortality;
- maternity leave has a positive impact on mothers' health outcomes.

In terms of evidence on fathers, analysis of data from the UK Millennium Cohort Study (a survey of parents of children born in the year 2000) suggests that when fathers took longer parental leaves, they were more involved in the care of their infants 9 or 10 months after the birth (Tanaka and Waldfogel, 2007).

Overall, the empirical evidence suggests that paid maternity leave has an important role to play in encouraging female employment, while unpaid maternity leave has much weaker effects. The level of paid maternity leave is also important. Statutory maternity leave provision in the UK is far from generous compared with most other OECD countries, and while the extent to which workplaces provide maternity leave provisions in excess of the statutory minimum is improving, research for BERR found that the largest increase in the incidence of paid maternity leave (and other family-friendly working practices) was found in workplaces where provision was already relatively high – with little change in industries where there was no provision in the previous wave of the survey, in 1998 (Whitehouse et al, 2007). This suggests some dichotomy between “good-practice” and “bad-practice” employers in the UK, which would fit well with the “high road”/”low road” model of business strategy explored in further detail in Chapter 8 below. The BERR research also found that workplaces in which the incidence of family-friendly working practices increased over the

54 See for example surveys by Waldfogel (2008) and Kamerman (2005). For specific evidence, recent research on a German maternity leave reform by Kluve and Tamm (2009) is informative. On child health effects, Ruhm (2000) and Tanaka (2005) are important studies.

period were more likely to be identified by managers in those workplaces as having improved in financial performance relative to others between 1998 and 2004, but it is not clear what the causal interpretation of this relationship is – whether high-performing workplaces had more spare funds to introduce family-friendly working, or whether family-friendly working actually improved workplace performance.

Crucially, there is clear evidence that maternity leave improves job retention for women. In the next section, we show that reductions in pay for women moving jobs after childbirth are a large part of the explanation for why women are paid less than men on average in the workplace. To the extent that maternity leave enables women to return to their pre-childbirth jobs, it makes a contribution towards gender equality in the workplace.

Finally, even disregarding the labour market effects of maternity leave, the research evidence on its positive impacts on mothers' and children's health are an important point in its favour. Health is an important component of economic well-being and hence labour market regulations which improve health should be supported in the same way as if they increased employment or income per head.

The right to request flexible working

The right to request flexible working, which has existed in the UK for parents with children under 6 and parents of disabled children under the age of 18 since 2003 and was extended to parents of children under 16 in April 2009, is a classic piece of “soft” labour market regulation, in that it gives employees the right to make a formal request for flexible working arrangements – but employers are under no obligation to agree to the request.

In the extreme version of orthodox labour market theory, this kind of regulation should have no impact on labour market outcomes – the rationale being that:

- if flexible working has no effect on productivity (or positive effects) and is something that employees would like to have, then they would already have negotiated it themselves without the need for government intervention.
- Conversely, if flexible working has an adverse effect on productivity, employers will

just refuse the request.

In fact, evidence from the third wave of the BERR employer work-life balance survey conducted in 2006 (Hayward et al, 2007) suggests that 91% of employers accepted all requests for flexible working in the 12 months prior to the survey, and 92% said they would consider a request for flexible working from any employee – even those without children. 40% of employers said they had received at least one request for flexible working in the twelve months prior to the survey. These statistics suggest that the establishment of the right to request flexible working has revealed considerable previously unmet demand for flexible working – certainly, it does not look as if the provisions are redundant or superfluous, as it would be difficult to explain the high level of requests in that case. Additionally, it looks as if employers are (in the majority of cases) prepared to be flexible about accommodating employees' own demands for flexibility. Again, this is powerful evidence that real-world labour markets operate differently from the idealised economic textbook version.

The *employee* work-life balance survey which was conducted in tandem with the employer survey (Hooker et al, 2007) found that there had been an increase in the availability of flexible working arrangements to employees since 2003. 56% of employees who responded to the survey said they had worked flexibly in the 12 months prior to the survey. 90% of employees said that at least one flexible working arrangement was available to them if they needed it. This was a slight increase compared with the previous work-life balance survey in 2003. The highest level of *unmet* demand among employees for flexible working was for flexitime (29% of respondents) and a compressed working week (27%).

There is no direct empirical evidence on the impact of the right to request flexible working on economic outcomes in the UK labour market. However, given that employers seem to be largely positive about accommodating requests for flexible working, it seems unlikely that the effects on productivity or profitability are negative. For the employees' part, if they make a request for flexible working then (presumably) this is something that they want to do, and it will hence improve their well-being, or at least leave them no worse off than before overall.

These figures suggest that flexible working arrangements which are initiated by employees are widespread, although not ubiquitous. In the next section we look more generally at

flexible and non-standard working arrangements from a wider perspective – part-time working, long hours working and flexible work patterns.

Flexible working patterns and working hours arrangements

This section looks at the economic impacts of working patterns which differ from what would ordinarily be characterised as full-time work in the UK[55] – part-time working and long hours of work. Unlike the employee right to request flexible working covered in the last section, these working arrangements cannot automatically be assumed to be initiated by the employee. Indeed, research shows that in many cases employees are working more (or less) hours than they would like to. For example, in the 2006 Employee Work Life Balance survey, while 69% of employees were happy with their working hours, 26% wanted to work less, while 5% wanted to work more. Once again, this illustrates the frictions that exist in the labour market of the real world compared with the textbook ideal; in the simple competitive labour market it is assumed that workers have a free choice over the number of hours they work. In reality, a substantial minority of workers seem to face constraints which prevent them from working the number of hours they would ideally like to work for.

Below I examine the extent of part-time working and long hours working in the UK, the pros and cons of hours flexibility from the point of view of employees, employers and the wider economy, and what the optimal extent of regulation of this aspect of work might be.

Part-time working and the gender wage gap

Part-time working in the UK is mostly a female rather than male phenomenon[56], and is largely associated with women who have left employment temporarily to have a child or children, and then re-enter work at part-time hours (Paull, 2008). There is also a

55 Recent data from ONS (2010) show that in autumn 2009, the split between women working 'part-time' and 'full-time' was approximately 43% part-time and 57% full-time.

56 The most recent statistics from ONS (2010) suggest that in autumn 2009, approximately 5.8 million women described themselves as working part-time compared with 1.9 million men (based on results from the Labour Force Survey). The split of part-timers was about 76% women to 24% men.

substantial wage gap between the average hourly earnings of men and women. For example, the results from the UK Annual Survey of Hours and Earnings (ASHE) – a 1% sample of all UK employees – show that in 2009, average (mean) hourly pay for full-time male workers was £16.03 per week – around 19 per cent higher than the average of £13.41 for full-time female workers[57]. Recent research by Manning and Petrongolo (2008) shows that women in Britain who work part-time have, on average, hourly earnings about 25% less than those of women working full-time, with the gap having widened greatly since the mid-1970s[58]. Around half of the difference in pay levels between full-time and part-time women cannot be explained by the characteristics of women working full-time and part-time observed in the data (age, education etc.); Manning and Petrongolo suggest that this remaining difference is due to occupational segregation. The right to request flexible working and the regulations introduced in 2000 to prevent "less favourable treatment" of part-time workers (see Appendix 1) appear to have had little effect on the gender wage gap.

The conclusions of Manning and Petrongolo are supported by evidence from the sociological literature on the extent to which working part-time is a constrained choice for women in the UK labour market. Grant, Yeadle and Buckner (2006) present evidence from survey data collected in six local authorities in England which shows that 54% of the part-time women workers surveyed had previously worked in jobs requiring either higher levels of qualifications, skills or experience, or which had involved more management or supervisory responsibility than was required for the current job. The implication of this analysis is that a substantial proportion of female workers are working 'below their potential', in jobs that do not use their full range of qualifications, experience and skills.

Similarly, Paull (2008) uses data from the British Household Panel Survey (BHPS) over the period 1991 to 2004 and finds that occupational segregation into part-time work for mothers persists *even after children have grown up and left home*[59]*.* Connolly and Gregory (2008) use the BHPS to look specifically at the extent to which women return to work in

[57] The equivalent figures for *median* full-time earnings were £13.09 for men and £11.42 for women respectively – a difference of 15%.

[58] The ASHE figures for 2009 show a gap in average (mean) hourly earnings of 29%, with full time women averaging £13.41 and part-time women averaging £10.33. Manning and Petrongolo's work was based on the LFS rather than ASHE.

[59] Specifically, Paull finds that only 58% of working women whose dependent children have grown up and left home are employed full-time, compared with 96% of their male counterparts.

less prestigious occupations when they return to work after childbirth. They find that one in three female corporate managers move down the occupational ladder, with two thirds taking clerical positions and the rest taking a selection of other low-skilled jobs. Women managers of shops, salons and restaurants are even worse affected, with almost half giving up their managerial responsibilities on return to the labour market as mothers. Women working in the public sector – particularly teachers and nurses – are more likely to be able to continue their career progression while working part-time than those in the private sector. Connolly and Gregory suggest that the reason for occupational downgrading is not that mothers want less demanding jobs but that part-time opportunities in higher-level jobs are restricted. Generally, women's best chance of avoiding downgrading is to stay with their pre-childbirth employer on a reduced hours basis, as good part-time opportunities rarely appear on the jobs market. The clear implication of this research is that generous maternity leave provisions, as well as employer flexibility about work roles, have a large role to play in allowing more women to stay in their pre-childbirth jobs and occupations after childbirth, thus reducing gender penalties and gender segregation in the labour market – although to the extent that occupational segregation or other forms of labour market discrimination between men and women are still a factor, improvements in maternity leave are unlikely to completely close the male-female pay gap by themselves.

Booth and van Ours (2008) present evidence (again from BHPS) on women's preferences for part-time versus full-time jobs which suggests that mothers (on average) prefer part-time jobs *even though they are worse paid and in lower occupations*. In the main, this seems to be because childcare is too expensive to be viable for many women in the labour market (even given the existing subsidies in the tax credit system). This suggests that increased childcare subsidies are also a prerequisite for reducing the gender pay gap and occupational segregation, and extending real rather than constrained choice to more working women.

Working long hours

Overall average hours at work in the UK increased from the mid-1980s to the mid-1990s, but have since been on a slow downward trend. Data from the LFS on the proportion of employees working over 45 hours show that the proportion of men working over 45 hours a week peaked at 37.4% (around 4.3 million men) in 1996, and subsequently fell steadily to 25.7% (3.2 million) by mid-2009. For women, the pattern looks very different; since 1997, the proportion of women working over 45 hours has been roughly constant at about 11% (around 1.1 million).

Green and Tsitsianis (2005) use BHPS data to show that in the UK, workers who are working more (or less) hours than they would like to are (on average) less satisfied with their jobs than workers who are happy with the number of hours they are doing. A review of the evidence on working long hours in the UK and a number of other countries by Kodz et al (2003) for the DTI found some correlation between long hours and deterioration of work performance, but no conclusive evidence that long hours working led to lower levels of *overall* work performance. There was some evidence that excessive long hours working is positively associated with employee health problems. On average, employees working longer hours seemed to be less happy with their work-life balance than employees working standard full-time hours, although a significant minority were *happier* working long hours – either because they enjoyed the job, or because they valued the extra income from working longer hours sufficiently to make it worthwhile. Analysis of the BHPS suggested a gender difference, with long hours working putting women under greater pressure and having a more negative impact on their health, well-being and satisfaction than for men.

The Working Time Directive (WTD), originally introduced in 1998 and extended to a number of categories of previously exempt worker in 2003, limits hours of work to a maximum of 48 per week unless the worker specifically signs an opt-out agreement with the employer[60]. Although the incidence of long-hours working (at least among men) has declined over the time the WTD has been in place, research that has covered this issue - for example Barnard, Deakin and Hobbs (2003) suggests that it is difficult to find a strong causal impact of the WTD on long-hours working. The fall in the proportion of long-hours male workers is a smooth trend in the data rather than a step-change (such as one finds,

60 The opt-out provision was originally meant to be a temporary measure but the UK Government has (so far) successfully resisted attempts by the European Parliament to abolish it.

by contrast, with hourly rates of pay when the National Minimum Wage was introduced in 1999). The downward trend began before the WTD came into force and has continued even though there have been few changes to its operation since then. Barnard et al state that “in part because of the ease with which the limit can be avoided [i.e. by signing an opt-out clause], the Directive has so far done little to change a long-hours culture, driven by employers' perceived needs for flexibility and workers' desire to supplement their earnings or status.” In fact, subsequent data on hours suggests that the long-hours culture *is* gradually reducing in importance in the UK, but it is not clear how much this can be attributed to WTD.

Summary of the effects of family friendly working practices, flexible working policies, and restrictions on working hours

Research on the labour market impacts of childcare policy produces the very clear result that childcare subsidies to working families can drive substantial increases in labour market participation, especially among mothers. This makes them an important part of ‘welfare-to-work’ strategy and implies that any future moves to scale childcare subsidies back (in the context of the current squeeze on the public finances) will have to be handled carefully to avoid adverse employment effects. Childcare subsidies, maternity leave and the right to request flexible working also have a role to play in reducing the gender pay gap, which most progressive commentators would argue is a worthwhile end in itself. This is because women who leave the labour market to have children and re-enter subsequently in a different job suffer a large pay penalty on average. Childcare subsidies, maternity leave and flexible working help women stay in the same job after having children, thus eliminating this penalty and making better use of the skills and experience they have gained in the labour market prior to having children. Maternity leave also appears to have significant benefits for mother’s and children’s health on average.

The fact that the introduction of the right to request flexible working seems to have unleashed considerable ‘pent-up’ or hidden demand for flexible working among the relevant sections of the UK workforce suggests that the simplistic version of the orthodox labour market model is a poor description of reality – because if the orthodox view were correct, individuals who required flexible working would have already asked for it. Unfortunately there is little hard evidence on the impact of ‘soft’ labour market policies like this on overall labour market outcomes, perhaps because of the prevalence of orthodox

economists who had assumed they wouldn't have any impact in the first place. This is a useful area for further research.

Finally, evidence on the effect of working long hours on job satisfaction, and the impact of the Working Time Directive, is mixed. Long-hours workers in the UK appear to be a mixture of workers who are not entirely happy with working long hours – perhaps because they are pressured to do so by their employers – and workers who are quite happy to do so, and who would probably be opposed to additional statutory restrictions on the maximum length of the working week. Men seem more likely to fall into the latter category than women. There is no evidence that the WTD has had a substantial impact on the incidence of long-hours working (which has been declining slightly in any case) – probably because of the availability of the individual opt-out option and poor enforcement of the legislation.

Trade Unions

In the orthodox picture of the labour market, trade unions have traditionally had a bad press. Like minimum wages, orthodox economists (following the lead of Friedman, 1962) have traditionally seen trade unions as little more than mechanisms for creating unemployment by raising wages above their market-clearing levels in the unionised sector[61]. Together with worries about the high number of working days lost to industrial action in the 1970s, the alleged adverse effects of trade unions on equilibrium unemployment levels in the economy were one of the justifications given by the Conservative governments in the UK for several pieces of legislation which placed new legal restrictions on the ability of trade unions to organise and to take industrial action[62].

However, by the 1980s the orthodox economic view of unions had been challenged by two streams of thought emphasising a potential *positive* role for unions under theoretical

[61] In fact, Friedman's analysis of the deleterious effects of trade unions goes beyond this. Using a simple two-sector model of the labour market in a closed economy, he argued that the higher the union "wage premium", the lower would be the wage for *non*-unionised workers. Thus, trade unions in this model are blamed for increased earnings inequality as well as higher unemployment.

[62] For example, the removal of the right to secondary industrial action, abolition of the pre-entry 'closed shop' and introduction of compulsory ballots before strike action. For the most part, the Labour governments from 1997 onwards maintained these new restrictions although they did introduce some additional legislation which made it easier for unions to organise – e.g. the right to ballots for union recognition in plants.

assumptions which deviated from strict orthodoxy:

- Analysis of the role of trade unions in an *imperfectly competitive* labour market environment showed that, as with the analysis of the impact of a minimum wage under imperfect competition shown in Chapter 2, there was scope for unions to increase wages (at the expense of reductions in profits) *without* adverse impacts on employment. This was formalised in the 'efficient bargaining' model of Oswald (1982).
- Progressive economists beginning with Freeman and Medoff (1984) suggested that unions could play a positive role in liaising with management to make workplaces work more effectively and more fairly by providing a trusted channel to articulate workforce suggestions and grievances. This was based on previous work on 'voice' mechanisms as a means for dispute resolution by the sociologist Hirschman (1970), as well as previous work in the economics of imperfect information by Nobel Laureate economists Joseph Stiglitz and James Mirrlees.

Thus, the economic analysis of trade unions is a good example of an area of economic theory where relaxation of the basic assumptions regarding the way the labour market works yields predictions about the potential effects of unions that are completely different from the standard view. However, the new theories tell us nothing about the magnitude of trade unions' positive impacts on wages and/or productivity or workplace functioning – or even if such effects can be detected in the real world. To establish this it is necessary to take a detailed look at the empirical evidence.

Trade union effects on wages

In the UK, econometric analysis using micro-data on the earnings of unionised and non-unionised workers suggests that the union "wage premium" – the extent to which unionised workers earn higher wages than non-unionised workers, controlling for other factors – has been falling over the last 15 years or so. Evidence from the 1980s suggested that the union average wage premium was around 10 per cent (Stewart, 1987; Blanchflower, 1999), although in union pre-entry closed shops (outlawed since 1990) the wage premium was sometimes a lot higher than this. The evidence from more recent

empirical work is mixed, suggesting that while it still exists, the union wage premium has fallen. Booth and Bryan (2004) use linked employer-employee data and find that once employer characteristics are controlled for, the average union wage premium is insignificantly different from zero. However, Blanchflower and Bryson (2007) find a slight premium using data from the Workplace Employee Relations Survey once other characteristics of the workplace and job are controlled for (around 3 percent for unionised workers in the private sector and 6 percent for the public sector). Using data from the Labour Force Survey, BERR report that the hourly earning of union members was 12.5 per cent more than non-members (although variables including age and education levels were not controlled for) (BIS, 2009). It appears that while the premium is not insignificant, it has declined since the 1980s.

Why has the union wage premium declined over the 1990s and 2000s? Potential explanations (not necessary mutually exclusive) include:

- *Increased competition in the product market* which has fed through into the labour market – effectively reducing the extent to which a 'surplus' or 'rent' is available for unions to bargain over.
- *Reduced willingness of employers to recognise unions for bargaining purposes*. For example, Millward *et al* (2001) report that even where managers report in surveys that employees have their pay set through workplace-level or organisation-level collective bargaining, union representatives and officials are either not involved or are only consulted in a minority of cases.
- *The minimum wage taking over some of the function of unions at the bottom of the wage distribution*. The establishment of the National Minimum Wage in 1999 raised wages for employees in the bottom ten per cent of the earnings distribution (Dickens and Manning, 2004). Empirical research on the impact of trade unions on earnings inequality in the 1980s and 1990s showed that unionised establishments tended to have lower earnings inequality controlling for other factors (Metcalf, 2001). It is quite possible that the minimum wage reduced earnings inequality in non-union establishments, making them more like unionised establishments in this regard.

In the US, while there has been some long-run decline in the estimated union wage premium using micro-data, recent research still shows a significant union wage premium

controlling for other factors – in the order of 20 per cent at the bottom of the wage distribution, and around 14 per cent at the middle (Schmitt *et al*, 2007).

Trade union effects on other aspects of the workplace

There is a good deal of evidence on the extent to which unions are associated with 'good practice' in the workplace. For the most part unions are associated with a greater incidence of good practices. For example:

- Budd and Mumford (2004) show that the presence of trade unions in the workplace was positively correlated with the availability of parental leave (above the statutory minimum), special paid leave and job-sharing options. However, unionised workplaces were less likely to offer work-at-home arrangements and flexible working hours[63].
- Research for BERR showed that union density was significantly related to reductions in more serious disciplinary actions such as suspensions and dismissals (Moore, Tasiran and Jeffreys, 2008).
- Meager et al (2002) found that trade union members were better informed about their rights at work than employees who were not trade union members.
- Michie and Sheehan (2003) examined the relationship between the characteristics of firms and the likelihood of the firm making product or process innovations using a survey of UK manufacturing establishments. They found that trade union recognition is positively related to several different types of innovative practice.
- Aidt and Tzanattos (2008), in a meta-analysis of data across developed and developing countries for the World Bank, found that the extent of collective bargaining by trade unions was negatively associated with unemployment, inequality and the incidence of strikes. In other words, trade union influence seemed to be associated with a whole range of positive economic outcomes.

From this evidence it would be very difficult to agree with the old-style orthodox view of

[63] It's not clear from the research to what extent unions were causally responsible for flexible working arrangements being less readily available, or whether this was simply a reflection of high union density in certain industries where flexible working was more difficult due to aspects of the production process itself. For example, in most manufacturing plants it's difficult or impossible to work from home, but this has to do with the fact that production is based in a factory, not because of trade union presence or absence.

trade unions as inimical to good labour market performance. Whilst in the UK (unlike in the US) there is little evidence of a substantial union wage premium, this does not mean that trade unions are not worthwhile institutions for their members, and indeed for the economy as a whole. There are three main reasons for believing this. Firstly, the existence of trade unions is correlated with several aspects of good workplace performance. Secondly, trade unions have an important role in promoting social justice in the workplace. Thirdly, as shown in the macroeconomic literature in Chapter 4, in countries where unions are involved in setting co-ordinated bargaining agreements across the economy, this is associated with lower unemployment.

Unemployment Insurance, In-Work Benefits and Active Labour Market Policy

A key aspect of the labour market “rigidities” which many commentators influenced by the orthodox view have pointed to as an explanation for high unemployment is the operation of unemployment insurance systems, and benefits for non-working people more generally. At the same time, the OECD (probably the most high-profile contributor to the debate at a global level) has recommended both active labour market policy and the use of in-work financial support for low-income earners as key planks of the strategy for reducing unemployment (OECD 2004, 2006, 2009). In this section we examine microeconomic evidence on the impact of all three of these policies in the UK and other comparable countries. This is particularly pressing in the light of the huge increase in unemployment in the UK and other developed nations as a result of the global recession of 2008-9.

Unemployment insurance and other out-of-work benefits

Systems of unemployment insurance (UI) pay benefits to people of working age who are unemployed, providing they meet certain conditions. The UK's version of this benefit is called Contributions-based Jobseekers' Allowance. These differ from country to country but in general include some combination of:

- an adequate record of previous contributions to the social insurance system (in the

UK, National Insurance Contributions);

- a time limit on receipt of benefit (after which assistance is means-tested rather than based on contributions). In the UK the time limit is six months;
- (in some countries) varying levels of benefit based on previous earnings, or family structure (so for example, more would be paid to families with children);
- job separation being not the claimant's fault (so for example, in the UK system you can qualify for benefit if you were made redundant, but not if you left your job voluntarily);
- criteria for actively seeking work (e.g. proof of job-search activity, a willingness to accept jobs that become available (subject to conditions about which jobs are suitable in some countries)).

Most countries also feature a means-tested “safety net” benefit for working age people seeking work who do not qualify for UI – in the UK this is Income-based Jobseekers Allowance. Often it is paid at a lower rate (although not in the UK for most claimants). In addition to this there are usually benefits available for other non-working people who are unable to work for various reasons. For example in the UK there is Employment and Support Allowance for people who are unable to work for sickness or health reasons, Carers Allowance for people who are full-time carers (e.g. for a relative) and Income Support (combined with the Child Tax Credit) for lone parents[64] and other unable-to-work groups.

The orthodox labour economist's view on UI and other out-of-work benefits for people who are able to seek work is fairly simple; the more generous out-of-work benefits are, the less likely people are to be in work. This is because UI raises the “reservation wage” - the net income from work above which people find it worthwhile to enter work. The level of UI is not the only factor which affects the reservation wage: it will also be affected by changes in gross wage levels, the tax system (higher taxes on low earners increase the reservation wage as they mean a worker has to earn a higher gross wage for the same level of net wage), in-work benefits (increases in in-work support reduce the reservation wage), and costs associated with work (e.g. travel to work, work clothes, etc. - these all increase the

64 Although the system is currently changing so that only lone parents with younger children are eligible to claim Income Support, which does not have compulsory availability-for-work conditions attached to it. From October 2010, only lone parents with children aged under seven will be able to claim Income Support; non-working lone parents whose youngest child is older than this will have to claim Jobseekers Allowance, and meet the work availability conditions, instead.

reservation wage). In general, the orthodox view is that anything which reduces the reservation wage is good, whereas anything that increases the reservation wage is bad. This means that, for example the OECD's 1994 *Jobs Study* – the classic statement of the orthodox position – advocates reducing the generosity of UI, short time limits, tightening the criteria for eligibility, and reducing the tax burden on low earners.

Most orthodox economists do not argue that out-of-work benefits for jobseekers should be abolished entirely, as they accept the rationale for a safety net to alleviate extreme poverty on equity or social justice grounds. However, they would mostly argue that the existence of safety nets represents an “equity/efficiency trade-off” whereby policymakers are accepting a less efficient economy in return for the increase in equity which the existence of out-of-work benefits promotes. Thus, the ideological driver behind this position is, once again, that the labour market will deliver optimally efficient outcomes in the absence of government intervention.

This is far from being the only view of the role played by UI in the economics literature, however. Whereas the orthodox view of the labour market assumes 'perfect information', so that workers can move costlessly into their most-preferred jobs, most “high-end” theoretical research into labour market dynamics – the process by which workers move from one job to another, and from unemployment to employment – is now dominated by 'search-matching' models of the labour market (e.g. Burdett and Mortensen, 1998). These deviate from the orthodox model of the labour market by assuming that job-search takes time and effort to secure a job which is the best fit (“match”) to each individual workers' characteristics. In such a model, it is quite possible that some level of UI greater than zero can actually enhance efficiency by providing workers with the means to make a more effective (and possibly more time-consuming) search for jobs, which means they will get a higher wage in employment than if they took a job quickly[65] (see, for example, Manning 2006).

One possible orthodox rejoinder to these arguments would be that, if intensive job search activity for a good “match” in the jobs market (rather than just taking the first job that comes along) is productivity-enhancing (and hence leads to higher wages), then there is a clear incentive for workers to make their own provisions – via savings or some other kind

65 Most of these models assume in addition that off-the-job search is more effective than on-the-job search, or that there are costs to moving job once in work - otherwise workers could presumably take the first job that comes along as a stop-gap and then move into a better match later, rather than remaining unemployed and seeking the best match.

of insurance – to fund job search in the event that they should be unemployed. In practice, though, many people do not seem to do this. For example, opinion polling in the US at the end of 2008, when unemployment was rising at a very rapid rate, showed that around half of working age people were worried about being able to keep up with credit card and mortgage repayments in the event of being made redundant (Raum, 2008). Also, it is very difficult for workers to assign realistic probabilities to the likelihood of job loss. For example, for the last decade UK citizens had been told that "boom and bust" was a thing of the past before it returned – with a vengeance – in 2008, with huge increases in unemployment. It is quite possible that someone making substantial provisions for an extended period of unemployment earlier in the 2000s, when the general consensus was that serious business cycle swings were no longer a problem, would have been regarded as ridiculously over-cautious. The caricature of the perfectly rational "economic person" is, in circumstances like this, a poor approximation to reality.[66]

The empirical evidence on the effects of UI is mixed. The macro-regression evidence shown in Chapter 4 indicated that the positive correlation between the generosity and duration of UI and levels of unemployment was one of the only robust findings from empirical studies of that type. In terms of micro evidence, this is usually based on examining labour market performance before and after specific reforms. Recent evidence from Germany on the "Hartz reforms" - a series of reforms to the unemployment system which implemented most of the OECD 'medicine' by reducing the time limit over which non-means-tested contributions-based UI was payable from an indefinite period to 12 months and tightening the job search criteria[67] – appears to show that the reforms had some effect in decreasing unemployment. For example, Jacobi and Kluve (2008), Eichhorst and Zimmermann (2007) and Posen (2008) suggest that there has been some decrease in unemployment which can be attributed to the Hartz packages (although Posen argues that unemployment reform was not a sufficient condition by itself, but had to be accompanied by a better macroeconomic environment to lead to substantial job growth in the years following 2004 – we examine this evidence in more detail in the next chapter).

However, research on the most recent major reform which occurred to the UI system in the UK – the replacement of Unemployment Benefit with contribution-based Jobseekers Allowance (C-JSA) in 1996, which tightened the work search requirements and reduced

66 Say a little about behavioural economics in this regard.
67 In fact, it was the *enforcement* of the job search criteria which was tightened.

the length of time for which the benefit was paid to claimants from a year to six months – shows that it is important to consider what happens to *inactivity*, as well as unemployment, when evaluating the success of reforms of this type. The official government evaluation of C-JSA claimed that the reform was successful because *flows off* the 'claimant pool' of people receiving C-JSA increased when the reform was brought in October 1996 (Rayner *et al*, 2000). However, Manning (2009) uses the JUVOS administrative data[68] to show that the JSA reforms did indeed result in large flows out of the claimant count, but the increased flows were overwhelmingly into *inactivity*, not employment. This demonstrates that a reform intended to increase job search behaviour can in fact have quite the opposite effect by uncovering 'hidden inactivity'. Petrongolo (2009) reaches very similar conclusions examining the same reform using data from the Labour Force Survey.

Recent work by Chetty (2008) looks directly at the effect of unemployment benefits on labour market search activity using US data (exploiting state-level differences in the generosity of the unemployment system). He finds that while the availability and generosity of unemployment benefits does increase unemployment durations, about 60 per cent of this increase is due to a “liquidity-enhancing” effect – helping unemployed individuals and their families smooth their consumption patterns over time, as well as helping unemployed workers secure better matches. Using cost-benefit analysis techniques taking into account the benefit of consumption smoothing on the well-being of the unemployed, Chetty argues that the optimal UI benefit level would be just over 50% of the average (mean)US weekly wage. By comparison, the current Jobseekers Allowance level in the UK is £64.30 – just 10% of average earnings.

The available evidence from surveys of the unemployed also suggests strongly that the vast majority of people claiming Jobseekers Allowance, and also many of the claimants of other benefits for non-working people, unemployed people, *want to work* and are not deliberately avoiding work. For example, a recent review of conditionality in the benefit system by Professor Paul Gregg (Gregg, 2008) finds that around 80 per cent of lone parents and 90 per cent of *new* claimants of Employment and Support Allowance (the benefit which recently replaced Incapacity Benefit for long-term sick and disabled benefit

[68] JUVOS (the Joint Unemployment and Vacancies Operating System) is a 5 per cent sample of all the claim records for unemployment related benefits, selected by reference to claimants’ National Insurance numbers, Each time a person with a relevant NI number makes a claim for unemployment-based benefits their details are added to the JUVOS record. The dataset can thus be used to analyse repeat claim spells and transitions onto and off benefits. For more details see http://www.statistics.gov.uk/StatBase/Analysis.asp?vlnk=224&More=Y

claimants) say that they want to get back to work[69]. This recent evidence tallies with the results of extensive research on the attitudes of unemployed people carried out in the 1980s and 1990s which showed similar results (e.g. Atkinson and Mogensen, 1993; Gallie and Paugam, 2000.)

In summary, the evidence on the effect of reforms to unemployment insurance is mixed. Evidence from Germany suggests that UI systems which are very generous, with indefinite eligibility to relatively high levels of benefits and limited job search conditions, can exacerbate the problem of long-term unemployment. This is consistent with the orthodox view of the labour market, but is also entirely consistent with a more sophisticated "search-matching" model of the labour market. One does not need to be an orthodox zealot to reach the conclusion that if unemployment benefits are very generous and there is no time limit attached to them, then it will be hard to get unemployed people back into the work. However, at the other extreme, evidence from the much less generous UK and US systems suggest that UI reforms which start from a relatively ungenerous base, and tighten eligibility conditions still further, can have adverse effects.

A 'third way' on unemployment insurance may be possible: this is exemplified by the Danish 'flexicurity' system, which combines generous benefits with stringent job search conditions and time limits. Research by Auer (2007) suggests that this hybrid approach can achieve low levels of unemployment while avoiding the negative aspects of the UK and US models. Additionally, to the extent that stringent employment protection is undesirable (which, as we saw earlier in this chapter, is not a clear-cut issue), the Danish model provides an *alternative* to high levels of employment protection – by replacing "within-job" income and living standards protection with "across-job" protection[70].

In-work benefits

One means of overcoming the problem that out-of-work benefits raise the reservation wage is to raise the level of *in-work* incomes using in-work benefits. The UK has a long history of in-work financial support, going back as far as 1971, when Family Income

[69] The proportion of *long-term* Incapacity Benefit claimants who want to work (e.g. who have been claiming for one year or more) is significantly lower, however. It was this fact which motivated the UK Government's decision to establish the Pathways to Work programme which aims to increase the number of Incapacity Benefit claimants returning to work (see Table 5.1 below).

[70] For more details on the Danish 'flexicurity' model see Eurofound (2007).

Supplement was introduced. This was replaced by Family Credit in 1988, the Working Families Tax Credit (WFTC) in 1999 and finally Working Tax Credit (WTC) in 2003. The UK system focuses very much on families with children, and disabled people[71].

There is, in general, less opposition to in-work benefits among orthodox economists than there is to several other aspects of labour market regulation. Partly this is because, given that the UK transfer system contains out-of-work benefits – which are more generous for families with children and disabled people – some kind of in-work financial support is necessary to restore financial incentives to enter work to something like the level that they would be in the absence of a benefit system[72]. Also, in-work benefits offer a way of redistributing income without adverse effects on the incentive to work (indeed, while encouraging work); this makes them desirable to many commentators on equity, as well as efficiency grounds. The UK has also been influenced by the political and economic debate on in-work benefits in the US, where the Earned Income Tax Credit (EITC) system has been shown to have significant positive impacts on the employment rates of lone parents and low income families with children (Eissa and Hoynes, 2004). Early New Labour thinking on in-work benefits was heavily influenced by the US experience[73], and WFTC was in some ways meant to be an analogue of EITC (although the operation of the system is actually very different in the UK from its US counterpart).

For the most part, non-orthodox economists are also supportive of in-work support through the benefit or tax-credit system, although there is a debate between economists who believe in a *perfectly* competitive labour market and those who believe in an *imperfectly* competitive labour market about what the net impact of an in-work benefit on wages is. In the perfectly competitive model, workers get the whole value of an increase in in-work benefits. In the imperfectly competitive model, the employer can (to a greater or lesser extent) use the in-work benefit as a subsidy, with overall employee pay increasing by only some fraction of its value. In other words the in-work benefit becomes (partially) an employer subsidy. An implication of this is that, for low-income workers, an in-work benefit *combined with* a minimum wage – i.e. the current UK policy mix – may be optimal; the minimum wage sets a floor to limit the employer's ability to reduce wages in response to the in-work benefit, while additional in-work support increases employees' net income to a

71 While childless non-disabled full-time working people over 25 are eligible for a WTC payment if over 25, the payments are much smaller than for the other eligible groups.
72 See, for example, Adam, Brewer and Shepherd (2006).
73 Indeed, Ed Balls's Harvard MA thesis in the early 1990s, before becoming an adviser to Gordon Brown, was an analysis of EITC.

level above which that which would be possible using the minimum wage alone (without creating adverse employment effects).

The empirical evidence on the effectiveness of in-work benefits in promoting employment shows clear results for lone parents – who face unambiguous financial incentives to enter employment as a result of the policy. Gregg, Harkness and Smith (2009) extend earlier work by Brewer *et al* (2004) to show that the increase in generosity of WFTC compared with its predecessor benefit, Family Credit, boosted lone parent employment by between 65,000 and 80,000 (between 3.8 and 5.2 percentage points) between 1999 and 2003[74]. WFTC also had other important non-labour market effects, reducing the spike of "high malaise" among mothers coincident with the transition from dual parenthood to lone parenthood, and increasing self-esteem and happiness among adolescent children in lone parent families[75]. On the other hand, Francesconi, Rainer and van der Klaauw (2009) look at the impact of WFTC on the labour supply of *married* mothers and find insignificant effects overall. This is largely because increasing in-work benefits for a couple where just the man is working can make the woman – the potential second earner – *less* likely to move into work, due to the increased household income even if she does not work. In the case of two-earner couples, increasing in-work benefits might make the second earner more likely to move *out* of employment. For couples where *neither* earner works, in-work benefits make it more likely that one earner will enter work. What these results show is that predicting the impacts of in-work benefit reform on couples is a lot more complex than for single people.

There has been little research on the impact of the WTC for childless people – due to its reduced generosity compared with WTC for families with children, it has been largely ignored by researchers. However, evidence does exist on the labour market impacts of an in-work transfer scheme called Earnings Top Up (ETU) which was piloted in the UK by the previous Conservative Government in the 1996, and ran until 2000. ETU provided cash payments to childless low-paid people working at least 16 hours a week. The payments were in the range of £20 to £30 per week for single people and £35 to £45 for couples. The fact that the study was a pilot project allowed for a reasonably rigorous empirical analysis which used a 'difference-in-differences' approach (where changes in employment

[74] See also Cebulla *et al* (2008) for a comparison between the labour market impacts of WFTC, the New Deal for Lone Parents (covered in more detail later in this section) and the introduction of work-focused interviews for lone parents.

75 At least, the gap in self-esteem and happiness between adolescent children in two parent families and those in lone parent families narrowed appreciably after the introduction of WFTC.

rates of eligible people in the pilot areas were compared with people in the control areas who would have been eligible had they lived in the pilot areas) to assess the impact of the scheme.

A summary of the results from the evaluation of ETU by Marsh (2001) found that take up was relatively low: just 18 per cent of eligible people in 1997, rising to 23 per cent in 1999. A majority of the target group in the pilot areas had never heard of ETU when interviewed for the evaluation. The study found only marginal impacts on employment as a result of the policy. Because the scheme was relatively poorly advertised, it is very hard to establish whether the small overall measured impacts were due to low employment elasticity's among the target group, or simply due to low take-up.

In summary, provided that they are well-designed and well-publicised, in-work benefits do seem to have a positive overall impact on employment of families with children (although it is important to take the interactions between first and second earners in the household into account, and there is evidence that in-work benefits can *reduce* employment of second earners for couple households). The impact on households *without* children is not possible to assess accurately given the current lack of empirical research in the UK and the problems with the implementation of the ETU policy in the late 1990s.

Overall, in-work benefits are an important example of how labour market intervention can deliver increases in the employment rate using the 'carrot' of increased in-work income rather than the 'stick' of decreased out-of-work income.

Active labour market policy

An increased emphasis on active labour market policy (ALMP) has been the main 'interventionist' recommendation that the OECD has been making for the last fifteen years, first in its *Job Study* (1994) and most recently in its 2009 *Employment Outlook*, where it argues that countries need to be spending a lot more on ALMP than they currently do to reduce the unemployment impact of the current recession.

The macro-evidence examined in Chapter 4 found no significant impact (positive or negative) of ALMP on unemployment levels using country panel data in most cases.

However, for the most part the extent and nature of ALMP is very crudely measured in macro-studies – usually expenditure per unemployed person on ALMP is the only variable which is entered into the regressions. In reality, ALMP can comprise a whole host of different policies, for example:

- **assistance with job search activity**. In some cases this just represents an extension – or reinforcement – of the standard qualifying conditions for unemployment insurance or income support benefits, and there is an overlap between out-of-work benefits policy and ALMP in this regard. Other approaches in this area are more active – for example, using personal advisers or training courses to assist unemployed people with job search.
- **Employer subsidies.** In these programmes, employers are given subsidies (normally, although not always, on a short-term basis) to take on long-term unemployed people, who are paid their level of benefit (plus some extra contribution in some countries' implementation of this policy).
- **Direct job creation.** In these programmes, the government – or a public sector agency – assigns long-term unemployed people to jobs directly.
- **Training.** Unemployed people are assigned to training schemes to improve their skills (and thus hopefully their employability).
- **Earnings supplements.** Some programmes include financial support for work entrants (normally in addition to any existing support available through the tax benefit system).

In most countries these policies are targeted specifically at the long-term unemployed and/or groups considered to be marginalised in their labour market attachment (e.g. the low skilled and unskilled, or disabled people who are capable of work).

There is substantial empirical evidence on the effectiveness of different types of ALMP – particularly from the US and Canada, where these types of programmes have a long history, and there is a commitment to formal evaluation of programmes in most cases. Many ALMP programmes in North America feature random assignment techniques whereby entrants to the programme are assigned (using a lottery process) to either a 'treatment' or 'control' group. The 'treatment' group enter the programme, whereas the control group are handled under the rules that existed *before* the programme came into place. As with randomised trials of drugs in medicine, the random assignment process is

designed to allow empirical researchers to estimate the 'pure' effect of the ALMP programme, without needing to use a complicated econometric framework to control for systematic differences between the treatment and the control group – *because there are no systematic differences between treatment and control groups*. Thus, subject to certain caveats[76], the evidence from ALMP evaluations represents probably the most robust evidence covered in this whole report.

Greenberg and Cebulla (2008) report evidence on the effectiveness of US active labour market initiatives from 28 programmes run in the US and Canada from the 1980s and 1990s. Their main findings are that:

- *mandatory 'work-first' programmes* – i.e. programmes that offer assistance with job-search, or which place participants into work directly through subsidised jobs – offer bigger impacts on employment than mandatory 'education-first' programmes – i.e. those that assign all programme participants to full-time education and training.
- Programmes which offer a *mix* of initial activities – i.e. where individuals are assigned to participate initially in *either* an education or training activity *or* a job-search activity – seem to perform well in terms of promoting employment, as well as from a cost-benefit analysis perspective.
- *Earnings supplement* programmes perform well in terms of promoting employment, although they tend to be more expensive from the perspective of the government budget than for other programmes.

OECD reviews of in-work support in their annual *Employment Outlook* publication reach similar conclusions (OECD 2004, 2006). The OECD also looks at evidence on direct public sector job creation programmes (not a major feature of the North American ALMP experience) and concludes that by and large, they produce inferior results to job search, subsidised job or earnings supplement programmes. To a large extent this is because participants in job-creation programmes appear to have no better chance of finding a 'regular' job after leaving the programmes – and in some cases the programmes actually *reduce* their likelihood of finding employment afterwards. This underlines the point that the way that ALMPs are designed is crucial in determining their effectiveness.

76 For example, the randomisation process needs to be followed rigorously, the programme must be small enough not to cause shifts in the local macroeconomic environment, and there need to be no *displacement effects* whereby individuals in the programme treatment group move into work *at the expense of* those in the control group.

What about evidence from the UK? Table 5.1 collects evidence from the main evaluations of active labour market policy that have taken place in the UK from 1998 onwards. These comprise three main kinds of policy:

1. The various **mandatory New Deals** that were introduced over the first few years of the Labour Government. The first New Deal was introduced first for long-term unemployed people claiming Jobseekers Allowance aged under 25 (in 1998) and then extended to the over-25s soon afterwards. An extensive period of assisted job-search (the 'gateway') was followed by assignment to one of four work or training options if the client had not secured a job after six months; (a) a subsidised job with an employer, (b) full time education and training, (c) a voluntary sector job or (d) a placement with the Environmental Taskforce.
2. the **voluntary New Deals.** These were introduced in the early 2000s for some of the groups not covered by the compulsory New Deals – for example lone parents and disabled people. They were voluntary programmes which offered people intensive job search assistance, training and jobs through public, private and voluntary sector "job brokers". As time went on the programmes were extended to include additional features; for example the New Deal for Lone Parents was expanded to include additional in-work credits for lone parents who had been on Income Support for more than a year, and work search premiums. Mandatory work-focused interviews (WFIs) were also gradually introduced for lone parents and disabled people (see Appendix 1 for exact details of the timetable).
3. the **Pathways to Work (PtW)** programme, introduced in 2004 as a new strategy to increase the rate of transition into work for claimants of Incapacity Benefit (IB). PtW involves mandatory work-focused interviews (WFIs) coupled with job search assistance. It was initially introduced for new claimants of IB in a few pilot local authority areas but has since been rolled out nationwide and extended to the stock of most existing IB claimants (see Appendix 1 for details of timings of the rollout.) In autumn 2008 the Government introduced **Employment and Support Allowance (ESA)** to replace IB for new claimants. For ESA claimants who are assessed as being capable of entering work in the future, the WFI requirements are similar to those in the PtW programme.
4. The **Job Retention and Rehabilitation Pilots** programme ran between 2003 in 2006 in certain pilot areas of the UK. It was devised to test ways of supporting the employment of people on sick leave who were deemed to be at risk of

leaving employment. This pilot was an innovation in a UK context in that it used *random assignment* to create treatment and control groups in the pilot areas in a similar way to the North American studies covered in Greenberg and Cebulla (2008). The results from this evaluation are hence more reliable than those of the other ALMPs covered in Table 5.1 below, where random assignment was not used.

Table 5.1. Evidence from evaluation of ALMPs in the UK

Policy Name	Evaluation	mandatory/ voluntary?	Benefit receipt impact	Employment impact	Other salient features
New Deal for Young People (short-run evaluation)	Dorsett (2004)	mandatory	Being in any of the New Deal options is associated with lower unemployment over the first 6 months – especially the 'Gateway'.	The employment option (subsidised jobs) had the largest employment impact after six months.	The Environmental Task Force Option was the least effective option in the New Deal. Full Time Education and Training was moderately effective.
New Deal for Young People (long-run evaluation)	Beale, Bloss and Thomas (2008)	mandatory	On average, measured over the four years after participation, programme participants spent 15 days per year less claiming out-of-work benefits. The effect fell over time.	Positive impact of New Deal lasts for a number of years after participation, although it reduces over time. The Employment option outperforms other options.	Qualifications have a big(positive) impact on the likelihood of achieving successful longer-term outcomes. Older clients more likely to achieve successful outcomes than younger clients. People who left NDYP for the Employment option perform better in the long-run than people who left for one of the other options.
New Deal for Lone Parents	Dolton et al (2006); Cebulla et al (2008); Brewer et al (2009)	voluntary	Reduction in benefit receipt of around 14 percentage points among lone parents who signed up for the programme.	Not measured	This is a particularly complex programme to evaluate because of its voluntary nature and the non-financial nature of help being offered. Initial take-up was poor: before 2001, only around 7% of lone parents participated voluntarily in NDLP.
New Deal for Disabled People	Stafford et al (2007);	voluntary	Reduction in benefit receipt by month 24 of programme of 16 percentage points for longer-term participants and 13 percentage points for more recent participants. Small increase in JSA claims for ex-programme participants	43% of programme entrants found jobs by November 2006. Of these, 57% found sustainable employment (3 months or more)	By 2006 around 3% of inflow onto incapacity-related benefits were entering NDDP. Women more likely to find paid work than men. People with basic skill problems less likely to be in work. Cost benefit analysis positive: Net social benefits of around £3,000 for longer-term participants
New Deal for 25-Plus	Wilkinson, 2003	mandatory	In the pilot schemes for ND25 plus, around 8 per cent more pilot participants had left JSA 18 months after entering ND25 plus than members of a comparison group.	For men, ND25 plus participants were 4 percentage points less likely to be unemployed 12 months after entering the programme than if it had not been introduced. For women, the impact was negligible.	The older participants were, the less likely they were to go into unsubsidised employment and the more likely they were to go into subsidised employment. Participants with longer unemployment duration before entering the programme were less likely to go into employment.
Pathways to Work	Bewley, Dorsett and Haile (2008)	mandatory	Effect on IB receipt 18 months after entering the programme was small and not	Significant increase in the probability of being employed 18 months after	No statistically significant impact of PtW on earnings – surprising, given the employment effects.

			statistically significant.	entering PtW (7.4 percentage points).	Stronger employment effects for women than men. Stronger employment effects for those aged under 50 than those aged over 50. Little effect on those suffering from mental illness. Larger effects on participants with dependent children.
Job Retention and Rehabilitation Pilot Scheme	Purdon et al (2006)	Randomised control trial	Not measured. Impacts on (self-reported) health of participants were minimal and not statistically significant.	None of the interventions tested (health interventions including physiotherapy, complementary therapy, and psychotherapy; and work interventions including ergonomic assessment) had any significant impact on probability of return to work for 13 weeks or more.	The pilot was designed to test interventions which might decrease the length of time people spent away from work through sickness and increase job retention for people with a health condition or impairment. It ran as a randomised control trial between 2003 and 2005 in six areas of the UK.

Before discussing Table 5.1 in detail, it is important to note that the quality of econometric evidence from the UK evaluations of ALMP falls some way behind the US evidence based on randomised assignment. With the exception of the Job Retention and Rehabilitation Pilots, randomised assignment has never been used in a UK evaluation of ALMP, largely because of ethical concerns. This means that the UK evidence is not as high-quality as the US evidence, but nonetheless all the evaluation studies used sophisticated econometric techniques in an attempt to control for possible biases resulting from the non-experimental nature of the programmes. Also, two of the programmes not subject to random assignment – the New Deal for Lone Parents and the New Deal for Disabled People – were voluntary, which makes the effects of the programme harder to evaluate as the sample of participants is, by definition, composed of those members of the target group who are more positively disposed towards moving into work.[77]

On the whole, the evaluations of UK ALMP schemes find evidence of positive effects from most programmes – although there is some evidence that the long-run effects are smaller than the short-run effects, where evaluations have measured them separately. As with the

[77] The government has moved increasingly towards a mandatory framework for both of these groups – Pathways to Work, which involves mandatory work-focused interviews for a large number of disabled benefit claimants, and the recent reforms to lone parent benefit eligibility which will result in lone parents whose oldest children is aged seven or over being shifted from IS to JSA and being obliged to search for work from October 2010.

US evidence showcased earlier, 'work-first' options seem to be more effective than full-time education and training based options – although there may be a selection effect at work here, with the most promising scheme clients able to find employment whereas less promising clients ended up in the FTET options. This conclusion would tally with the relatively poor outcomes from the Job Retention and Rehabilitation pilot programmes, which were aimed at a groups that were particularly hard to place in work for any sustained length of time.

From October 2009 the Government began to replace the existing New Deal 25 plus, New Deal for Young People and New Deal for 50 plus with a 'Flexible New Deal' scheme which integrates the schemes together and expands the role of private and voluntary-sector contractors in delivering work placements[78]. As this has only just been introduced, no evidence on its effectiveness is yet available[79]. However, recently Gregg and Layard (2009) have made a proposal for a 'Job Guarantee' scheme which would take the 'work first' approach to its logical conclusion by creating jobs for people who have been through the Flexible New Deal and failed to find a job, using direct funding from the public purse to create the jobs. Gregg and Layard propose creating low-skilled jobs in sectors such as maintenance (e.g. of public housing, schools, hospitals and roads), and social care (e.g. home helps). Workers would be paid the rate for the job (e.g. the National Minimum Wage rate or just above), rather than just benefit rates.

There is some evidence from Denmark and the Netherlands, where these types of schemes have been tried already, that they reduce unemployment (see for instance OECD 2007) – which is just as we would expect, given that the government is essentially creating additional jobs. Previous evidence on whether schemes like this can help long-term unemployed workers into unsubsidised jobs is mixed (see OECD 2006, for example) – it depends very much on whether the Job Guarantees can help clients acquire the skills they need to forge a long-term relationship with the labour market and on whether continued support with job search is provided throughout the programme. The final point to note here is that schemes like this do involve additional initial expense relative to New Deal programmes; for example, Gregg and Layard have estimated that a scheme of Job Guarantees for all flexible new deal claimants for six months after going through the new deal would cost around £2.5 billion *more than* existing policies. Obviously, to the extent

[78] For information on the Flexible New Deal go to http://www.dwp.gov.uk/supplying-dwp/what-we-buy/welfare-to-work-services/flexible-new-deal/

[79] For very preliminary evidence on the Flexible New Deal see Knight (2010).

that people entering the Job Guarantee scheme do manage to make the transition into sustainable long-run employment, this will reduce costs in the long run – as well as bringing considerable social benefits.

To summarise the existing evidence on ALMPs, the claim by Labour MP Frank Field (a vocal opponent of recent welfare-to-work schemes) that the New Deals represent "a £60 billion waste of money" (Field, 2008) seems not to be backed up by the balance of evidence. However, each of the schemes has undergone considerable evolution over the last twelve years, while new schemes have also been introduced in the interim. There is a clear need for a more holistic approach to the evaluation of ALMPs in the UK which takes account of changes in the impacts of the scheme over time, the interactions of each scheme with the macroeconomic environment (which has changed greatly since 1997) and the changes in the characteristics, demographics and spatial distribution of long-term unemployed and inactive people over the 2000s.

Evidence from Impact Assessments of Labour Market Regulations

The final type of evidence I look at in this chapter comes from Impact Assessments (IAs) of labour market regulations. IAs are a tool used by the government to assess the costs, benefits and risks of policy proposals on businesses, charities and/or the voluntary sector. The BIS website states that IAs "identify and assess all the options, both regulatory and non-regulatory and determine whether the benefits justify the costs."

The methodology for preparing IAs involves *cost-benefit analysis* (CBA), which is a tool for appraising the size, and distribution, of the benefits which a policy might have on different sections of the economy, as well as the costs it might impose. CBA involves using various techniques to "monetise" expected impacts of a policy (i.e. convert different impacts into financial terms), so that the costs and benefits can be compared. The principle behind this idea is that policies with a relatively high benefit-to-cost ratio are more attractive in terms of maximising the UK's overall "welfare" than projects with a low benefit-to-cost ratio.[80]

[80] I use the term "welfare" here rather than Gross Domestic Product or some other measure of output because the principle behind IA is that non-monetary benefits (such as benefits to the environment, or improved health in the population) are converted into monetary benefits and included in the cost-benefit calculation, and vice-versa for environmental and social costs. Of course, the methodology for doing this is both complex and contentious, and by no means free of value judgements. For example, if a policy proposal reduces overall economic output but makes the poorest people in society better off, it is not possible to incorporate these distributional effects into the overall

Government departments and regulators are required to publish an IA for every regulation they introduce. As part of a Public Service Agreement, BIS is committed to produce an annual publication which summarises the data from the individual IAs, showing the ratio of the benefits and cost of regulation right across government. The latest of these publications, published in October 2009 (HM Government 2009) contains summaries of all the IAs for regulations established by legislation which received Royal Assent or was made by Parliament in the financial year 2008-09. Analysis of the subsample of these regulations which relates to the labour market[81] shows estimated total monetised benefits of around £278m and estimated total costs of around £154 million (in 2007 prices). Hence the ratio of total benefits to costs is around 1.8 – which suggests that the Government itself views labour market regulations as welfare-enhancing. While Impact Assessments should be viewed alongside the other evidence presented in this report - as just one of many tools for assessing the desirability of individual regulations – the fact that, taken as a whole, recent labour market regulations are calculated to have delivered more costs than benefits counts as yet more evidence against the orthodox view of the impact of labour market regulations on economic performance.

Summary of microeconomic evidence

The microeconomic evidence examined in this chapter sheds a lot more light on the relationship between labour market regulation and various aspects of economic performance than the descriptive evidence examined in Chapter 3, or the cross-country macro regressions covered in Chapter 4, could ever do. As each subsection contained a summary of the important results, this chapter summary draws out the key findings across studies of different aspects of regulation.

Overall, it has to be said that there is little support for the orthodox economic view that labour market regulation is always and everywhere a contributor to poorly performing

CBA without applying value judgements about how we much importance we should attach to the welfare of the least-well off members of the population compared with people further up the income distribution. See Reed 2008 for a detailed discussion of the UK Government's 'Green Brook' project appraisal methodology, which uses a similar framework.

[81] Details of the analysis are available from the author on request.

economies. Support for orthodoxy is not non-existent, but it is thin on the ground. The only two findings in this chapter which unequivocally back up negative view of labour market regulation that the OECD was espousing in the mid-1990s are, firstly, that employment protection legislation reduces the flow of workers between jobs (and thus, perhaps, slows down reallocation of labour from less productive to more productive uses in the economy); and secondly, that generous unemployment benefits without job search conditions attached can lead to persistent high unemployment.

Even in these cases, however, the overall picture from microeconomic research is more complex. Econometric studies are split fairly evenly on whether the overall impact of EPL on overall productivity in the economy – as opposed to job flows – is positive or negative, and this in itself casts some doubt on the idea that a reduction in job flow rates is necessarily a bad thing. And if unemployment benefits include mandatory job search conditions, the evidence from Denmark suggests that they can be generous without contributing to rising unemployment.

In other areas of labour market regulation the orthodox prescription fares badly overall. Collating information from studies in the US and UK shows no overall effect of minimum wages on unemployment. Trade unions seem to have no significant negative consequences for labour market outcomes, and may have positive effects in promoting workplace cohesion and social justice. Parental leave policies are important for encouraging female employment and reducing the gender wage gap.

Meanwhile, the aspects of labour market intervention which the OECD has endorsed – active labour market policy, childcare subsidies and in-work benefits – seem to be highly effective at increasing employment rates, and channelling extra resources to low-income working families. It is important to make an observation here about the finding from the previous chapter that higher tax as a share of national income was correlated with lower employment. However, in-work benefits and other subsidies clearly have the potential to lower the net tax burden on low-income working families, and it is this, rather than the overall tax rate, which seems most relevant for increasing employment rates at the margin. This is a clear example of an area where microeconomic analysis can tell us a lot more than crude aggregates.

Finally, there are some areas of labour market regulation where current research fails to

really get a handle on what the causal effects on labour market outcomes are (this is particularly the case with the right to request flexible working). More rigorous analysis of the impact of this measures on the labour market would be useful.

6. The Interactions between Labour Market Flexibility and Other Markets

This chapter looks at the interactions between labour market flexibility and a selection of other markets in the UK economy. Conventional economic theory suggests that policymakers should look at the impact of policies in a *general equilibrium* context where possible, i.e. taking into account all 'knock-on' effects on other markets as well as the original effects. Of course, this makes the impacts of a policy measure all the more difficult to evaluate in total. Here we present a selection of evidence from three different markets – the product market, the transport sector, and international migration (i.e. the extent to which the UK labour market is directly linked to what happens in other labour markets and other countries.) As well as delivering some very useful additional insights over and above the areas we have already looked at, the main message from this chapter is that the UK labour markets can't be viewed in isolation from the rest of the economy – or indeed from what's happening abroad.

LMF and product market flexibility

Some of the macroeconomic cross-country studies analysed in Chapter 4 of this report look at the relationship between labour market performance and measures of *product* market flexibility, as well as labour market flexibility. Product market flexibility relates to the degree of competition between firms in the product market and conversely, the degree to which the product market is subject to regulation. As with labour market flexibility, product market flexibility is a multi-dimensional concept, and has to be entered into regressions as a composite index[82].

A lot of the work which uses measures of product market regulation (PMR) in macro-regressions comes from the OECD, and most of it finds that high levels of product market regulation have an adverse impact on labour market performance, although the effects do not seem to be particularly large. For example, Basselini and Duval (2006) find that a

[82] For example, the main OECD product market regulation (PMR) indicator includes information on the extent of state control of business enterprises, legal and administrative barriers to entrepreneurship and barriers to international trade and investment. The OECD also produces sectoral regulation indicators for the extent of regulation in the professional services, retail trade, energy, transport and communications, and 'overall regulatory impact'. See OECD (2009b) for more details.

reduction of two standard deviations[83] in PMR is associated with a reduction in unemployment of around 0.7 percentage points. If PMR were normally distributed[84] across countries, a reduction of two standard deviations would be equivalent to going from the top 5% most regulated product markets to the median – a large change with a relatively small impact on unemployment (assuming, of course, that the causality runs from PMR to unemployment and not the other way round). Fiori, Nicoletta, Scarpetta and Scianterelli (2007) find similar results.

The finding of a negative association between PMR and labour market performance is not unanimous, however. For example, although Amable, Demmou and Gatti (2007) find that high PMR is associated with increased inactivity measured at the aggregate level in each country, product market deregulation appears to *increase* levels of inactivity for "prime age" men (aged 25 to 54) in their results. Their rationalisation for this result is that low-skilled men on the margins of the labour market in this group suffer from low productivity, which leads to a lack of demand for their labour – and that this is exacerbated by increases in product market flexibility[85]. Amable *et al* also find that the overall impacts of labour market deregulation on employment performance are negative for countries where PMR is particularly low to begin with. Again, this goes against the grain of orthodoxy.

The theory behind the interaction of labour and product markets is not straightforward. A simple orthodox view would presume that, if an economy is starting from a situation of relatively high product market and labour market regulation, deregulating either the product or the labour market would lead to beneficial results, and deregulating both markets would lead to the best results of all. However, a more sophisticated reading of economic theory makes it clear that this is not automatically true. For one thing, the 'theory of second best' in welfare economics analysis (Lipsey and Lancaster, 1965) suggests that in an economy with *any* departure from the perfectly competitive paradigm, a movement towards the competitive paradigm in one sector of the economy (e.g. the product market) does not necessarily enhance efficiency if other sectors (e.g. the labour market) remain

[83] Standard deviation is a measure of dispersion in a statistic. For a normally distributed variable (see next footnote), an increase of two standard deviations would correspond in going from the median (middle) value in the population to just above the "95th percentile" (i.e. 95% of the way up the distribution). Thus, for most variables, a two standard-deviation increase is quite a large change.

[84] Many characteristics of populations approximate a normal distribution when graphed – for example the heights of individuals. It is a characteristic 'bell-shaped' curve.

[85] Faggio and Nickell (2005) find evidence for the UK that wage levels for prime-age men are negatively related to inactivity. They argue that labour supply of less-skilled workers has been reduced because of decreasing relative wages, which discourages low-skilled people (particularly men) who eventually leave the labour force and move into inactivity.

unchanged[86].

A simple orthodox retort to this critique would be that this simply underlines the importance of deregulating across the board rather than in only a few industries or markets. However, there are good reasons for thinking that *some* degree of regulation enhances performance in both labour and product markets. The evidence shown in Chapter 5 shows that many aspects of labour market regulation are associated with better economic performance, at least to some degree. This is no less true of the product market – for example, the existence of competition legislation implies that left to themselves, some sectors of the economy would tend towards monopoly (or 'oligopoly', where the market is divided up between a few firms) rather than perfect competition, which is based on a large number of small firms. To the extent that product markets have features that are inherently imperfectly competitive, we cannot simply either that deregulating the labour market or the product market, or indeed both, will automatically lead to improved economic outcomes. The issue needs to be assessed by detailed empirical investigation.

LMF and transport

The provision of affordable and accessible public transport represents one of the most obvious areas of physical infrastructure investment that can improve the operation of the labour market[87]. By making it possible for workers to reach a wider range of work locations at reasonable cost, transport infrastructure provision – whether based around public transport options, or facilitating private transport through (for example) provisions of roads – means that workers have a larger choice of firms and firms have a larger choice of workers. In the framework of the "search/matching" models of the labour market examined in Chapter 1, this should improve the operation of labour markets by making them "thicker" and more competitive[88]. Whilst the pure orthodox view of the labour market largely ignores the questions of labour market frictions such as transport and mobility costs, nonetheless a broad spectrum of economists – including those of an orthodox persuasion – would agree

[86] This is backed up by some of the detailed theoretical literature. For example, Amable and Gatti (2004) use a model of dynamic efficiency wages in the labour market combined with monopolistic competition in the product market. In this framework, the best strategy for lowering the aggregate unemployment rate is to increase the extent of employment protection while also increasing product market competition.

[87] Human infrastructure investment (i.e. human capital or skills) is another obvious area where public investment can make a difference; this is handled in more detail in Chapter 7.

[88] The recent review of options for UK transport led by Sir Rod Eddington (DfT/HMT 2006) contains a clear statement of the theory behind these stipulations. For an independent critique see Reed (2008).

that investments in transport improve the operation of the labour market. This view is reflected in UK government policy: the 'Green Book' used for appraisal of public investment projects includes techniques for measuring the benefits of transport infrastructure projects in terms of better access to work and reduced commuting times.

The effects of transport provision on the labour market raise two key issues which are particularly important for this report. One is that transport infrastructure is often subsidised – for example, it is estimated that the Crossrail project in London will cost £16 billion between 2010 and 2017 (when it is scheduled to open), of which £5 billion is being provided by central government[89]. It needs to be subsidised because many of the benefits from improved transport accrue indirectly, via new job opportunities for workers, new sources of profit for firms, and capitalisation of the benefits into increased house price and business property values (Gibbons and Machin, 2006)[90]. The (limited) evidence that increased levels of tax in OECD countries are associated with worse labour market outcomes (as reviewed in Chapter 4) is often used by commentators on the political right to argue that tax rates should be as low as possible to encourage labour market efficiency. However, if tax revenue is being used to finance transport infrastructure investments it is quite possible that the overall impact of taxation on labour market performance – taking into account new infrastructure – could be *positive*. Thus, it is clear that studies which just look at the impact of the 'tax wedge' while ignoring anything that the tax wedge pays for, are potentially one-sided and misleading.

Secondly, there is some interesting evidence from the economic geography literature on how 'real world' labour markets operate which uses data on commuting patterns to analyse the phenomenon of 'excess' commuting – whereby there are a high incidence of workers making long commutes from place A to place B, even when there are workers making commutes from place B to equivalent jobs in place A. As Hamilton (1982) points out, this finding is hard to reconcile with a view of the labour market where job opportunities for workers with particular skill sets are reasonably homogeneous. The existence of commuting in itself – say, from suburban 'satellite towns' into central London – does not invalidate the standard competitive view of the labour market, since if there are productivity

[89] For more details on the Crossrail funding settlement see http://www.crossrail.co.uk/the-railway/why-crossrail/funding-for-crossrail

[90] In theory, it would be possible to capture some of these benefits via a tax on the increased value of residential and business properties associated with the infrastructure investment. However, a combination of technical problems with regard to implementation, and potential unpopularity of the additional tax, mean that this has not been done in practice in the UK (although other countries, including the United States, use similar approaches extensively).

advantages to businesses clustering in a certain location (resulting from reduced costs of recruitment, reputational effects of a certain area, better access to ancillary services and so on) then we would expect wages to be higher in those locations, which would provide an incentive to commute. However, the existence of two-way commuting patterns *for the same type of job* is harder to explain. A number of studies find that the amount of commuting undertaken is much larger than the underlying distribution of jobs and housing would suggest is optimal in the simple competitive model of the labour market. For example, Small and Song (1992) calculate that commuting is about three times higher than optimal given the actual distribution of work and housing in Los Angeles. Manning (2003b) finds that ten times more male residents could find employment in their own ward in London than the number of men who actually do work in their own ward, and mean commuting distance is twice the optimum.

As Gibbons and Machin (2006) point out, "all this makes little sense against a background of perfectly competitive labour and housing markets, since spatial equilibrium requires that identical individuals cannot be made better off by swapping place of work or place of residence." As Manning (2003b) points out, the fact that there are people in employment in suitable jobs close to an individual's place of residence is not the relevant issue *at the time that an individual wants a job* – he or she needs a vacancy; markets for suitable vacancies are much thinner than the overall job distribution at any point in time and this means that workers need to search further afield[91]. As with some of the labour market behaviour examined in Chapter 5, this is important evidence against the simple perfectly competitive view of the labour market and in favour of a more complex "search/matching" model, with correspondingly more complicated implications for things like active labour market policy and unemployment benefit generosity (as explained in Chapter 5).

LMF and migration

The extent of migration into and out of the UK labour market is obviously an important aspect of how flexible the labour market is. Yet curiously, migration is not a commonly looked-at variable in analyses of labour market flexibility. Admittedly there is a large and growing volume of work on the impacts of migration on the UK labour market and other

[91] It is possible to rationalise some of the excess commuting in terms of two-earner households, where there may need to be a locational compromise that results in one of the earners commuting a longer distance than would be the case if he or she lived on their own (Kim, 1995). However, excess commuting is also present along one-earner households, so this cannot be the full explanation for the observed patterns.

labour markets, but discussion of the effects of migration has tended to fall under a separate heading to discussions of labour market flexibility in the discourse of the OECD and other economic commentators.

Political debates over the desirability and the optimal extent of migration in the UK have also taken on a very different shape from debates over the desirability of labour market flexibility. Whereas in the flexibility debate it has tended to be the political right which has argued for increased flexibility at all costs, and the centre and left taking a more nuanced approach, in the migration debate it has been some sections of the right (led by pressure groups such as Migration Watch) which have been arguing for stricter controls on immigration, whereas the centre and left have (mostly) been more positive about the benefits immigration might be able to bring.

There is also a difference in public perceptions about migration and other aspects of labour market flexibility. Ipsos MORI's regular poll of 'the most important issues' facing Britain today' shows that in April 2008, 42 per cent of respondents said that immigration or immigrants were one of the four most important issues facing Britain today, compared with only 6 per cent who did so in April 1998 (MORI 2008). No other labour market topic has figured so highly in the index since the early 1980s (when unemployment was seen as the most pressing issue).

Aggregate statistics show that there has been increased net migration into the UK; between 1996 and 2007, net immigration into the UK increased from around 44,000 in 1996 to around 237,000 per year by 2007 before falling back to 163,000 in 2008[92]. Some (but by no means all) of the increase up to 2007 was driven by the entry of additional countries from central and eastern Europe into the EU in 2003; the UK, Sweden and Ireland were the only three existing EU members to grant workers from these countries full freedom to work in their national labour markets.

Critics of increased migration into the UK argue that it has several adverse impacts on UK economy and society[93]:

1. It is argued that increased immigration *reduces wage levels* for workers

[92] The gross annual inflow of migrants increased from 329,000 to 557,000 per year, while the migrant outflow also increased, from 285,000 per year in 1996 to 340,000 in 2007. See ONS (2009).
[93] See for example Coleman (2008) and Migration Watch (2008).

already living in the UK.

2. It is argued that increased immigration *reduces employment prospects* for existing UK-based workers (i.e. immigration increases unemployment or inactivity rates in the UK.
3. It is argued that increased immigration places *increased pressure on infrastructure and public services* in local areas experiencing high rates of net immigration (for example, hospitals, schools, and other social provision).
4. It is argued that increased migration is *undermining social cohesion* in the UK.

There is a good deal of evidence on the wage and employment effects of migration, summarised in Latorre and Reed (2009). Recent papers examining the effects of increased migration on wage levels in the UK include Dustmann, Frattini and Preston (2008), Latorre and Reed (2009), Manacorda, Manning and Wadsworth (2006) and Nickell and Salaheen (2008). All these papers use evidence from the UK Labour Force Survey, although the econometric techniques and regression specifications used differ. In every case, the estimated effects of increased immigration on average wage levels are very close to zero – in some cases they are positive and in some cases negative, but they are invariably small. For example, Latorre and Reed estimate, using data from 2000 to 2007, that a one percentage point increase in the share of migrants in the UK working age population (for example, from 10 per cent to 11 per cent of the population) would decrease wages by around 0.3 per cent. For someone working at UK minimum wage levels on a 40-hour week, this implies a cut in gross pay of around 70 pence a week – a tiny amount. There is some evidence of slightly larger negative effects on the wages of *previous* immigrants into the UK, and also for people at the bottom end of the wage distribution, but the effects are still small.

In terms of the employment effect, work for the UK Department of Work and Pensions by Gilpin *et al* (2006) and Lemos and Portes (2008) using data from the UK Labour Force Survey and the Worker Registration Scheme (with which all new migrants from the EU A8 accession countries have to register on arrival in the UK) find tiny, and statistically insignificant impact of increases in migration on unemployment. Dustmann, Fabbri and Preston (2005) reach similar conclusions using Labour Force Survey data.

Research using macroeconomic models to look at the overall impact of migration in a

wider range of economic issues mostly leads to similar conclusions, with a few caveats. Kirby and Riley (2006) use the National Institute for Economic and Social Research (NIESR)'s NiGEM macro-model to simulate the effect of increased migration on the UK economy and find very small overall effects. Based on previous analysis by Blanchflower and Shadforth (2007), Blanchflower (2007) argues that additional inflows of workers from the accession countries have reduced the equilibrium rate of unemployment in the UK by moderating wage demands (and hence reducing wage and price inflation) as UK-born workers have been worried about being made redundant at the expense of incoming migrants. This explanation would suggest a trade-off between lower wages and increased employment arising from increased migration- however this is *not* supported by the micro studies referenced above, which find very little effect of migration on either wages or employment.

There is less evidence on the impact of migration on either infrastructure pressure or social cohesion, because these outcomes are inherently harder to measure than straightforward economic outcomes. Research from the Institute for Public Policy Research (Lewis, 2005) suggests that the public often fails to understand the difference between asylum seekers (who are legally unable to work in the UK while their applications for asylum are being processed), illegal immigrants, and legal migrants (e.g. from other EU countries) whose employment rates are actually several percentage points higher than those of the UK-born working age population (Pollard, Latorre and Sriskandarajah 2008).

One important issue which can lead to short-run problems with service provision is that funding for local public services such as education, police and social care comes primarily from central government[94], and funding allocations are base on estimates of population size. Rapid increases in population size in a given local authority, resulting from immigration, can result in public service funding per head falling in the short run, with adverse consequences for service quality. The system for funding public services currently lacks sufficient flexibility to respond very quickly to changes in population size (HoC Communities and Local Government Committee, 2008).

It is important to consider the contribution that immigrants make to the public purse and to

[94] NHS resources are allocated separately from local government through the Department of Health to Primary Care Trusts, but similar issues to do with rapid increases in population size apply.

service delivery, however. Sriskandarajah, Cooley and Reed (2005) estimate that on average, immigrants' net fiscal contribution (taxes paid minus benefits and services received) was approximately £800 per person higher than UK-born residents in the fiscal year 2003-04. That is, on average each immigrant paid £800 more in tax, and/or received £800 less in benefits and services (or some combination of the two) compared to UK-born people. From these results it certainly looks as if migrants are 'paying their way' on average. Rutter, Latorre and Mulley (2009) look at the economic 'footprint' of migration in the East of England, an area that has seen a rapid increase in migration in recent years, with a 124 percent increase in the foreign-born population in the last decade, to around 9 per cent of the region's total population and 12 per cent of its labour force. The study reveals that migrants are a key source of labour in the region, and have helped the labour force expand, offsetting skills 'gaps' found in the region's labour market and performing hard-to-fill jobs in industries such as agriculture and hospitality and catering which employers experience difficulty finding UK-born workers to do.

Migrant workers also play a key role in public services such as health and social care – and if net migration became negative, it is quite possible that public services could experience increased vacancies and difficulties in recruitment, leading to labour shortages (at least in the short run.) Finch *et al* (2009) suggest that re-migration of recent immigrants from the EU back to their home countries has increased markedly over the course of the 2000s – perhaps in response to the falling value of the pound against currencies such as the Polish zloty and the Czech koruna. The recent economic downturn, worse in the UK than most other European countries, may also exacerbate this process.

Overall, most of the negative consequences of migration as alleged by anti-migration pressure groups seem to be either outright falsehoods (as in the cases of wage and employment effects) or one-sided exaggerations (as in the case of the impact of migration on public services). We should bear in mind that the data available to analyse the impact of migration in the UK do not support a very robust analysis at *local area* level – most of the evidence base is for the UK as a whole. It may be that there are negative effects of increased immigration on wages or employment of native populations in specific local areas. However, it is important to emphasis that the overall impact of migration on pay and employment appears to be very small. Strangely, the House of Lords Economic Affairs Select Committee report on migration (HoL Select Committee on Economic Affairs, 2008) took a negative view of migration *because* the aggregate impacts were small. However,

this seems a bizarre interpretation. Given the important role that immigrants play in the UK labour market, we should pause very carefully before recommending additional restrictions which might create shortages in certain occupations[95]. At the same time, progressive policymakers need to be careful that easy availability of migrant labour to fill hard-to-fill vacancies is not used as an excuse to reduce expenditure on UK-based people of working age who require additional active labour market assistance to find work.

[95] Indeed, there is a danger that the new 'points-based' system for allocation of immigration permits to potential workers from countries outside the EU might do this, although there it has not been running for long enough for evidence to be gathered on its effects.

7. Labour Market Flexibility, the Business Cycle, Recession and Possible Depression

So far, the analysis in this report has paid little attention to business cycle factors, but given the dominant policy issue of how to tackle the recession, this chapter examines whether business cycle conditions affect the case for labour market flexibility.

Chapter 4 has already looked at evidence from empirical macroeconomic studies but most of these studies just treat business cycle effects as control variables rather than looking at how business cycle and aggregate demand conditions in the economy interact with labour market institutions. Meanwhile, most of the microeconomic evidence from Chapter 5 comes from the decade between 1996 and 2006 – a period of more or less continuous growth for the UK economy, the achievement of which after a quarter-century of macroeconomic volatile and 'boom and bust' led many commentators to conclude that the UK had entered a new era where the huge economic fluctuations of the 1970s, 1980s and 1990s were behind us.

Sadly, we now know that this was over-optimistic. Following the freezing of global credit markets in mid-2007 in the wake of a huge global asset bubble, the UK (along with most other industrialised countries) plunged into the deepest recession since the 1930s. Monthly estimates of GDP from the National Institute for Economic and Social Research suggest that the economy contracted by around 6% between the start of 2008 and mid-2009 (NIESR, 2009).

This chapter looks at how a deep recession – possibly a depression – may affect the case for labour market flexibility in the UK and other countries.

A new spin on the orthodox rhetoric?

As BBC *Newsnight* economics editor Paul Mason (among others) has pointed out, the current economic crisis wasn't supposed to happen, according to neoliberal orthodoxy (Mason, 2009). Deregulation and liberalisation of global financial markets worldwide, along with other market-oriented reforms, were meant to have put the economic difficulties of the 1970s and 1980s to rest and ushered the advanced economies – and especially, newly

emerging economic giants like China and India – into a new period of rapid growth. In fact, as Nobel Laureate economist Paul Krugman has pointed out in his recently updated second edition of *The Age of Depression Economics* (Krugman, 2008), the period after 1990 when the neoliberal "Washington Consensus" reigned supreme as a guide to economic policy – particularly in developing countries - has produced a series of major financial crises – the Mexican 'tequila crisis' of 1994, the Asian crisis and the LTCM hedge fund collapse of 1997-8, and the 'dot com' bubble collapse of 2000-01. Most recently, in autumn 2008 the entire global financial system came perilously close to collapse, only saved by huge financial support packages from the US and UK.

As a very large blot on the neoliberal copybook, critics of the direction which economic policy has been taking over the last three decades might have thought, *a priori*, that the current economic crisis would discredit orthodoxy and send policymakers rushing out in search of more progressive policy solutions to problems in financial markets and other markets including the labour market. However, orthodox economic commentators have instead used the severity of economic recession to argue that in fact we need *more* deregulation in the labour market, not less, to decrease unemployment (as discussed earlier in Chapter 1 of this report). This has also been part of the rationale behind calls by employer organisations not to implement additional labour market regulations, and indeed to scale back existing regulations, for example the directive on temporary workers, new paternity rights, and entitlements to time to train. The implicit assumption behind this line of argument is that highly regulated labour markets can have low unemployment and strong performance on other variables when the economy is growing strongly, but when recession hits, rigidities can impede recovery. In other words, national economies can "get away with" labour market regulation when macroeconomic performance is strong, but not when it is weak.

In essence, this is not a new argument at all, but the re-emergence of an old one. It was in the early 1980s, when the leading industrialised economies began to experience levels of unemployment higher than anything seen in the post-war period, that calls for deregulation of labour markets first came to the fore. Likewise, the OECD's 1994 *Jobs Study* recommendations – largely orthodox in tone – were set against the backdrop of a new wave of global economic slowdown and rising unemployment in the 1990s, which persisted in certain major continental European economies as the decade wore on (e.g. Germany, France, Spain), although not others (e.g. Denmark and the Netherlands).

Does the evidence we have examined so far suggest that labour market regulation has worse impacts when unemployment rises in a recession? Looking first at the macro evidence assessed in Chapter 4, Basselini and Duval (2006) find that the impact of macroeconomic shocks on unemployment seems to be amplified by high unemployment benefits and dampened by centralised wage bargaining systems. OECD (2009b) also presents updated evidence using similar specifications, which shows that stricter employment protection tends to reduce inflows into and out of unemployment, but this seems to be equally true of booms and recessions, so doesn't really add anything to the evidence previously examined. Likewise, the OECD findings on the impact of unemployment and the tax wedge show similar effects to the research covered in chapter 4 but do not show any appreciable differences in the effect of these two variables in recessions compared with other macroeconomic conditions.

The idea that certain kinds of unemployment benefit regime can make it harder for economies to recover from recession seems quite sensible at first glance. If benefits are indefinite and job-search conditions are weakly enforced (as was the case in Germany in the 1990s) then it is possible that short-term unemployment can become long-term unemployment. There is a good deal of evidence showing that long-term unemployment is particularly damaging to the re-employment prospects of long-term unemployed workers because of depreciation of skills and detachment from the labour market (Gregg and Tominey 2005, Bell and Blanchflower 2009). However, examination of evidence for Denmark suggests that high unemployment benefits for recently laid-off workers are no barrier to recovery from recession if combined with job-search conditions, effective and well-funded active labour market policies (European Foundation for the Improvement of Living and Working Conditions, 2007; Auer, 2007).

Another potential problem seen in the 1980s – particularly in a UK context – is that if the system of state support for unemployed people is overwhelmed by millions of extra claimants, there may be a temptation for the government to reduce headline unemployment figures by encouraging a shift of work-seeking benefit claimants onto benefits which do not impose work-search conditions. This is, to an extent, what appears to have happened with Invalidity Benefit and its replacement Incapacity Benefit during the period of Conservative government in the 1980s and 1990s, where the number of

claimants[96] rose from 700,000 in 1981 to 2.8 million in 1996 (National Statistics, 2002.) Fortunately this trend began to reverse in the 2000s. Recent initiatives to "re-activate" long-term sick and disabled workers who might be capable of work given suitable assistance packages – the Pathways to Work and Employment and Support Allowance programmes – have made some progress in reducing the Incapacity Benefit caseload, but it is unclear to what extent this will continue in the short run in the context of the current recession (although so far inactivity levels over the last two years as a proportion of the population have been very stable – see Table 7.1 below).

The main recommendation from the most recent *OECD Employment Outlook* (OECD, 2009b) in the context of the current recession is that spending on active labour market policies needs to rise if developed economies are to stand any chance of limiting the rise in unemployment to levels unprecedented since the 1930s. From a 25-year low of 5.6% in 2007, the average unemployment rate across the entire OECD had risen to a post-war high of 8.9% by June 2009. The OECD argues that there is strong evidence that in previous recessions, spending on active labour market measures has not kept pace with the increase in the number of eligible clients as unemployment has risen (OECD, 2009b). Given the clear empirical evidence on the success of certain kinds of ALMP programme shown in Chapter 5 – particularly job search and work experience programmes – it seems unfortunate that funding for these programmes does not expand in line with the increase in the number of clients during recessions, and indeed the OECD argues for increased spending on ALMPs with a proven success record, as well as pointing out that due to the reduction in the number of job opportunities during a serious recession, it may be necessary to make more use of ALMP options which are not 'work first' in nature (e.g. training programmes). The OECD also argues, to its credit, that the "safety net" feature of unemployment benefits in a time of substantial increases in unemployment is vital. Many people who become unemployed may be out of the labour market for a considerable time, and it is important that out-of-work benefits are generous enough to avoid families falling into dangerous levels of poverty and hardship. The OECD's call for increased spending on ALMPs is particularly resonant in the UK, where overall spending on ALMPs as a proportion of GDP, at 0.3%, is only around half the OECD average[97].

To summarise, the most important conclusions to come out of evidence on the interaction

[96] Strictly speaking, this figure refers to the number of people in receipt of either Incapacity Benefit/Invalidity Benefit *or* Income Support on grounds of sickness or disability, or a combination.
[97] See http://www.oecd.org/employment/keystatistics

between macroeconomic conditions and labour market regulation seems to be that:

1. policymakers need to think carefully about the design of the unemployment benefit system. Ideally benefits should be high enough to ensure that families can survive during the downturn, but "activation conditions" – i.e. job-search requirements and active labour market policy – are helpful in (trying to) ensure that long-term unemployment remains as low as possible. If long-term unemployment does rise it is important for the long-term unemployed to be kept in touch with the labour market rather than shifted onto other benefits.
2. for most other features of the labour market regulatory environment, business cycle conditions don't change the message from the empirical evidence already examined in the last two chapters.

Rethinking macroeconomic policy and its interactions with the labour market: Lessons from Ireland, Germany and the 1930s

The question of what labour market regulations lead to the best economic outcomes in terms of economic growth, the distribution of resources and other aspects of well-being is often seen as an exclusively 'supply-side' phenomenon. The orthodox view of macroeconomic policy – associated with institutions such as the OECD and the IMF, as well as the UK Government and the European Central Bank – is that monetary policy (the setting of interest rates) should be run in accordance with an inflation target, and that the use of fiscal policy for macroeconomic purposes – in 'Keynesian' fashion - is unnecessary. In the last couple of years this view has been severely challenged by the severity of the recession, the advent of *deflation* – i.e. a falling price level – in most major economies, and the loss of 'traction' of monetary policy as interest rates hit a zero lower bound. Later in this section I discuss how the current crisis changes the priorities for macroeconomic policy, and how macroeconomics interacts with the labour market in these circumstances. But first, I outline and critique the standard account of how monetary policy affects the level of unemployment in 'normal' (i.e. non-deflationary) circumstances.

Macroeconomic policy and the labour market in normal conditions

The standard model of how monetary policy affects the labour market is based around the concept of the NAIRU (Non Accelerating Inflation Rate of Unemployment), which is the level of unemployment at which price inflation in the economy is stable. In this model, an attempt to expand employment below the NAIRU by stimulus – either monetary (e.g. cutting interest rates) or fiscal (e.g. cutting taxes) leads to labour shortages and an 'overheating' economy which causes wage and price inflation rather than an expansion in real output. Inflation will accelerate unless the stimulus is reversed and the 'excess' demand is taken out of the economy. Conversely, a monetary or fiscal contraction reduces demand, which leads to higher unemployment, but also falling inflation (because wage claims are moderated and there is lower demand for consumption goods, which puts downward pressure on prices). The clear implication of the NAIRU model is that demand side policies can affect unemployment only in the short run and only in a way that is unsustainable in the long run. In the long run, unemployment trends back towards the NAIRU.

Some initial evidence in favour of the NAIRU model was provided by the increase in inflation rates across the world economy during the 1970s as policymakers attempted to use macroeconomic stimulus to fight unemployment – and then the slump in inflation in most countries during the 1980s as tighter monetary policies became the norm, unemployment rose and wage claims moderated. However, while the NAIRU model has become standard orthodoxy for macroeconomic modellers and policymakers, as Coats (2006), Palley (2007) and Schettkat and Sun (2009) point out the evidence base for it in recent decades is less than compelling. Empirical estimates of the NAIRU over time for different economies show that it is unstable, and tends to track the *actual* unemployment rate to a large extent. To the extent that this is the case it makes the NAIRU a much less useful policy tool, because a temporary change in unemployment might have permanent effects – in which case the idea of a stable 'structural' rate of unemployment, which the economy naturally gravitates to, loses all meaning.

The NAIRU model also has the potential to furnish policymakers with misleading advice. In the US, Krugman (2008) relates a cautionary tale: he was one of many (indeed the majority) of macroeconomists arguing in the mid-1990s that the US's NAIRU was no lower than about 5.5%, and recommended to Federal Reserve Chairman Alan Greenspan that interest rates should be raised as soon as unemployment went below this level. Greenspan decided, against the majority view, to carry on with low interest rates until he

saw clear signs of accelerating inflation in the US economic statistics. As it turned out, those signs never materialised. US unemployment kept falling – to below 4% - *without* an increase in price inflation. (The low interest rate *did* contribute to other macroeconomic problems in the following decade – in particular the housing bubble – but these affects occurred outside the framework normally used for NAIRU analysis).

Conversely, Fitoussi (2003) argues that the difference in interest rate policy between on one hand the German Bundesbank (which effectively set monetary policy for most of Europe in the run-up to the establishment of the Euro) and the ECB (which now set monetary policy in the Eurozone) and on the other hand the US Federal Reserve, is at least partially to blame for the discrepancy in unemployment rates between the US and most of Europe. Basically, his argument is that the ECB keeps interest rates too high – which if the NAIRU model were correct should lead to deflation, but which instead leads to persistent high unemployment. Meanwhile, Eurozone governments are prevented from using fiscal policy instead of monetary to reduce unemployment because of the Stability and Growth Pact, which limits the size of the deficits that member states can run.

Comparison of the recent macroeconomic experiences of the UK and Germany by one of the UK's leading macroeconomists, Wendy Carlin, underlines the point that overzealous monetary policy can have adverse impacts on the labour market (Carlin and Soskice, 2007, 2008). Carlin shows that over the 1990s and early 2000s, while unemployment fell in the UK, the gradual appreciation of sterling during the UK's consumption boom in the late 1990s reduced import prices and boosted real wages, allowing unemployment to fall without the emergence of wage pressure. Conversely, the German exchange rate was constant or depreciating slightly against other currencies during the same period, and the Bundesbank pursued price stability despite deflationary pressures in the German economy. This meant that Germany was unable to recover from the high unemployment levels which it had faced since the reunification of West and East Germany in 1990 until 2005, when a boom in exports enabled unemployment to fall. Carlin also suggests that the Hartz reforms to unemployment benefits examined in the previous section may have had the unintended consequence of workers raising their levels of "precautionary" savings (i.e. savings designed to fund a period of unemployment in the event that they get laid off), as state-provided unemployment insurance has become less generous. The effect of this was to depress private consumption growth and aggregate demand still further.

It would be wrong to suggest that the ECB's tight monetary policy has led to high unemployment *everywhere* in the Eurozone; several economies including the Netherlands, Austria and Ireland secured very low unemployment rates in the years immediately following the establishment of the Euro. However, as Schettkat and Sun (2009) point out, the Eurozone regime can end up as a fiscal and monetary straitjacket for national economies struggling with persistent high unemployment, perhaps as a result of previous negative shocks or policy mistakes previous decades (e.g. reunification in Germany, and the need to restructure the inefficient Spanish economy after the Franco regime ended in the mid-1970s.[98]) The priority of the ECB is price stability – largely regardless of the consequences for unemployment or other labour market variables. This is also the case for the UK's Monetary Policy Committee, but, having kept the pound and not being subject to the Stability and Growth Pact, the UK has channels of adjustment that are not open to Eurozone members. It is possible that a *dual* ECB target of price stability *and* full employment, such as the US Federal Reserve uses, could result in better aggregate European unemployment performance in the future. The return of high unemployment as a policy problem among most OECD countries in the wake of the recent economic crisis may well prompt some re-evaluation of what the priorities for monetary policy should be, and further research on the record of the ECB compared with the Fed and central banks in other industrialised countries is an important priority for the future.

The dangers of flexibility? Deflationary spirals, Keynesian unemployment, and the economic crisis of 2008-9

Orthodox macroeconomic models assume that if unemployment exists in labour market equilibrium, it must be because real wages are too high – in other words, an orthodox analysis of the unemployment which arises if a minimum wage is set above the market-clearing wage level is carried through to the labour market as a whole. Because the minimum wage only affects wages at the bottom of the labour market and can't really be blamed for unemployment further up the wage distribution, the culprits for unemployment in this kind of model are wage-setting institutions – either trade unions or some other kind of 'insider power' which workers somehow exercise, keeping wages above the market-clearing level.

[98] For more on Spain see Muñoz de Bastille (2005).

In a deflationary environment (such as most leading economies are now in), the implication of the orthodox economic model becomes that wages need to *fall* in nominal terms to maintain employment. Ireland, as one of the economies worst affected by the current recession, is a useful example to use here. After a huge asset and housing boom, the Irish economy went into reverse gear as the financial crisis hit, with Gross National Product per head falling by 4.6% in 2008 and 9.4% in 2009. Meanwhile, unemployment on the ILO definition (as a percentage of the labour force) rose from 4.6% in 2007 to 11.8% in 2009 and is forecast to reach 13.8% in 2010 (Barrett *et al*, 2009).

The leading economic research institute in Ireland, the Economic and Social Research Institute (ESRI), operating with an orthodox economic model, has argued that nominal wages need to fall by 7% between 2009 and 2011 to restore full employment (so far they have declined by 1% in 2009 after rising by 3.5% in 2008). (Fitzgerald, 2009).

However, as Keynes pointed out in the *General Theory of Employment, Interest and Money* in 1936, it may also be possible for an economy to experience unemployment when wages are too *low*. This is because the level of wages partially determines the level of *demand for goods and services* in the economy – which in turn determines labour demand, which determines employment. If workers are paid too little, the unemployment consequences for the economy could be just as bad as if they are paid too much (Dreze, 1997 and Amendola *et al*, 2004 present formal models of this effect). Deflation can also impact negatively on consumer demand because consumers holding money in cash or in bank accounts (which cannot fall in nominal terms) postpone buying durable goods on the grounds that their price is falling and so there is an implicit gain to waiting to purchase later when the price will be lower.

There is some tentative evidence that Ireland is now caught in a ‘deflationary spiral’, with prices – and consumer demand – falling (Weldon, 2009). In Autumn 2008, rather than launching a fiscal stimulus along the lines of the US or the UK, the Irish government cut spending and raised taxes in an emergency budget. A second budget followed in spring 2009. With consumer price inflation running at minus 5 percent for 2009, the Irish economy is now in the grip of a severe deflation. It is quite possible that continued fiscal tightening could reduce demand still further and convert the Irish recession into a depression – very much as occurred in the 1930s in the US, where wages fell by over 20% in nominal terms between 1929 and 1933 (Thoma, 2009).

In defence of the Irish government's current approach, wages did rise sharply in the boom years before 2007 and the ESRI argues that they had reached unsustainable levels and in the absence of being able to use currency depreciation to restore competitiveness (as Iceland has done, for example), there is no alternative but to let nominal wages fall. However, the danger with this approach is that the deflationary 'cure' may be worse than the disease, with the Irish economy suffering from an acute lack of effective demand. A fiscal stimulus in the short run – combined with some wage restraint to restore competitiveness over the longer term as global recovery (hopefully) kicks in – might well be a better option than the current 'hairshirt' policies.

The lesson to take away from this section is that downward wage flexibility – or policies which strive to produce downward wage flexibility - may actually *contribute* to higher unemployment in a recessionary context, and policymakers need to be wary of this.

Comparing the UK's labour market trajectory in the current recession with previous recessions

Based on the latest available data, the recession of 2007-09 (which has seen a fall in UK Gross Domestic Product of around 6% from the pre-recession output peak) is the most severe contraction of economic activity for the UK since the 1930s, surpassing the early 1980s recession (which saw a total fall in output of around 4.5%) and the early 1990s recession (which saw a fall in output of around 2.5%)[99]. However, the time path of unemployment and employment rates in the UK labour market has been very different over the three recessions. Table 7.1 below shows how unemployment and employment rates were affected in each of the last three recessions. For both rates I show what the rate was when the recession started (i.e. when labour market conditions started to deteriorate) and what it was when it finished (i.e. when labour market conditions started to improve. The analysis uses quarterly labour market data from the Office for National Statistics. For each statistic I list the particular quarter that the data are taken from. As the impact of the current recession on the labour market may not have run its course yet, the 'after' row for the late 2000s recession should be taken as indicative only.

[99] The figure for the current recession is taken from HM Treasury (2009). The figures for earlier recessions are taken from TUC (2009a).

Table 7.1 Unemployment and employment in the last three recessions

	Early 1980s		Early 1990s		Late 2000s	
	Rate (%)	**Quarter**	**Rate (%)**	**Quarter**	**Rate (%)**	**Quarter**
Unemployment						
Before	5.8	1980q1	7.1	1990q3	5.8	2008q2
After	11.9	1984q2	10.6	1993q1	7.8	2009q3
Change	+6.1		+3.5		+2.0	
Employment						
Before	73.8	1980q1	75.0	1990q2	74.6	2007q3
After	67.8	1983q2	70.3	1993q1	72.5	2009q3
Change	-6.0		-4.7		-2.1	

Source: ONS (2010), ONS LFS online data.
Notes: figures used are for men aged 16-64 and women 16-59.

Table 7.1 shows that the UK labour market seems to be performing much better in the current recession than it did either in the early 1980s or the early 1990s. The 1980s and 1990s recessions saw a rise in unemployment of between 1 and 1.5 percentage points for every percentage point decrease in GDP over the recession as a whole. By comparison, unemployment has only risen by 2 percentage points so far in the current recession, despite the fact that GDP has fallen by around 6 percentage points. At the same time, the fall in employment over the last two years has been a lot shallower than in the 1980s and 1990s recessions. Additionally, it is interesting to note that the proportion of working age people who are *inactive* (i.e. not in employment and not actively looking for work has not changed at all in the current recession (at least so far), being steady at 21.1 percent between the third quarter of 2007 and the third quarter of 2009[100]. Direct comparison of inactivity rates for the early 1980s and early 1990s recession is not possible because the ONS time series for inactivity only goes back as far as 1993 on a consistent basis. However, as the TUC's June 2009 *Recession Report* (TUC 2009a) points out, so far this recession looks very unlike the 1990s recession (which saw a long-term increase in activity rates)[101].

The message from these aggregate statistics is that the UK labour market is doing a lot better in this recession than it did in the last two recessions. However, this is not the whole picture. Given that the UK's overall national income is falling a lot faster than employment, by definition it must the case that income *per worker* is falling more quickly than overall output. There is clear evidence that this happening because *average hours worked are decreasing .* Analysis from Eurostat (2009) shows that between the second quarter of

[101] Inactivity rates were fairly stable during the early part of the 1980s recession but they began to rise a few years into the recession, peaking more than a year after GDP stopped falling. As yet, the current recession has not been going on for long enough for a direct comparison to be possible.

2008 and the second quarter of 2009, average hours worked by employees fell by 0.4 hours, while the proportion of employees working part-time increased by 0.8 percentage points[102]. The annual rate of increase in earnings has also fallen – from 3.3 per cent in the autumn of 2008 to 1.2 per cent by the autumn of 2009 – although this still outstripped output growth in the economy (which was *negative* over the same period).

It is not clear at the time of writing which precise factors have enabled employment to stay relatively high in the face of the severest recession since the 1930s. Part of the explanation is that public sector employment has risen slightly (by 105,000 employees during 2009 if the effects of nationalisation of Northern Rock, Lloyds Banking Group and Royal Bank of Scotland Group are stripped out[103], offsetting falls in the private sector. And there is also tentative evidence that the greater emphasis on active labour market policies – such as the Future Jobs Fund guarantee scheme for young people and the extra spending on helping the unemployed find work – have helped restrain the rise in unemployment. Thus, Jobcentre Plus services appear to making a positive impact on claimant unemployment levels - the number of claimants coming off JSA in January 2010 was 13 per cent. This compares favourably with January 1991 (a comparable period in the economic cycle) when only 7 per cent of claimants moved off unemployment benefit (TUC, 2010).

Additionally, there have been increases in the proportions of part-time and temporary workers in the UK labour force, and there has also been an increase in the number of 'involuntary part-timers' – i.e. part-time workers who would like to work full-time but cannot find a full-time job (TUC, 2009b). There is also some evidence that unions and firms are negotiating temporary short-time working arrangements as a response to the fall in demand for goods and services in the economy (Incomes Data Services, 2009). To the extent that these agreements enable workers to stay in jobs with their accumulated skills and experience, ride out the recession and then return to full-time work as the economy recovers, they are certainly preferable to mass redundancies. At the moment, however, it is impossible to say how long temporary short-term working is sustainable, and how many of these workers will eventually be made redundant.

[102] Average earnings are also increasing more slowly during the recession than before – in autumn 2008 the annual rate of increase in earnings (including bonuses) was 3.3%, whereas by autumn 2009 it was 1.2%. However, price inflation (as measured by the Consumer Price Index) also fell over this period (from over 5% to below 2%), so *real* wage increases were actually higher in autumn 2009 than in autumn 2008.

[103] See TUC (2010) for more details.

There is an interesting comparison to be made with other leading industrialised countries here. As BBC economics editor Stephanie Flanders points out, the US unemployment rate has risen much faster in the current recession than the unemployment rate in either the UK or Germany. Flanders argues that US employers have (on average) adopted an approach of laying off staff as quickly as possible, to reduce short-term costs. By contrast, companies in Germany (and to an extent in the UK) have been much more likely to hold onto their skilled workers and reduce average hours of work rather than instigate mass redundancies. Which strategy proves to be the most effective at maximising medium to long run productivity probably depends on the speed and strength of recovery from recession. A quick recovery in 2010 would reward British and German companies' decision to hold on to their staff, whereas a slow, faltering recovery might mean that British and German companies eventually have to lay many of their short-time working staff off anyway. Comparing the employer response to the recession in different countries is an urgent topic for further research as the recovery from recession hopefully begins.

Commentators on the right of the political spectrum have used the relatively good performance of the UK labour market in the current recession to argue that this shows the benefits of a "flexible labour market" and the rewards which the UK has reaped from the reforms which the Conservatives introduced in the 1980s and early 1990s. However, Table 7.1 shows that, relative to the size of the recession (in terms of lost output), the rise in unemployment during the early 1990s recession was not much different from the early 1980s recession[104]. The main difference in labour market behaviour seems to be between the current recession and both earlier recessions, rather than between the early 1980s and the early 1990s. This does not fit with the orthodox view of the relationship between LMF and labour market performance, because the labour market was *more* regulated in the late 2000s than in the early 1990s in most respects (as Appendix 1 shows.)

It is entirely possible that some of the additional labour market regulations – for example the right to request flexible working – have *improved* the operation of the labour market and made it more able to withstand recession. There is no way to be sure of this at the moment – partly because the recession is too recent for rigorous empirical work to have been conducted on it, and partly because we won't be sure what the overall impact of the recession on the labour market was until some years afterwards. However, even though

[104] The economy did recover more quickly from the early 1990s recession than the early 1980s recession. However, it is not clear to what extent this was due to the labour market being more flexible, or whether it was due to the recession being not as bad in the first place.

the full picture is still far from clear, the available data categorically refute the view that the UK labour market is performing better than in the early 1990s because it is less regulated.

8. Labour Market Regulation and "High Road" Firm Strategies

This chapter looks at the connection between labour market regulation and the kind of competitive strategies which firms pursue in the marketplace. The TUC has examined this issue before in its 2002 report *The High Road.* A "high road" strategy for business success involves combining the following elements:

- high value-added product strategies
- high levels of training and investment
- high productivity and wages
- good workforce terms and conditions

Proponents of the orthodox view of labour markets would assume that employers are already maximising profits and so there is no reason to discuss policy strategies to shift them to the "high road" – the market should automatically converge to the productivity-maximising strategy. However, as we discussed in Chapter 1, more realistic models of the labour market and firm behaviour allow for multiple equilibria, where many firms could be pursuing a "low road" strategy that is efficient to the firm (in the sense of delivering reasonable levels of profit), but globally sub-optimal (because economies dominated by "low road" firms perform worse in terms of key aggregate economic outcomes – like wages and productivity – than "high road economies".)

The previous TUC report argued that many firms choose the "low road" rather than the "high road"[105] for various reasons:

- managers need a higher level of training or education to be able to implement high road strategies effectively, and many British managers are not up to the required standard.[106]
- Alternative business strategies which can deliver competitiveness – such as low-cost, low-quality strategies – are often easier to implement, and quicker, than the

[105] In reality there is likely to be a continuum of approaches between "high road" and "low road" firms.

[106] Research by Bloom and van Reenen (2007) using a panel of over 700 medium-sized enterprises in the UK and other European enterprises shows a massive variation in the quality of management among UK firms and a "long tail" of very poorly managed companies. Poor management was strongly correlated with low productivity. Some of the best quality management was associated with firms under American ownership, who managed to being in better quality management practices on average.

high-road solution.

- There are often ownership and corporate governance pressures pushing firms towards the 'low road' model. For example, private equity houses which acquire firms push for maximum profitability over a short timescale and this is not usually compatible with the high road approach, which requires time for investments to bear fruit.[107]
- There are obvious benefits for workers from the high road approach (e.g. in terms of increased pay and better working conditions)[108] but in many firms trade union organisation or other forms of employee organisation are weak and so workers are unable to exert influence on management to promote higher value-added strategies.

As far as this report is concerned, the key question regarding the "high road"/"low road" model is: how does labour market regulation affect firm's choices of competitive strategies? I also discuss the extent to which this model of firm behaviour is reflected in current government policy, if at all.

Labour market regulation and the high road

For the "high road"/"low road" model to be a valid model of the way UK industry works, there must be some constraint(s) on firms' behaviour that keeps them stuck in the "low road" business model and stops them moving to a "high road" strategy. It is possible that various forms of government intervention – including perhaps labour market regulation – would be able to provide the required "push" to enable more firms to make a transition to the "high road" model. However, in its 2002 report the TUC's main recommendations were not directly aimed at the labour market, but rather, at corporate governance. They were as follows:

1. **Implementing the recommendations of the UK Government's 2000 Company Law Review** - in particular the proposed requirement for quoted companies to produce an

[107] See, for example, the review of the private equity industry conducted by TUC (2007).

[108] A good summary of recent evidence on the effect of 'High Performance Working (HPW) Practices' (the working and management practices commonly associated with the "high road" model) is found in Chapter 8 of the UK Commission on Education and Skills' recent report *Ambition 2020: World Class Skills and Jobs for the UK* (UKCES, 2009). This report cites a range of evidence showing that organisations adopting an integrated range of HPW practices are likely to perform better (see for example, Patterson *et al* 2008 , Tamkin 2005 and Guest 2006 on the relationship between HR practices and productivity and profitability in firms).

Operating and Financial Review (OFR) which would have provided more information on overall company strategy and expanded the requirement for companies to include a 'fair view' of their business in their directors' report. Legislation to introduce the OFR was enacted but then repealed before it was due to come into force in 2006, after pressure from employers' organisations.

2. **Implementing the Myners Review proposals** for promoting a higher level of investor activism. The Myners Review of institutional investment (Myners, 2001) found shortcomings in the expertise and organisation of investment decision-making by pension fund trustees and produced a range of recommendations for improving oversight of companies by investors such as pension funds. These mainly focused on increasing the quality of specialist expertise which investors make use of, more active engagement with shareholders and "unclear contractual structures which generate strong and unnecessary incentives for herding and short-termism in investment".[109] The government largely incorporated Myners' principles into institutional investor guidance, but within a voluntary framework – in other words there was no additional legal requirement for pension funds to follow the guidelines, although a substantial proportion did so. More recently (2007-08) the government consulted on updating the principles and decided to revise the principles to comprise "a smaller number of higher-level principles… to provide more flexibility for schemes in terms of their size, financial position and strategy to explain their investment decision-making approach to stakeholders." (HMT/DWP/Pensions Regulator, 2008)

3. **Implementing the European Directive on Information and Consultation.** This directive gives employees the right, subject to certain conditions, to request that their employer sets up arrangements to inform and consult them about issues in the organisation in which they work. The Regulations came into force for organisations with 150 or more employees in 2005, and were extended to organisations with more than 50 employees by 2008. A case-study based evaluation of the implementation of the Directive by Hall *et al* (2008) produced mixed findings: in some of the workplaces studied, the Directive had made a considerable difference to decision making, whereas in others it had made little, if any, difference to management behaviour.

How much can *labour market* regulatory measures influence firms' choice of business strategies? Can regulation 'push' firms into adopting high value-added strategies? There

[109] See HMT (2004) for a detailed summary of the Myners Review principles and the government's response to them.

are certainly theoretical models where this can happen – particularly as regards firm-specific skills formation. For example, Estevez-Abe *et al* (2001) hypothesise that social protection mechanisms (like generous unemployment benefits and employment protection legislation) improve workers' incentives to invest in firm-specific skills, and find some (albeit modest) evidence for a link between the extent of labour market regulation and the extent of firm-specific human capital using data from a panel of OECD countries. However, other factors not to do with the labour market – such as a stable macroeconomic environment, and a corporate governance framework that encounters far-sighted firm behaviour – are probably more important in this regard.

There have been empirical studies of the extent to which the minimum wage, in particular, generates knock-on effects on firms' training strategies. The idea behind this is that employers invest in training their workers so that they will be productive enough not to be 'priced out' of employment by the minimum wage. This training exercise presumably imposes costs on the firm in the short run, but benefits the firm and the worker in the long run. The overall evidence on this is mixed. Heyes and Gray (2003) find some evidence from a study of around 250 British establishments that the UK National Minimum Wage did provide a positive boost to training in some cases among small and medium sized enterprises (SMEs); Arrowsmith *et al* (2003) produce similar findings. However, overall it is hard to find substantial 'shock effects' of the minimum wage in the UK (Grimshaw and Carroll, 2006). McLaughlin (2009) uses evidence from Denmark and New Zealand to suggest that a high minimum wage is not enough *on its own* to encourage firms to adopt a 'high road' strategy as the highly competitive product markets that a lot of low-road firms operate in, and the fear that other employers will 'poach' trained workers, makes firms reluctant to change their basic business strategy. McLaughlin suggests that a more co-ordinated institutional framework based on sectoral agreements between firms would be more effective at encouraging increased training than the 'blunt instrument' of the minimum wage.

Government skills strategy and the 'high road'

It is fair to say that since 1997, much of the UK's skills strategy has mostly reflected a 'human capital' or skills-driven model of business development, based on the idea that improvements in the skills and qualifications base of the population, combined with the use of in-migration for vacancies that would otherwise be difficult to fill, can secure a high-

productivity economy. The government has often taken the view that little, if any intervention is needed to persuade employers to adopt 'high-road' strategies beyond making improvements to the skills base – either through better school and university education, adult learning schemes (such as the ill-fated Individual Learning Accounts of the early 2000s, abandoned because of widespread fraud and abuse), or workplace learning initiatives such as the Union Learning Fund[110] and Train to Gain[111]. New institutional initiatives – the establishment of the Learning and Skills Councils to oversee adult learning (in England) and the introduction of 25 Sector Skills Councils to promote skills development and the reduction of skills gaps and shortages in each sector – have given employers a key role in driving the direction of change.

Professor Michael Porter's 2003 review of UK competitiveness policy for the then Department of Trade and Industry, *UK Competitiveness: Moving to the Next Stage* (Porter and KeteIs, 2003) made a forceful argument that simply relying on a continuation of the business-driven changes that had secured competitive advantage through cost base reductions during the 1990s would not be the best strategy for the future. In recommending a much greater stress on innovation and high-value added in business strategy – essentially something very similar to the TUC 'high road' model - Porter observed that:

"competing on relatively low input costs and an efficient business environment is no longer sufficient to achieve the levels of prosperity the country is aiming for. Lower taxes, less regulation and an even smaller role for the government are no longer the most critical elements for UK competitiveness. To achieve higher prosperity, UK companies will need to upgrade their productivity by competing on more unique and more innovative products and services. This will require changes in management behaviour, but it will also require targeted investments in the business environment, and the developing and strengthening of new types of institutions."

[110] Shaw *et al* (2006) find broadly positive impacts of the Union Learning Fund in terms of developing learning capacity via the number of Union Learning Representatives recruited and trained, an increase in dedicated roles and resources within unions in support of lifelong learning, and an increase in the allocation of funds to support learning. However, the evidence from the evaluation is mostly qualitative because the quantitative aspect of the research suffers from a small sample size.

[111] Evaluation evidence on the impact of Train to Gain is so far mainly disappointing. The scheme's impact on employee satisfaction and motivation seems to have been good but the impact on labour market outcomes is limited and there seems to be a high degree of 'deadweight' – i.e. the scheme is funding learning that would have taken place anyway. However take-up of the scheme has increased recently as it has been made more flexible in response to the downturn. For more details see National Audit Office (2009).

However, the developments in skills policy which followed the Porter review instead gave business *more* of a 'driving seat' role in setting the skills agenda as they see fit, rather than questioning the direction that employers' business strategies were leading the private sector in as Porter recommended. The Leitch Review of Skills (Leitch Review, 2006) took a pure 'human capital' view of the recipe for economic success and increased UK productivity – essentially arguing that if the skills base of the UK population is increased, there will be an automatic feed-through into higher productivity, provided that the extra skills are valuable to employers. To ensure that skills are valuable to employers, Leitch recommended the creation of an employer led Commission for Education and Skills to oversee progress towards national targets for the proportion of the population attaining qualifications at each skill level - replacing a number of existing skills quangos. Further recommendations included rationalising the existing structure of vocational qualifications so that only SSC-approved qualifications can received public funding, and routing all adult vocational skills public funding in England, other than community learning, through Train to Gain and Learner Accounts (the successor to Individual Learning Accounts) by 2010. The UK Government has adopted these recommendations.

While the Leitch Review took a very supply-side view of UK skills policy, since its publication skills policy has gradually evolved towards an approach that places a greater focus on skills demand. In World Class Skills (DIUS, 2007) a nuanced change in tone emerged, with the skill needs of individuals and employees being recognised as integral to policy success, and a vision of a 'demand-led' skills system beginning its development. In 2008, the Secretary of State signified a further policy shift with reference to the importance of integrating skills policy with a strategy of 'industrial activism', especially in key areas such as the development of the low carbon economy. More recently the Government announced in *New Industry, New Jobs* that it was developing a new skills activism policy approach that would be at the heart of industrial strategies designed to enable the economy to recover from recession (TUC, 2009c)

The first report from the UK Commission for Education and Skills (UKCES) which was established as a result of Leitch's recommendations, *Ambition 2020: World Class Skills and Jobs for the UK* (UKCES 2009) also takes took a more balanced approach. The UKCES report argues that *both* the supply of skills and the demand for skills are important. On the supply side, the report assesses the prospects of achieving "world class" employment and skills – of becoming one of the top countries in the world in terms of the

proportion of adults qualified at higher skill levels – and estimates that the UK's relative international position is actually likely to deteriorate by 2020, rather than improving[112].

Meanwhile, on the demand side the report finds evidence of a growing mismatch between the numbers of high skilled people and the numbers of jobs in the UK which require high skills. Research by OECD (2008) shows that between 1998 and 2006, the increase in the number of people qualified at tertiary level (i.e. university degree or equivalent)[113] was four times bigger than the increase in the number of jobs in occupations that generally require this level of education. This pattern of increases in the supply of skilled workers outstripping the increase in the demand for skilled jobs was not seen in most other OECD countries[114]. Neither is it the case that the huge growth in the supply of skilled workers between 1998 and 2006 was making up for earlier skills shortages; in 1998, the UK had one of the highest ratios of highly-skilled workers to highly-skilled jobs of any OECD country.

As the report suggests:
"These combinations of a relatively small initial 'gap' between demand and supply, a slow growth in demand for skilled jobs and a large gap between skills supply growth and skills demand growth are a possible set of 'lead indicators' of potential future imbalances between high level skills availability and skills demand, i.e. potential 'over-supply' or 'deficient demand' for high level skills.' (UKCES, 2009).

Recent research on the wage premium for graduates also finds that while the overall wage return to degree-level education remains high, there is increasing *dispersion* in the returns to degrees across different institutions and subject categories, implying that some types of degree are a lot less valuable than others. At the same time, the number of graduates in jobs which do not require graduate-level qualifications on entry increased markedly between the mid-1990s and the mid-2000s (Green and Zhu, 2008).

The UKCES believes that the increasing evidence of "overqualified" graduates in the UK labour market is largely due to failure of employers to utilise graduate-level skills

[112] For example, the report's projections suggest that, on current trends, by 2020 the UK is likely to be ranked 10th out of OECD countries on the proportion of adults with high-level skills (compared with 12th in 2009); 21st on intermediate level skills (compared with 18th in 2009); and 23rd on low level skills (compared with 17th in 2009).
[113] More precisely, the definition of 'tertiary' used here is levels 5 or 6 of the OECD's International Standard Classification of Education (ISCED). See http://stats.oecd.org/glossary/detail.asp?ID=1436 for more details.
[114] With the exception of the Netherlands, Ireland and Spain.

effectively:

"The relatively low level of skills in the UK, the limited extent of skill shortages and the potentially relatively low demand for skills relative to their supply, taken together, imply a demand-side weakness. The UK has too few employers producing high quality goods and services, too few businesses in high value added sectors. This implies a need to raise employer ambition, to stimulate demand, as much as to enhance skills supply." (UKCES, 2009)

Although the UKCES report does not make specific policy recommendations for how to create an economy based on "world class" levels of skilled workers and jobs, its analysis fits in very well with the "high road"/"low road" analysis of the problems the UK faces in this area. In contrast to the Leitch Review, UKCES recognises that both demand *and* supply of skills are important. Expanding the number of skilled workers in the UK is a strategy with huge potential for improving UK productivity – *provided that* employers make use of those additional skills.

Certainly the UK Government should take the UKCES's analysis on board and take the demand side of skills policy into account when considering future initiatives to promote a highly skilled economy. This means that to the extent that labour market regulations such as the NMW, Train to Gain and the Union Learning Fund and the European Directive on Information and Consultation help 'nudge' employers toward a high road strategy, they are more important than ever, and may need to be supplemented with further measures such as stronger economic and business support, improved employee relations and personnel management policies and an effort to upgrade work organisation and job design[115]. Certainly the recent Skills White Paper, *Skills for Growth* (BIS 2009a), which commits the Government to taking an 'active approach to equipping this country for globalisation by making sure we have the skills that underwrite the industries of the future' suggests that in the immediate future such a move towards a demand side approach will continue.

[115] For more detailed suggestions along these lines see, for example, Keep (2007).

9. Conclusions

The most important message that emerges from this in-depth review of the evidence on the relationship between labour market flexibility and economic performance is that generally it is *not* the case that labour market deregulation gives rise to better performing economies. The 'orthodox' view that deregulation was a prerequisite for economic efficiency has been in something of a retreat since the heyday of the *OECD Jobs Study* in the mid-1990s (although it remains powerful and influential, particularly on the right of the political spectrum). The evidence presented here shows that this retreat has been for a very good reason – the empirical facts simply don't support the orthodox view.

This is not particularly surprising, given the chasm which exists between the stylised perfectly competitive, perfectly rational, frictionless textbook economy which the proponents of orthodoxy take as a representation of reality, and the way real-life labour markets work. More realistic approaches – whether based around amending the neoclassical economic model to make it fit the real world better, or jettisoning the model and starting again from different foundations – deliver very different guidelines for policymakers about the desirability of particular labour market regulations than those produced by the orthodox model.

And the balance of empirical evidence suggests that, as far as the best research to date can tell, the critics of orthodoxy are right. Empirical approaches based on cross-country aggregate data – be they two-way graphs or more sophisticated regressions on panels of countries – suffer from serious methodological drawbacks which make it almost embarrassing that orthodox economists have relied on them for so long. The results from macro regressions differ widely according to the specifications and time periods used and the labour market outcomes looked at. To the extent that these regressions do produce reliable results, they provide little support for the orthodox view. The strongest evidence from macro research is that co-ordinated wage bargaining systems are associated with lower unemployment – a finding in direct contradiction to the orthodox view.

Evidence from micro-level empirical work is more robust, but equally frustrating for the proponents of orthodoxy. Basic tenets of the orthodox model – for example, that minimum wages cause higher unemployment – fail to be supported by a meta-analysis of the micro evidence. Similarly, there is no evidence that strong trade unions are an economic liability.

Employment protection legislation does seem to reduce job flows in the economy, but there is no consensus from the theoretical or empirical literature on whether this is a good or bad thing. Unemployment insurance systems *can* increase the level of long-run unemployment if badly designed (for example, if paid for an indefinite length of time with no conditionality built in), but if well designed, they provide additional income security to workers at risk of redundancy without having an adverse impact on labour market performance.

For the other types of labour market regulation considered, the news is even better: there is good evidence that they have *positive* impacts on many aspects of economic performance. Paid maternity leave provisions and childcare subsidies play a vital role in allowing many women to stay in skilled, high-quality jobs in the labour market after having children. Without them, the gender pay gap would most likely be much worse than it is now. The right to request flexible working, derided by many orthodox economists as pointless 'soft' regulation, seems to have had a real impact in freeing up many employees' work hours. Active labour market policies, if well designed, can make a substantial difference to the employment prospects of the long-term unemployed and groups who are marginalised from the labour market. And in-work benefits boost labour supply while redistributing income to low-paid workers. All these policies can be viewed as enhancing labour market performance *and* contributing to social justice at the same time.

The evidence base on the positive impacts of many of the UK's current labour market regulations (many of which have only been introduced in the last decade) vindicates Nobel Laureate economist Robert Solow's 1998 statement to the effect that that labour market regulations generally evolve *for a reason*, in response to particular needs which are not met by the unfettered free market. For the most part they are not just obstacles stupidly placed in the path of market forces which would otherwise function perfectly. The recent near-collapse of financial markets, on the back of several decades of liberalisation undertaken in the belief that a less regulated market was always a more efficient market, is a salutary lesson that the world does not work the way that proponents of orthodoxy would like to believe it does. This is a very important point to bear in mind when examining proposals from the opponents of labour market regulation for a 'moratorium' on further regulations, or a roll-back of recent regulatory measures. It is important not to fall into the mindset that the labour market would work perfectly if only left to its own devices. There is no empirical evidence for this view, and a lot of evidence against it.

Furthermore, it is important to consider the interaction between the labour market and other parts of the economy, whereupon the empirical evidence takes us even further away from the orthodox view. For example, public spending projects such as improvements in transport infrastructure can improve economic performance, a point which is often forgotten by right-wing critics who rail against increased 'tax and spend'. And it is strange to hear commentators on the right attacking increased immigration into the UK when migration is one of the areas where a moderately flexible policy *does* seem to have delivered positive dividends for the UK economy.

The current economic crisis provides some evidence – albeit tentative at the present time – that the orthodox treatment of macroeconomic policy may be as flawed as the orthodox treatment of labour market microeconomics. While it is more important than ever for active labour market policies and unemployment insurance to be well-designed under these conditions, there is a case for saying that the European Central Bank and the Bank of England should have a dual target of price stability *and* full employment – like the US Federal Reserve – rather than focusing obsessively on inflation. And chronic deflationary measures – such as we have witnessed in Ireland over the last eighteen months – are likely to do far more damage to the labour market than any kind of labour market regulation within reason.

Finally, the move away from the straightjacket of orthodoxy into a richer and more realistic economic framework for analysing the labour market raises the issue of a *positive* role for labour market regulation – not just correcting injustices and improving labour market functioning at the margins, but potentially shifting the whole economy towards a better equilibrium. Many employers remain trapped in a 'low road' approach to production and cannot realise the full potential of their staff, the innovations embodied in their products, or their markets. For the UK economy to perform strongly in the future, much more of the country's production will have to shift from a 'low road' to a 'high road' model. And labour market regulation is likely to be one of the key mechanisms to help UK business get there.

Appendix 1 – Labour market deregulation and regulation, 1979 to present

Table A.1. Benefits and ALMP

Year	Description	Based on EU directive?
1980	**Unemployment Benefit** Earnings-related supplements abolished	
1986	**Unemployment benefits** 'Restart' interviews introduced for long-term unemployed	
1988	**In-work benefits** Family Credit replaces Family Income Supplement – generosity increased, eligibility conditions simplified	
1990	**Active worksearch requirement** Unemployment Benefit claimants and some categories of Income Support claimant required to 'actively seek work' – in addition to being available for work	
1996	**Unemployment Benefit** Replaced by Jobseekers Allowance – period for which contributions-based benefits payable reduced from one year to size months. Eligibility conditions tightened	
1998	**New Deal for Long Term Unemployed introduced** Similar programme to NDYP but for those aged 25 and over. Renamed **New Deal for 25 Plus** in 2001.	
1998	**New Deal for Young People introduced** Fixed but escalating sanctions for participants who fail to attend regular interviews or take part in one of four mandatory programmes including subsidised employment, full-time education or training, and the environmental task force.	
2001	**Incapacity Benefit claimants** Initial work focused interview introduced for new claimants	
2001	**Jobseekers Allowance Joint Claims** Both members of childless couples must meet the requirements of the benefit to be eligible	
2001	**Lone parent benefits** Initial Work Focused Interview (WFI) introduced for lone parents, for new and repeat clients with youngest child aged at least 5 years and 3 months, and existing customers with a youngest child aged 15 to 15.	
2002	**Lone parent WFIs** Phased introduction of WFIS for all new and repeat benefit claimants and existing claimants with a youngest child aged at least 5.	
2003	**Pathways to Work scheme** Introduced in pilot areas of the UK for new Incapacity Benefit customers. All participants are required to attend an initial WFI, with most then required to attend another 5 interviews.	
2004	**Lone parent WFIs** All lone parents required to attend a WFI.	
2004	**WFIs for partners of benefits claimants** WFIs introduced for partners of customers claiming Income Support and Incapacity Benefit (with and without children) and Jobseekers Allowance (with children).	
2005	**Pathways to Work extended** Introduced for *existing* IB claimants in 10 per cent of the UK (for most claimants receiving IB for up to 6 years)	
2005	**Quarterly WFIs for lone parents with older children** Youngest child aged 14-16	
2006	**Pathways to Work extended** For new IB customers, extended to 40 percent of the UK	
2007	**Jobsearch requirements for JSA claimants aged over 50** Claimants must start a more intensive regime of help and support lasting for up to 13 weeks, 22 months into a claim	
2007	**Lone parent WFIs** Six-monthly WFIs introduced for lone parents with youngest child aged 5 to 13	

2008	**Employment and support allowance** Replaces Incapacity Benefit and Income Support for new disabled and long-term sick non-working benefit claimants	
2008	**IB replaced by Employment and Support Allowance** New claimants required to undergo a Work Capability Assessment. Claimants assigned to the support group (no compulsion to undertake work-related activity) or the work-related activity group (required to attend WFIs and participate in work related activities, including drawing up an action plan.)	
2008	**Lone parent benefits** Phased introduction of jobsearch requirements for lone parents with youngest child aged over 5 (by 2010). Moved from Income Support to Jobseekers Allowance.	
2008	**Lone parent WFIs** Initial WFI for lone parents with youngest child aged 0 to 4 years followed by reviews every 6 months/ This completes the roll-out of monthly Work Focused interviews for lone parents with children aged 13 and below	
2008	**Lone parents with youngest child aged 12+ moved to JSA** with accompanying job-search conditions	
2008	**Pathways to Work extended** National roll-out completed for new IB customers	
2008	**WFIs for partners of benefit claimants** Repeat WFIs introduced every 6 months for partners of parents on JSA.	
2009	Introduction of Flexible New Deal	
2009	Lone parents with youngest child aged 7 moved to JSA	

Table A.2. Employment Protection and Fair Treatment at Work

Year	Description	Based on EU directive?
1980	**Unfair dismissal** Minimum period of continuous work needed to qualify for protection from unfair dismissal raised from six months to one year	
1982	**Repeal of Fair Wages Resolution** The Fair Wages Resolution had provided for the extension of sector-level union-employer wage agreements to non-union firms	
1985	**Unfair dismissal** Minimum qualifying period raised from one year to two years	
1989	**Employment of young workers** Protective legislation repealed	
1989	**Employment tribunal costs** In some circumstances employees made to pay a pre-hearing deposit as a contribution to employer's costs	
1994	**Rights for part-time workers** Strengthened as a result of House of Lords judgement on the interpretation of EU Directive 76/307 on equal treatment in employment for part-time workers	Yes
1995	**Disability Discrimination Act** Outlaws discrmination against people in respect of their disabilities in relation to employment	
2000	**Treatment of part-time workers** Part-time workers can no longer be treated less favourably than comparable full-time workers in terms of pay and conditions	Yes
2002	**Fixed term contracts** Workers on fixed term contracts can no longer be treated less favourably than workers on permanent contracts in terms of pay and conditions.	Yes
2003	**Discrimination at work** Protection from discrimination at work on grounds of sexual orientation	Yes
2003	**Discrimination at work** Protection from discrimination at work on grounds of religion or belief	Yes
2004	**Gangmasters Licensing Act**	

	New legislation requiring agencies (gangmasters) in the agricultural, shellfish and food packing sectors to be licensed.	
2005	**Disability Discrimination Act 2005** Extended the provisions of the 1995 Act.	
2008	**Agency workers' sick pay** Agency workers made eligible for Statutory Sick Pay in line with other workers.	
planned	**Temporary and agency workers** Implementation of the EU Temporary Agency Workers Directive 2008/104/EC to guarantee agency workers equal pay and conditions with other employees. The Directive was passed in 2008 but the Government has said its provisions will not come into force in the UK until 2011 at the earliest.	Yes

Table A.3 Employment Relations

Year	Description	Based on EU directive?
1980	**Unfair dismissal** Minimum period of continuous work needed to qualify for protection from unfair dismissal raised from six months to one year	
1982	**Secondary Industrial Action** The definition of a 'trade dispute' was narrowed, which reduced the range of circumstances in which secondary action could be taken. Industrial action aimed at extending the closed shop and union recognition to third party employers was outlawed	
1982	**Removal of Union Immunity from Prosecution** Prior to this point unions had been immune from liability in torts arising from industrial action.	
1984	**Ballots for industrial action** Made compulsory prior to industrial action	
1984	**Ballots for union administrative matters** Made compulsory, e.g. for the election of certain union officials and for the maintenance of union political funds	
1988	**Abolition of post-entry 'closed shop'** Any requirement to be a union member in order to continue in employment in a workplace was removed.	
1988	**Union discipline of members refusing to obey strike calls** Power of unions to discipline non-striking members limited	
1990	**Abolition of pre-entry 'closed shop'** Any requirement to be a union member in order to be hired for a job was removed	
1990	**Ban on Secondary Industrial Action** i.e. action involving employers who are not immediate parties to the trade dispute	
1990	**Dismissal of strikers** Employers able to dismiss strikers in a wider range of circumstances	
1990	**Union responsibility for unofficial strike action** Legal responsibility of unions for unofficial strike action extended	
1993	**Notice of industrial action** Unions required to give employers seven days' notice of the commencement of industrial action	
1995	**Individual vs. Collective bargaining** Employers allowed to offer incentives for employees to accept individualised terms and conditions of employment outside the scope of collective agreements without falling foul of the statutory obligation not to discriminate between union members and non-members	
1999	**Unfair dismissal** Qualifying period for making a claim reduced from two years to one	
2000	**Disciplinary hearings** A worker attending a grievance or disciplinary hearing has the right to be accompanied by a colleague or trade union official.	
2000	**Industrial action ballots**	

	Removal of requirement to name union members in notice of industrial action	
2000	**Statutory trade union recognition** Procedures for trade unions to obtain recognition in organisations with more than 20 employees	
2000	**Unfair dismissal** Protection against unfair dismissal for employees taking part in lawfully organised industrial action	
2004	**Employment dispute resolution** Statutory dispute resolution procedures and revised employment tribunal regulations.	
2004	**Union membership rules** Legislation governing the ability of unions to exclude an expel individuals on grounds of their political party membership	
planned	**Employer blacklisting of trade unions** The Government has consulted on plans to introduce legislation which would make it illegal for employers or other organisations to compile 'blacklists' of trade unionists and to refuse to hire workers based on such blacklists.	

Table A.4 Working Time Regulations

Year	Description	Based on EU directive?
1998	**Working Time Regulations** Provide workers with the right not to work more than 48 hours per week, and minimum of 4 weeks' paid annual leave, daily weekly and in work rest periods and special protections for nightworkers and adolescent workers. Individual workers can arrange to work more than 48 hours by agreement with their employers.	Yes
2003	**Extension of working time regulations** To previously excluded sectors and activities (road, rail, air, sea, offshore work and junior doctors	Yes

Table A.5 Leave Regulations

Year	Description	Based on EU directive?
1998	**Paid annual holiday** Minimum of 4 weeks' annual holiday entitlement introduced	Yes
1999	**Maternity leave** Qualifying period reduced	Yes
1999	**Parental leave** An employee who has worked continuously for an employer for a year gained the right to take 13 weeks' unpaid parental leave for each child born or adopted after 15 December 1999.	Yes
1999	**Time off for emergencies** All employees gain the right to a reasonable amount of time off in order to deal with emergencies involving a dependent.	Yes
2002	**Parental leave** Extension to parents of all children under age of 5 and those placed for adoption between 1994 and 1999	Yes
2003	**Adoption Leave** Adoptive parents entitled to two weeks' paid adoption leave at the SMP rate	Yes
2003	**Maternity leave** Paid maternity leave increased to 26 weeks and unpaid maternity leave increased to 26 weeks, allowing a new mother to have up to a year off in total	Yes
2003	**Maternity Pay**	Yes

	Statutory Maternity Pay (SMP) increased to £100 per week.	
2003	**Paternity Leave** Fathers entitled to two weeks' paternity pay at the standard rate of SMP	Yes
2007	**Maternity and Adoption Pay** Extended to nine months from April 2007	
2008	**Maternity Leave** Legislated to remove the exception which allowed an employer to discriminate against women on additional maternity leave	
2009	**Holiday pay** Extension of holiday entitlement to 28 days including bank holidays	Yes
planned	**Additional Paternity Leave** The government intends to extend paternity leave at some point in the future so that parents can transfer some of the mother's maternity leave to the father. However no date for introduction of this scheme has yet been set	
planned	**Maternity Pay** Planned extension to 12 months – no date set as yet	

Table A.6 Flexible Working

Year	Description	Based on EU directive?
2003	**Introduction of right to request flexible working** Available to parents of children under the age of 6 or parents of disabled children under the age of 18	
2008	**Extension of right to request flexible working** Extended to parents of children aged 16 or under	
2007	**Extension of right to request flexible working** Extended to carers of sick and disabled adults	

Table A.7 Consultation

Year	Description	Based on EU directive?
2000	**European Works Council Directive** Implementing regulations come into force.	Yes
2005	**Information and Consultation Directive** Introduces statutory duty for employers to consult with and inform workforce representatives in public and private sector organisations with 150 or more employees.	Yes
2008	**Information and Consultation Directive** Extended to organisations with 50 or more employees	Yes
planned	**Extensions to European Works Council Directive** Agency workers will count towards the threshold above which bodies repreeanting workers are to be formed in the temporary work agency that has placed them.	Yes

Table A.7 Wage Regulations

Year	Description	Based on EU directive?
1983	**Equal pay** Strengthening of principle of 'equal pay for work of equal value'	Yes
1986	**Wage councils** Restrictions on scope and power of Wages Councils (which set minimum wages for a range of low-paid workers)	

1993	**Wages Councils** Abolished	
1999	**National Minimum Wage** Introduced at £3.60 per hour for employees aged 22 and over, £3.00 per hour for employees aged 18-21. Increased several times over 2000-09 – currently set at £5.80 per hour for workers aged 22 and over, £4.83 per hour for workers aged 18-21 and £3.57 per hour for workers aged 16-17	
2004	**National Minimum Wage** New rate for 16-17 year olds and 'fair piece' rates	

Sources: Deakin and Morris (2005), Dickens and Hall (2005), Jones (2003), Griggs and Bennett (2009), BIS website.

Appendix 2. Main EU Directives on Labour Market Regulation

Directive Name	Year	Relevant UK Legislation
Protection of employees in the event of their employer's insolvency	1983	Employment Rights Act 1996; Pensions Scheme Act 1993
Employer's obligation to inform employees of conditions applicable to the contract or employment relationship	1993	Employment Rights Act 1996
Collective redundancies	1994	Trade Union and Labour Relations (Consolidation) Act 1992
Organisation of working time	1996, 2003	Working Time Regulations 1998, Working Time (Amendment) Regulations 2003
Protection of young people at work	1996, 2000	Working Time Regulations 1997, Working Time (Amendment) Regulations 2002
Extending to the UK the Directive on establishment of a European Works Council or procedure for informing and consulting employees	1999	Transnational Information and Consultation of Employees Regulations 1999
Extending to the UK the Directive on parental leave	1999	Maternity and Parental Leave Regulations 1999
Part-time work	2000	Part-time Workers (Prevention of Less Favourable Treatment) Regulations 2000
Fixed term work	2001	Fixed Term Employees (Prevention of Less Favourable Treatment) Regulations 2002
European Company Statute: Employee Involvement	2004	The European Public Limited-Liability Company Regulations 2004
Equal treatment in employment and occupations	2000, 2003, 2006	The Employment Equality (Sexual Orientation) Regulations 2003; The Employment Equality (Religion or Belief) Regulations 2003; The Employment Equality (Age) Regulations 2006
National information and consultation of employees	2005	The Information and Consultation of Employees Regulations 2004

Source: BIS, “EU Employment Directives”, http://www.berr.gov.uk/whatwedo/employment/employment-legislation/employment-directives/index.html

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