

THE MODERNISATION OF BRITAIN'S TAX AND BENEFIT SYSTEM

**Number One. Employment Opportunity in a
Changing Labour Market**

FOREWORD BY THE CHANCELLOR OF THE EXCHEQUER AND SECRETARY OF STATE FOR EDUCATION AND EMPLOYMENT

When we began our work in Government 7 months ago, we reaffirmed that the aim of Government - as first set out in the 1944 Employment White Paper - was high and stable levels of growth and employment. But we recognised that the world had changed dramatically and the old methods would not, on their own, address one of the central problems our country faced - that one in five households of working age had no-one in work.

The old approach to full employment relied heavily on the levers of macroeconomic management. But that was because active welfare to work policies were less important when a high proportion of the unemployed were only out of work for a short time. Skills mattered less when unskilled workers had access to good job opportunities. The interaction of tax and benefits for the low paid was less relevant when most jobs paid a wage which took people well above the levels of benefits. Flexible working practices were less important when fewer people needed to balance work and family responsibilities. And the focus on the claimant unemployed was valid when those outside the labour market were there from personal choice, rather than lack of opportunity. But now the old policy agenda has become out of date.

Since entering Government, we have begun to put in place the measures necessary to tackle the problem of worklessness in today's labour market. Our New Deal for the young unemployed, which, includes training, begins in January and goes nationwide from the spring. We are establishing programmes to help those who have faced permanent exclusion from the labour market - the long term unemployed, lone parents and the sick and disabled. The Government has invested extra resources in education - £2.3 billion - in the first Budget. And we have asked Martin Taylor, the Chief Executive of Barclays Bank, to look at options for reform of the tax and benefit system, to promote work incentives, reduce poverty and welfare dependency, and strengthen family and community life. We are also facing up to the problem of social exclusion that we must address together as a nation, by offering employment opportunity.

This paper is the first of what we plan will be a series of documents marking the staging posts on the road to reform. It sets out the Government's analysis of the problems we face, the challenges of economic and social change, and the framework for Government policy.

Over the next few months, the Government will be looking particularly at the options for tax and benefit reform to ensure work pays. We want to encourage an open debate about the options we face.

We are facing a future in which skills, employability and adaptability are more important than ever. There is a lot more work to do. But we cannot continue to rely on a system set up to solve yesterday's problems. We must ensure that today's tax, benefit and employment policy reflects today's labour market.

GORDON BROWN

DAVID BLUNKETT

Employment Opportunity in a Changing Labour Market

- 1 Introduction and summary
- 2 The state of the labour market
- 3 Changes and challenges
- 4 A new approach to tax, benefit and employment policy
- 5 Implementing the strategy

CHAPTER 1. INTRODUCTION AND SUMMARY

1.01 This paper sets out the labour market background to reform of the tax and benefit system. The labour market is not like any other market. It is the most important link between the global economy and the real experiences of individuals and families. Changes in the global environment, international trade, new technology and the economic cycle matter to individuals mainly through the effects they have on jobs and wages.

1.02 Because of this clear link between the performance of the labour market and the well-being of individuals, governments have a responsibility to ensure that individuals are able to participate effectively in the new labour market; to get jobs and to share in rising living standards. As part of this responsibility, governments need to know where labour markets work and where they fail. Only then can they secure the successes, and address the failures.

1.03 This paper:

- shows the changing experience of individuals and families in the labour market as we enter the 21st century - in particular it looks at those excluded from work, or in low paid jobs, or subject to a cycle of both low pay and unemployment;
- identifies how changes in the broader economy and society have affected the labour market - from trends in technology and trade; from changes in society; and from the organisation of work;
- reaffirms the commitment to high and stable levels of employment - making the case for a new approach to tax, benefit and employment policy that reflects the realities of the new labour market, and the problems it faces;
- looks critically at where we stand on the key criteria for a successful labour market - macroeconomic stability, flexibility, employability and skills, and at whether work pays;
- sets out the policy initiatives that will support this agenda; including reform of the tax and benefit system.

Summary

1.04 In the UK the employment rate is high by international standards. Claimant unemployment has now fallen by almost 1½ million from its peak in 1992, and on the International Labour Organisation definition by nearly 1 million. But there remains an unacceptably high level of structural unemployment in the UK. After 5 years of economic recovery, unemployment stands at 7.1 per cent on the ILO definition - around 2 million people (almost twice as high as its level 20 years ago, at a similar stage of the economic cycle). We are now at a critical stage in the economic cycle; where wage inflation and skill shortages have in the past prevented unemployment from falling further.

1.05 The headline picture on unemployment also hides a more complex, dynamic picture. For many unemployment spells are short. But a significant proportion of the labour force are at risk of repeated or prolonged periods of unemployment, amounting to a significant detachment from work. We also need to broaden the picture to include many other groups excluded from the labour force altogether - neither employed nor unemployed. Lone parents, the long-term sick and disabled, and the spouses of the unemployed have particularly low employment rates. Worklessness is increasingly concentrated in non-working families - about 3½ million households with at least one adult members of working age have no one in work - or 18½ per

cent, compared to 9 per cent in 1979.

1.06 Earnings for those in work have been rising, with the gap between the high and low paid having gone up sharply in the last two decades. Evidence on the dynamics of the labour market shows a clear link between unemployment and low pay. This low pay - no pay cycle means that, for many groups, income mobility is low. Relative poverty - defined as the proportion of the population living below half average income - is increasingly a problem for people below pension age, mainly through lack of work, but also through low pay. Many of those who suffer most are families with children.

1.07 The labour market faces new challenges. There are also important long term trends in the demand for skills and manual labour - driven by changes in technology and trade - which have led to a deterioration in the demand for unskilled labour throughout the developed world. In the UK, the job prospects of those without skills have declined dramatically. Alongside these economic changes, there have been important social and demographic trends - including the growth in female employment and changes in household composition - and changes in the nature of working practices.

1.08 As a relatively open and dynamic economy, the UK ought to be well placed to take advantage of the challenges posed by structural change. An important pre-condition is to avoid the boom and bust economic cycle, which has done immense damage to the UK's labour market over the last 20 years. We do have relatively flexible factor and product markets, compared to many of our European partners. But more can be done to open up product markets to further competition; to improve the record on flexibility and adaptability of labour markets; to set minimum standards at work, and to ensure the rewards from work are broadly based. We need to improve skills and employability, and address many of the features of the tax and benefit system that are failing to reward work and allow people to climb the earnings ladder.

1.09 The Government reaffirms the commitment to high and stable levels of employment. The analysis in this paper shows clearly that employment opportunity for all - the modern definition of full employment for the 21st century - cannot be achieved solely through macroeconomic demand management. While a stable and growing economy is an important precondition, we also need to ensure individuals have the skills required for a modern labour market, that we move people from welfare to work, and ensure work pays. A key element of this forward agenda will need to be a reform of the tax and benefit system.

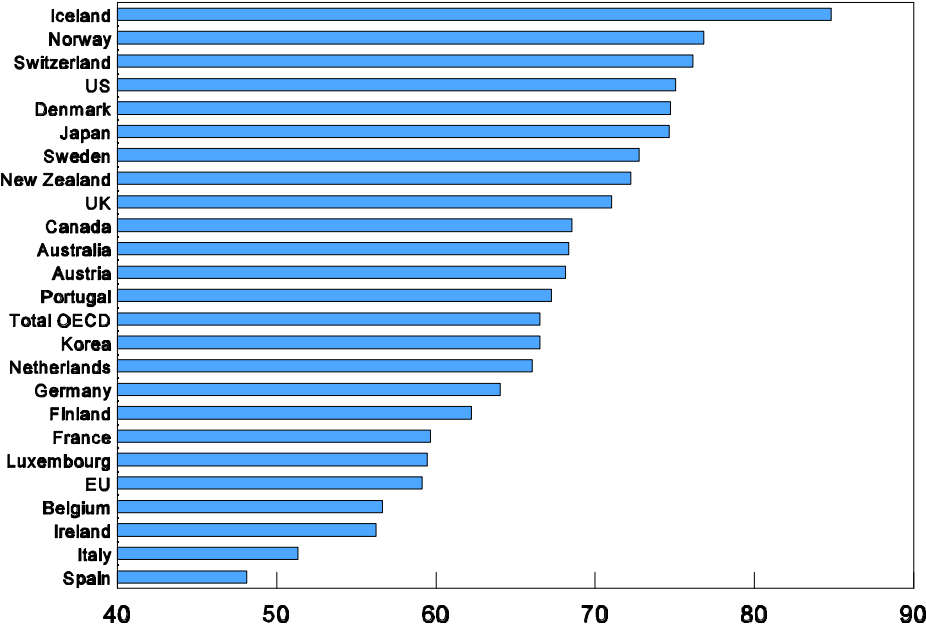
CHAPTER 2. THE STATE OF THE LABOUR MARKET

This chapter looks in detail at the experience of individuals and families in the UK labour market. It looks behind the monthly unemployment statistics, to show how long-term and repeated spells of unemployment affect people over time. It examines in detail the experience of those outside the labour market altogether - neither employed nor unemployed. It considers the way in which the experience of individuals relates to other members of their household and family. And it looks at recent evidence on the dynamics of unemployment, low pay and persistent inequality.

Employment

2.01 In the UK today over 26 million people - over 70 per cent of the working age population - are in work. This is a relatively high rate of employment compared with many other European countries, although below the levels of Japan and the US. The UK is also notable for providing a wide range of opportunities to fit work around personal and family circumstances, and has been relatively successful at supporting the increased labour supply of women. The employment rate in the UK is also very variable over the economic cycle - reflecting the swings in output there have been over the last 20 years, and the relatively low costs of hiring and firing workers.

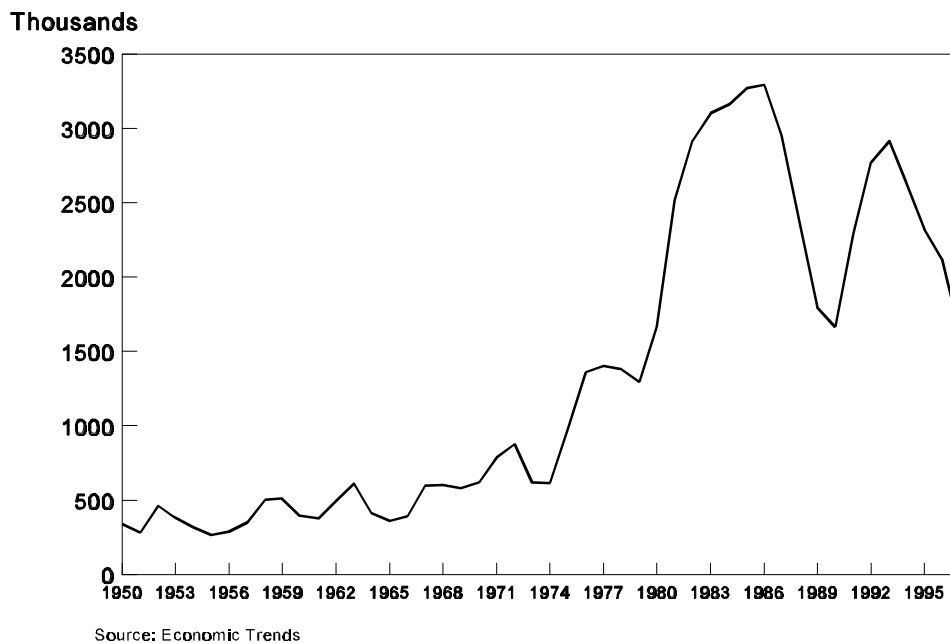
Chart 2.1: Employment / Population ratio ¹



¹ Total employment divided by the working age population
Source OECD

Unemployment

Chart 2.2: Claimant unemployed 1950-1997



2.02 High unemployment is the most obvious sign of a failure in the labour market. Chart 2.2 shows how registered unemployment has varied since the 1950s. Unemployment in the UK fluctuated between 1 per cent and 3 per cent of the workforce from the 1950s until the middle of the 1970s, before rising to around 4½ per cent by the end of that decade. But since 1980, it has averaged around 8½ per cent. And even today, when the UK is in its fifth year of economic recovery, unemployment stands at over 5 per cent on the claimant count definition, and 7.1 per cent on the International Labour Organisation definition - around 2 million people (almost twice as high as the level 20 years ago, when the economy was at a similar stage in the economic cycle).

The prospects for unemployment

2.03 Recent reductions in unemployment have been encouraging, particularly since wage inflation has been relatively restrained. But a particular concern is whether unemployment is now close to what the economy can sustain in its present state without igniting inflationary pressures.

2.04 It is useful to think of unemployment as consisting of two parts - a cyclical part, which varies directly with short-term fluctuations in aggregate demand, and a non-cyclical part which reflects the structural characteristics of the labour market. Non-cyclical unemployment is referred to variously as the NAIRU (Non-Accelerating Inflation Rate of Unemployment) or, less technically, as underlying or structural unemployment. The distinction is often made between the short-run NAIRU, which the economy cannot exceed in the short term without generating wage inflation, and a long-run NAIRU, which the economy can only reach after a period of stability. Reducing unemployment below the NAIRU will tend to lead to an increase in inflation - a temporary trade-off of lower unemployment for higher inflation. Sustainable reductions in unemployment require a reduction in the NAIRU itself - which in turn requires the labour market

to work more effectively.

2.05 The NAIRU cannot be directly observed and is very difficult to estimate. It must therefore be inferred from observed inflation and unemployment data, and other labour market indicators. There is broad agreement that the NAIRU rose in the UK during the 1970s and 1980s, and this increase has been partly reversed since the late-1980s. But there is less agreement about the current level of the NAIRU, with a wide range of estimates. One worrying sign is the increasing evidence of skill shortages in certain industries and occupations, although it is not yet clear whether these will feed through into a general upward pressure on wages.

Long-term unemployment

2.06 The figures for the levels of unemployment hide a more complex picture of the flows into and out of unemployment. There are, on average, about 3½ million separate new spells of unemployment every year:

- about half of those entering unemployment leave within the first three months - of whom about 80 per cent leave for jobs;
- about two-thirds leave within six months - of whom two-thirds leave for jobs;
- about a quarter are still unemployed after 1 year;
- those still unemployed after 2 years have only a 50 per cent chance of leaving unemployment for a job in the following year;
- of those that leave unemployment, about a quarter are back on the register within 3 months, and a half within a year¹.

2.07 The increase in unemployment over the last 25 years is largely explained by increases in the duration of unemployment, rather than the numbers who become unemployed (although there is also a lasting effect from the large numbers who have become unemployed during the last two recessions). The long-term unemployed are disproportionately older, disproportionately men, and far more likely to be low skilled. Psychological and sociological studies have found a clear connection between unemployment and deteriorating psychological health and motivation. There is also evidence that lack of a recent work history is used by many employers as a way of sifting out applicants. For all these reasons, the long-term unemployed find it much harder to find work, those who do leave unemployment are much more likely than the short-term unemployed to move onto other benefits, and those who do find work typically have to accept wages far lower than in their previous job.

Unemployment and age

2.08 Unemployment is particularly high for the young. High youth unemployment is the result of high relative inflows into, rather than long durations of, unemployment. But, where people do experience long spells of unemployment at an early age, the result can be demoralisation and alienation. There is evidence that early unemployment leaves scars which can damage later

¹ These statistics are based on figures published in: Sweeny, K. (1996) *Destinations of leavers from claimant unemployment*, Labour Market Trends, October.

labour market performance². Youth unemployment has also been linked to crime³.

2.09 Although the chance of becoming unemployed tends to decline with age, when older workers do become unemployed they can be particularly vulnerable to long periods of unemployment. The over 50s spend, on average, twice as long in unemployment as those under 25. About 80 per cent of those under 25 who experience unemployment leave to get a job - and most of the rest move into training. But for the over 50s, of those who leave the register, only 60 per cent move into jobs - with a fifth moving onto other benefits.

The dynamics of unemployment

2.10 These figures on overall flows do not show how the experience of unemployment affects individuals over time. Longitudinal data, which tracks panels of individuals over time, suggests that around 10.6 million people experienced a spell of claimant unemployment in the period 1991-95⁴. In this period claimants made an average of 1.9 claims each, with each individual spell lasting on average 7.6 months, and a total average time spent in unemployment of 14 months. This adds up to almost 12 million person-years of claimant unemployment in the five year period. Unemployment in the 1990s recession was much more evenly spread, both geographically and industrially, than in the 1980s recession, and there is no strong evidence that the numbers of people experiencing a spell of unemployment has risen significantly over the last decade.

2.11 Is the threat of unemployment a real one for the majority of workers, or is it concentrated among a relatively small number of individuals who cycle in and out of work? The 10.6 million people who claimed unemployment benefits between 1991 and 1995 - about a third of the labour force - were made up of:

- 4 million people who spent more than 1 year unemployed in the five year period, of whom 2 million spent more than 2 years;
- 2 1/4 million who experienced more than 1 spell of unemployment, but less than 1 year of unemployment in total;
- 4 1/4 million who experienced a single spell of unemployment lasting less than 1 year, of whom 3 1/2 million spent less than 6 months in unemployment.

The 4 million who spent over a fifth of the period on unemployment benefits represent about 1 in 7 of the labour force. These figures do, though, relate to a period when unemployment was high. Looking forward, if unemployment continues to fall, then the situation is likely to improve.

2.12 About a quarter of the 10.6 million claimants had three or more separate spells of unemployment. Analysis by occupation suggested that repeated spells may be related to specific occupations and amongst seasonal workers - with those in skilled construction trades, agriculture, forestry and fishing, and supply teaching relatively likely to make a high number of claims of a relatively short duration. But for many it is a sign of genuine labour market disadvantage.

² Beaudry, P and Dindaro, J (1991) *The effect of implicit contracts on the movement of wages over the business cycle: evidence from micro data*, Journal of Political Economy.

³ Freeman, R (1996) *Why do so many young American men commit crimes and what do we do about it?* Journal of Economic Perspectives.

⁴ Teasdale, P (Department of Trade and Industry), forthcoming in Labour Market Trends

Other non-employed groups

2.13 The debate about unemployment also needs to recognise that the unemployed are not the only group of people without work. A higher proportion of the working-age population are now “economically inactive” (i.e. neither employed nor unemployed) than when the economic recovery began. It should certainly not be the Government’s objective to have all those of working age in work. Many of those outside the labour market are there voluntarily, because of their family responsibilities, because they have retired early, or are in full-time education and training. But many would work if they had the opportunity and incentive to do so (about 2½ million of the economically inactive want a job)⁵. Among benefit recipients, the key groups are:

- over 1 million lone parents on income support;
- ½ million spouses of the unemployed;
- over 1½ million people on long-term incapacity benefit.

There have also been important trends over time in the participation rates of older, unskilled men - many of whom have been displaced from declining industries - and have failed to get the new jobs that replaced them.

Lone Parents

2.14 Over one-fifth of all families with dependent children in the UK are headed by a lone parent. And, despite the widespread availability of part-time work in this country, and the provision of Family Credit - factors which ought to help labour market participation by lone parents - the UK has one of the lowest employment rates for lone parents in the developed world. In the UK just over 40 per cent of lone parents work; compared with 82 per cent in France and 60 per cent in the USA. This is down from 48 per cent in 1978; while in the same period the employment rate of married or cohabiting mothers has risen from 53 per cent to 65 per cent.

2.15 There are a number of explanations. The fastest growth in lone parenthood has been from among those who have never married, and those with few sources of financial support other than means-tested benefits. There are also important links to the labour market prospects of the absent parent - where the poor job prospects of one parent impact on those of the other. Child maintenance payments help, when they are regular and substantial, to relieve poverty and to support the move into work. However, evidence from the Child Support Agency tentatively suggests that, among lone parents on Income Support, less than half of the absent parents are in work. Where the lone parent is in work and on Family Credit, nearer two-thirds of absent parents are employed.

Spouses of the unemployed

2.16 Another group of the non-employed, who are not counted in the monthly claimant count of unemployment, are the ½ million non-working spouses of the unemployed. Spouses of people in work are about 50 per cent more likely to be in work than the spouses of the unemployed. One of the reasons for this is that people with poor labour market prospects tend to partner with other people with poor prospects, and many couples actually meet at their place of work. But the partners of the unemployed are also not helped or encouraged by the benefit system. They do not have access to employment programmes provided for the claimant unemployed, and face no obligation to look for work as a condition for receipt of social security.

⁵Laux, R (1997) *Measuring labour market attachment using the Labour Force Survey*, Labour Market Trends, October.

Long-term sickness and disability

2.17 The numbers of people of working age out of work because of sickness and disability has increased by 1½ million over 20 years, and public spending on disability related benefits is now over two thirds the amount spent on the National Health Service. Spells on Incapacity Benefit are typically much longer than spells of unemployment. The long-term sick and disabled face problems of reduced motivation, employer discrimination, outdated skills, and poor availability of suitable employment. 70 per cent are ex-manual workers, concentrated in areas with declining industries.

Older workers

2.18 The growth in the numbers on long-term sickness and disability benefits is an element of the sharp fall in the labour market participation of older men. The proportion of men aged 55-64 who are outside the labour market has risen from 14 per cent in 1977 to 37 per cent today. If there were the same proportion of working-age men in employment now as 20 years ago, overall employment would be nearly a million higher. Much of this non-participation by older men will be voluntary, and a response to the availability of early retirement packages. But if it were entirely voluntary, we might expect those with higher skills and pay to be most likely to leave the labour market. But in fact the trend has been concentrated on those with lowest skills; often after displacement from a declining industry. Only 54 per cent of men over 50 with no qualifications are in work.

Workless households

2.19 These trends in individuals' unemployment and labour market participation have important implications when viewed across households. Lack of employment is increasingly concentrated in particular households. The Labour Force Survey⁶ suggests that, of households with adult members of working age, 3½ million (18½ per cent) are without work. Working-age, workless households contain about 5 million adults and 2.7 million children. The strengthening recovery has at last started to bring the number down from its peak in Spring 1996, when 1 in 5 working age households had no one in work. But, despite the fact that the UK has a relatively high overall employment rate, the number of workless households are higher than in most other developed countries - shown in chart 2.4.

2.20 A longer view of workless households has been undertaken by the DSS on the Households Below Average Income (HBAI) database derived from the Family Expenditure Survey. Using this data source, the proportion of working-age households with no member in work rose from 9 per cent to 21 per cent between 1979 and 1995-96. The growth has been caused by both economic and social factors; and the interaction between them. The shift to smaller households, described in chapter 3, accounts for a quarter of the rise between 1979 and 1996, and a half of the rise since 1988. However, a large part of the explanation for the growth in workless households is the polarisation of work between households and, in particular, the fact that the increase in female employment has occurred disproportionately in households which already contained working members⁷.

⁶ More detail on the composition of working-age households is set out in Hastings, D (1997) *Economic activity of working-age households*, Labour Market Trends, September

⁷ Gregg, P and Wadsworth, J (1995) *A short history of labour turnover, job tenure and job security, 1975-1993*, Oxford Review of Economic Policy

Chart 2.3: Unemployment and numbers of workless households 1979-97

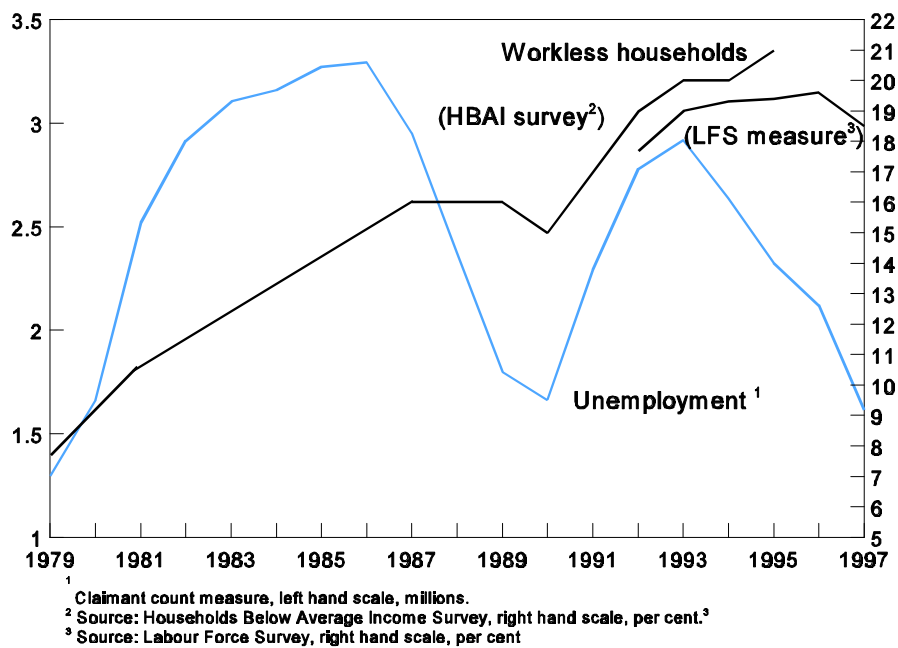
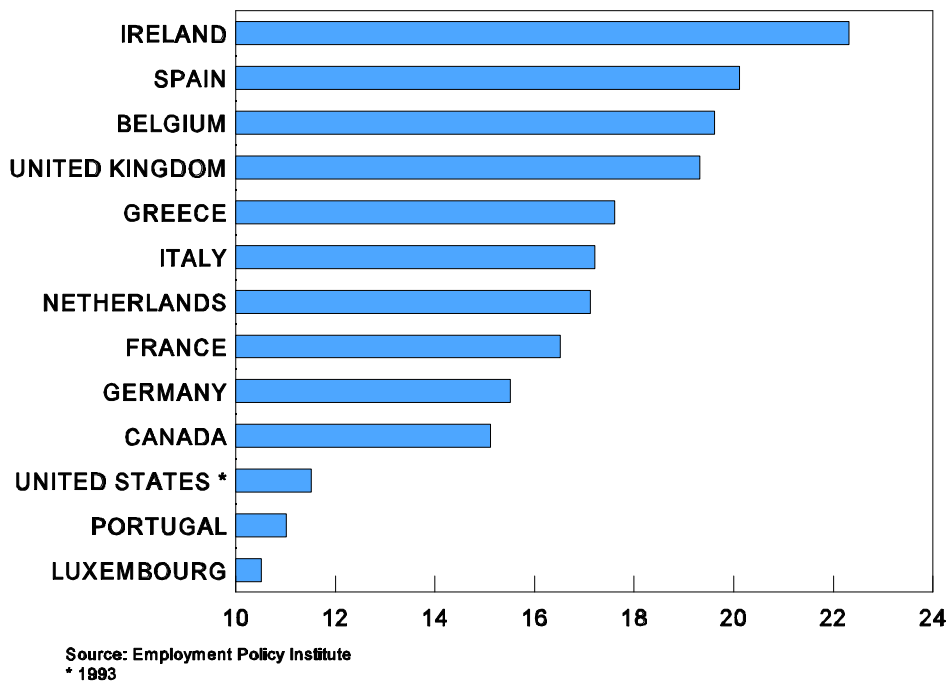


Chart 2.4: Workless Households rate



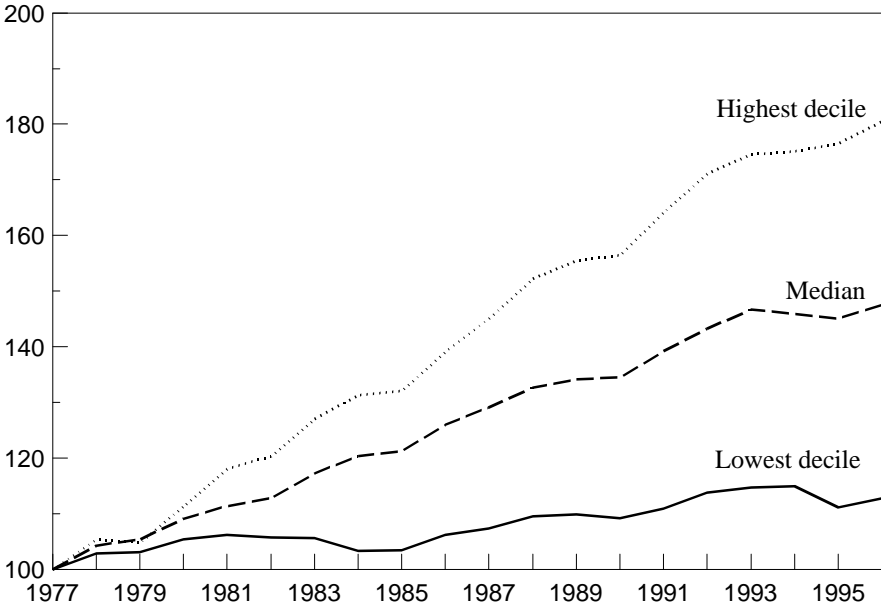
2.21 In some cases, for example where workless households result from voluntary early retirement or full-time education, there may be no direct link between worklessness and labour market disadvantage. But, in most cases, worklessness goes hand-in-hand with low income. Over 80 per cent of workless households are dependent on benefits, and this rises to over 90 per cent for couples with children. The HBAI survey finds that three quarters of those in working age, workless households are in the bottom 30 per cent of the household income distribution,

after housing costs. The rising number of working-age workless households has made a significant impact on the bottom end of the income distribution, and led directly to greater income inequality. And, since the majority of workless households contain people not on the claimant count, a strategy to reduce worklessness cannot rely solely on action to reduce the numbers conventionally defined as unemployed.

Inequality and Poverty

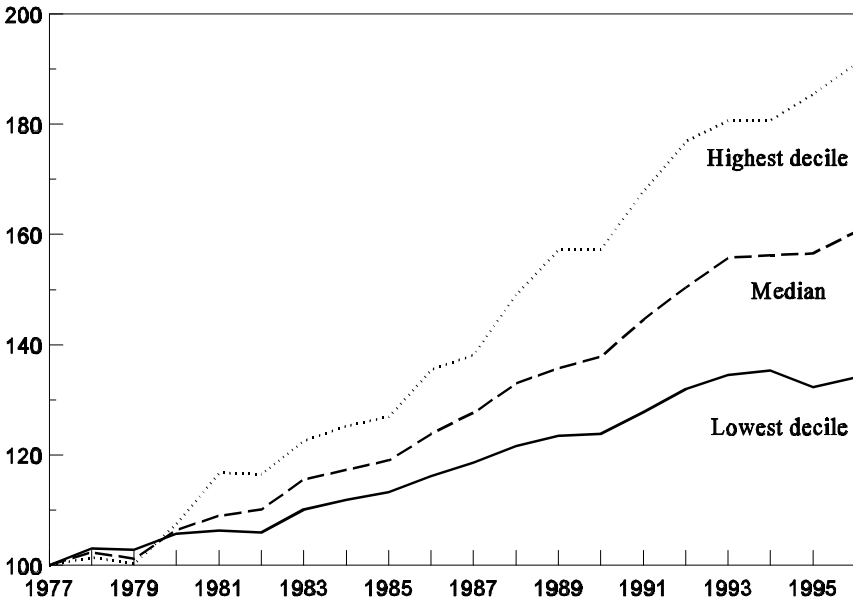
2.22 The rise in wage inequality since the late 1970s in the UK has been among the fastest of all developed countries. As charts 2.5 and 2,6 shows, wages have risen for all points in the earnings distribution. However, wages for the lowest paid - particularly low paid men - have seen only a small increase in real terms.

Chart 2.5: Dispersion of male wages 1977=100



Source: New Earnings Survey 1977-97

Chart 2.6: Dispersion of female wages Index 1977=100



Source: New Earnings Survey 1977-97

2.23 The experience of inequality *in work*, and the growth of working-age households *out of work* has had important implications for the composition of the poorest families. Due to economic growth, average real incomes almost always rise over a sustained period. However, more people had a living standard below half the average 1979 household incomes in 1994-95 than they did in 1979. That is, more people lived in absolute poverty (if defined as being below half average 1979 income, after housing costs) at the end of that fifteen-year period than did at the beginning. Greater worklessness played a key part in that increase. Many more of those in absolute poverty (under that definition) at the end of the period were workless.

Numbers with real income, after housing costs, below half the average 1979 income				
	1979		1994-95	
	millions	%	millions	%
Workless households	1.7	34	2.8	53
Self-employed	0.6	13	1.1	21
Work-rich (ie fully-employed employee households)	0.3	6	0.3	5
Partially-employed employee households	1.0	21	0.8	16
Pensioner households	1.3	27	0.3	5
Total	5.0		5.2	

2.24 Many of the poorest families in Britain are pensioners, but the number of pensioners with incomes below half the contemporary national average has been falling; and relative poverty is now more likely to be experienced by people of working age. Fewer pensioners are in absolute poverty - on almost any definition - than previously. But this does not necessarily mean that many individual pensioners have seen a large increase in their income in real terms since retirement. What has happened instead, to a large extent, is that the population of pensioners has changed. Newer pensioners tend to be better off than their older counterparts, and that accounts for much of the apparent improvement in the position of pensioners in the income distribution.

Earnings Mobility

2.25 Wage inequality is of less concern if individuals face only short periods on low pay, and a good chance of mobility into higher paid jobs, than if there are permanent differences between the life chances of individuals. Data sources that follow people over time are still in their infancy, but early results show a disturbing picture of individuals moving between low pay and unemployment, and significant numbers trapped in low pay over many years - perhaps over their entire working life.

2.26 There is some evidence that wage mobility has been low in the 1990s - people on low wages have tended to stay on low wages. 48 per cent of men in the bottom tenth remained there one year later, and of the remainder only 20 per cent moved up the distribution. (The rest have dropped out the earnings distribution altogether). Even after three years, 26 per cent remain in the bottom tenth. The lower down the wage distribution individuals are, the more likely they are to leave employment. A comparison of the mobility levels of the 1990s with those of the mid 1970s and mid 1980s indicates that both short and longer run wage mobility has fallen considerably, and that the opportunity to move up the distribution of wages is lower now than a

couple of decades ago⁸. These results come from a recently available data set - the New Earnings Survey Panel - which tracks individuals' earnings over time. The British Household Panel Survey (BHPS) between 1991 and 1994 also finds considerable persistence in low pay⁹ - albeit for a short period during a recession. It shows that those who are low paid are also more likely to move out of employment altogether, and those who were low paid before a spell of non-employment are even more likely to return to low pay when they move back into work. Single pensioners, lone parents and the long term sick and disabled are the most likely to remain in poverty.

2.27 An analysis by the Institute for Fiscal Studies (IFS)¹⁰ confirms a picture of significant numbers facing persistent low pay. By tracking a panel of men aged 18-60 and not in full time education between 1991 and 1994, the authors found that 30 per cent of those experiencing some unemployment started in the bottom fifth of the wage distribution, while 56 per cent of those leaving unemployment moved into jobs with wages in the bottom fifth of the distribution. They also found evidence that, of those men who moved out of work then back in again, over 40 per cent experienced a reduction in wages of over 10 per cent over the 3 year period. Of the men who were in the bottom quarter of the earnings distribution in 1991, half were still there in 1994, 13 per cent were out of work all together, while only 6 per cent had ascended to the top half of the earnings distribution. Among women there was slightly more mobility into the top half of the earning distribution, and much more movement out of work. The IFS also found that some groups of workers face an unusually high probability of being in low pay over their entire working lives, particularly the least qualified.

A Low Pay - No Pay Cycle

2.28 Bringing together the evidence on earnings mobility, and the evidence on moves in and out of work, provides a clearer picture of the link between earnings and unemployment¹¹. Those who suffer a spell of unemployment tend to move into lower waged jobs - and their wages generally do not recover unless or until they then have several years of continuous re-employment. And the duration of unemployment causes a further, permanent effect on earnings which is proportional to the length of the spell. This means that repeated spells of unemployment have a particularly bad effect on earnings - not only do repeated spells accumulate to a long period of total unemployment, but frequent spells also interrupt the recovery process from the previous spell. Age also has a significant influence on the relationship between earnings and unemployment. Among young workers, experience of short spells of unemployment often reflects a process of matching jobs to workers, and in many cases will not have significant effects on future earnings. But significant effects do develop from long durations of unemployment. Workers over 35, and even more over 45, are significant losers from unemployment. There is also a significant effect depending on the previous position in the earnings distribution - those who are relatively well paid in their previous job suffer a disproportionately high and long lasting earnings penalty from unemployment. In short, unemployment means a step down in earnings - and long term unemployment means an even greater step into persistent low pay.

2.29 This picture is confirmed by evidence on "entry jobs"¹². People who lose their jobs tend to

⁸ Dickens, R (1997) *Caught in a trap? Wage mobility in Great Britain: 1975-94*, Centre for Economic Performance.

⁹ Stewart, M and Swaffield, J (1997) *The dynamics of low pay in Britain. Jobs, wages and poverty*, Centre for Economic Performance.

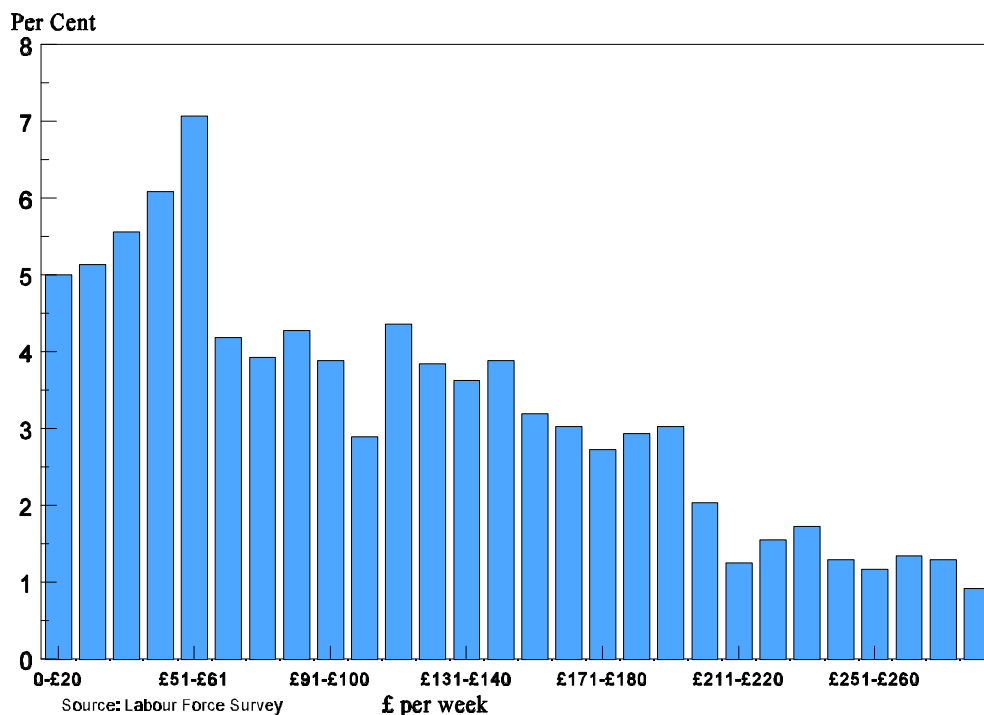
¹⁰ Gosling, A, Johnson, P, McCrae, J, Paull, G (1997) *The dynamics of low pay and unemployment in early 1990s Britain*, Institute for Fiscal Studies.

¹¹ Gregory, M and Jukes, R (1997) *The effects of unemployment on subsequent earnings: a study of British men, 1984-94*. Centre for Economic Performance.

¹² The data is drawn from the LFS panel for 1996 (all four quarters). An entry is defined as where a person (aged 18-59/64 and not a student) has reported being out of work in any of the past 4 quarters in the panel and in work in the final quarter - the only one with wage

return to work with low wages. The Labour Force Survey¹³ suggests that one in five people of working age - about 6½ million people - ended or started a job, and one in ten did both, in the course of 1996. Job-to-job moves often result in moves to higher quality jobs, from temporary to permanent work, and with the majority staying within the same industry. But when jobs are lost, and followed by a spell out of work, the entry jobs often represent occupational downgrading, and a switch from permanent to temporary status. The Labour Force Survey suggests that, of those employees who had been unemployed a year earlier, only 22 per cent of jobs taken by those out of work are full time and permanent, and they are predominantly in lower grade occupations. The Labour Force Survey panel shows that the median weekly wage taken by those moving into employment from non-employment was just £115. This weekly figure reflects an average hourly rate of just over £4 an hour, and the high proportion of part-time work.

Chart 2.7: The distribution of entry wages



Children

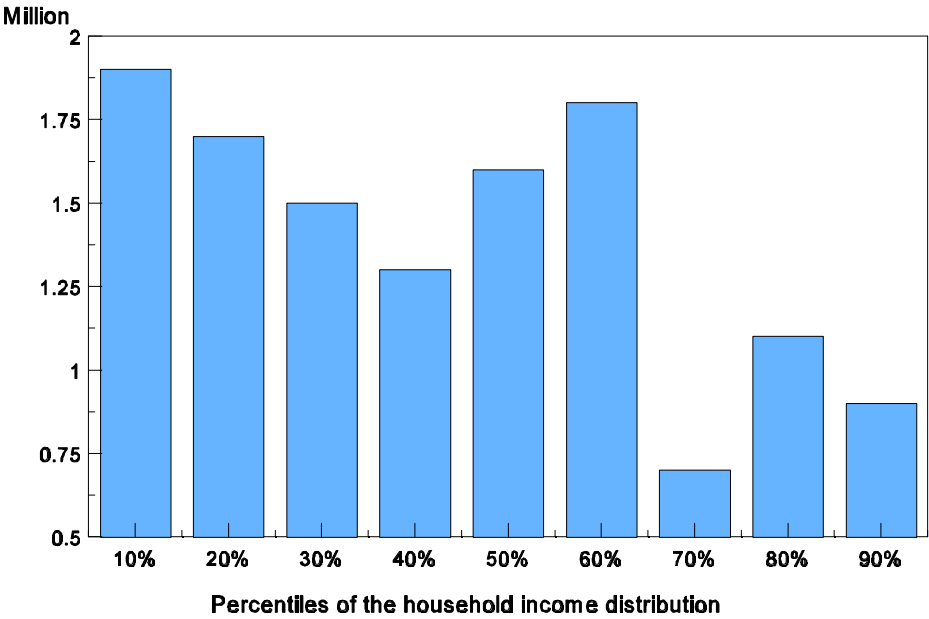
2.30 This paper has focussed on people of working age. But some of the worst effects of poverty and worklessness are felt by children. After taking into account housing costs, 4.2 million children - a third of all children - were in households below half average income in 1995. The position of children has been strongly affected by increases in unemployment and lone parenthood - the proportion of children living in families without a full-time employee has increased from 18 per cent in 1979 to 33 per cent by 1995. But, while the majority of poorer households with children have no-one in work, a large number of the poorest children - 1.4 million in 1994-95 - live in working households.

data. Students are excluded. Those on short term sickness or maternity should be excluded but errors may be present. The data is unweighted and suffers from some attrition bias.

¹³

Gregg, P and Wadsworth, J (1995) *A short history of labour turnover, job tenure and job security, 1975-1993*. Oxford Review of Economic Policy.

Chart 2.8: Numbers of dependent children below various percentiles of the income distribution.



2.31 Research on the dynamics of low income¹⁴, using the British Household Panel Study, highlights how people with children are less likely than young childless couples and single adults to move up through the income ladder and escape poverty. More recent evidence can cast some light on the effects of childhood deprivation on subsequent labour market performance. Children from poor families tend to have poor labour market performance in later life. The National Child Development Study, started in 1958, and the British Cohort Study, from 1970, follow people through time - and provide the wide range of information required to separate out the various linkages. These surveys¹⁵ both show a significant role for childhood experiences in explaining future labour market disadvantage; mainly through the link between parental poverty and poor school attendance and attainment. Lone parenthood reduces the subsequent job prospects of children, and increases the chance that children will themselves go on to form lone parent households, but only where the original parent was out of work¹⁶.

Excluded communities

2.32 The same people who experience unemployment may also face a variety of other problems. Unemployment, poor educational attainment and benefit dependency often interact with other social problems such as bad housing, crime and substance misuse, to create a vicious circle of disadvantage. The concentrations of disadvantage and deprivation in small and specific local areas are of particular concern.

¹⁴ Jarvis, S and Jenkins, S (1997) *A year in the labour market*. Employment Audit, Employment Policy Institute.

¹⁵ Gregg, P and Machin, S (1997) *Childhood Poverty and Success or Failure in the Young Adult Labour Market*, Centre for Economic Performance

¹⁶ Kieran, K (1996) *Lone Motherhood, employment and outcomes for children*. International Journal of Law, Policy and the family, Oxford University Press.

Conclusions

The evidence in this chapter paints a much more complex picture of the labour market than that shown by the monthly unemployment statistics. The labour market is characterised by a high volume of flows between jobs, and into and out of unemployment. In many cases these job moves are beneficial for the individuals concerned, and for the economy as a whole. Repeated spells can reflect specific occupations or, particularly among young people, a process of matching; as workers experiment with different jobs. But, in some cases, repeated spells of unemployment are a sign of poor employability - particularly when unemployment spells add up over time to a significant period of labour market detachment. There is a significant proportion of the labour force - in recent years, around 1 in 7 - who are at risk of experiencing prolonged periods of unemployment, or repeated spells of unemployment amounting to a significant detachment from the world of work. We should also consider the experiences of those outside the labour market altogether. This chapter has identified specific groups, beyond the claimant unemployed, more of whom would work if the appropriate employment opportunities were available.

The main source of poverty is increasingly lack of work. But, although employment is often a necessary condition for the relief of poverty and inequality, it is not always sufficient. Despite the in-work support provided by Family Credit and other benefits, earnings are often not high enough to lift poor families permanently out of poverty. The interaction between low pay and unemployment is a two-way process: those with low pay face particular risks of insecure employment and unemployment; and experience of unemployment often leads to a substantial loss of earnings and low wages in "entry" jobs. These problems can be concentrated in specific local areas, and can have particularly damaging effects on children.

CHAPTER 3. CHANGES AND CHALLENGES

This chapter looks at the forces at work in the labour market that explain the experience of individuals. It sets out some important longer run trends, many of which are common to other developed economies. In particular, it identifies the effects of technological development on the demand for skills and the increased globalisation of the economy. It also looks at the social and demographic changes which impact on the labour market - particularly the growing labour market participation of women, and changes in household composition.

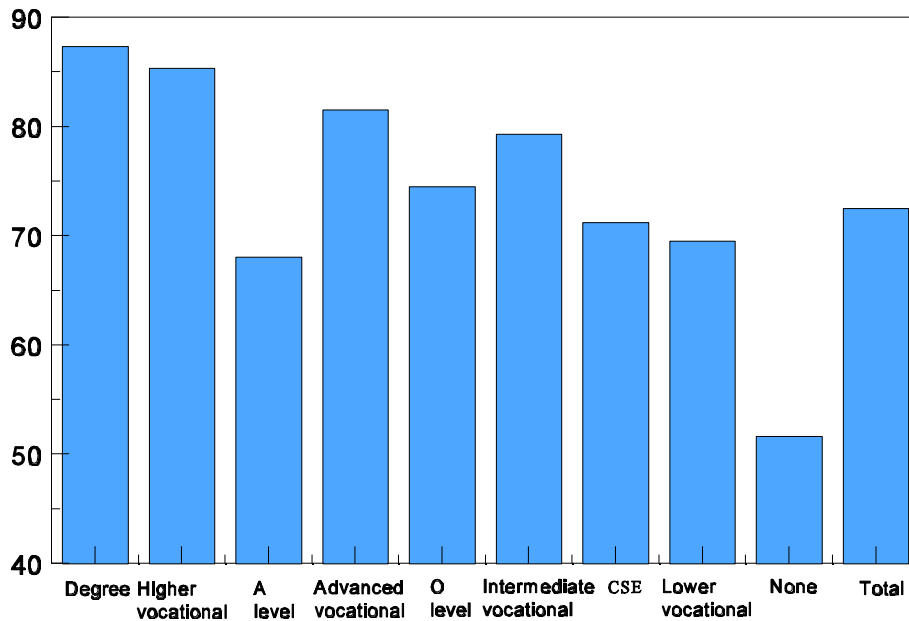
The decline in demand for unskilled labour

3.01 Throughout the OECD the employment rate of low skilled and poorly educated workers has been falling since at least the early 1980s; while in the UK and the US there is clear evidence that relative wages of unskilled workers have also been falling. These increases in the relative *demand* for skilled labour have been accompanied, and may have directly caused, an increase in the *supply* of skilled labour. The proportion of people in lower skilled groups has been falling throughout the developed world. The situation is sometimes described as a race between the supply of and the demand for skilled labour. Where the increase in the supply of skilled workers has been fast enough to meet the demand for skills, the relative position of the unskilled workers has been maintained. But in many countries, including the UK over the last 20 years, the increase in the supply of skilled workers has not been rapid enough to meet the increased demand. The relative wages of skilled workers has been bid up - leaving those without skills, and particularly manual workers, in a deteriorating labour market position.

3.02 Chart 3.1 highlights the dramatic decline in employment rates of people with relatively low skills. The widening gap in job prospects between skilled and unskilled men aged 25 to 49 has been particularly dramatic. Only 5 per cent of prime-age men with a degree are not in work, compared to 33 per cent of those with no qualifications - up from 3 and 10 per cent respectively in 1979. Only around a half of the collapse in the employment rate of prime-age men appears as measured unemployment. But a study of the patterns of relative unemployment rates of skilled and unskilled labour¹⁷, combined with a theoretical model of the labour market, finds that almost 2 percentage points of Britain's unemployment rate can be explained by changes in the demand for skills. The gap in job prospects is also reflected in wages - for full time men, the wage gap between degree holders and those with no formal qualifications has risen from 61 per cent in 1979 to 89 per cent.

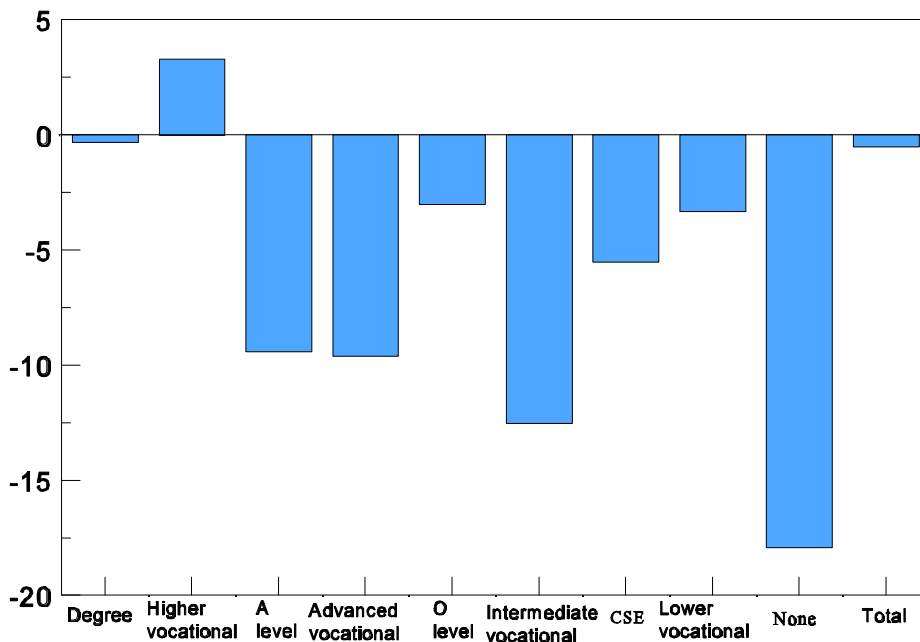
¹⁷ Nickell, S and Bell, B (1995) *The Collapse in Demand for the unskilled and unemployment across the OECD*, Oxford Review of Economic Policy

Chart 3.1: Employment rates by highest qualification 1997 ¹



¹ All persons of working age. Source: Labour Force Survey; analysed by Peter Robinson, Employment Policy Institute

Chart 3.2: Employment rates by highest qualification - change since 1979 ¹



¹ All persons of working age. Source: Labour Force Survey; analysed by Peter Robinson, Employment Policy Institute.

3.03 Another long-run trend, intertwined with the decline in demand for lower skilled workers, has been the shift away from industrial and manual work. Typically, full-time male workers with few educational qualifications, but craft skills specific to their industry, have found their skills made obsolete by structural change. In the 1960s manufacturing output accounted for more than a third of Gross Domestic Product; today it accounts for around 20 per cent. And over the

same period employment in manufacturing has fallen from around a third of overall employment to around 15 per cent.

3.04 There are two main explanations of the deterioration of the labour market prospects of low skilled and manual workers:

- the rapid development and diffusion of new technology, and new forms of work organisation, may be biased against those with poor skills; and
- the increase in international trade with countries with a relatively abundant supply of low skilled labour may be putting downward pressure on the demand for low skilled labour in the developed countries.

3.05 A wide and expanding academic literature on both these phenomena has highlighted a role for both, but with technological change the more significant. The two explanations are not mutually exclusive: for example, the growth in international competition may itself be a spur to technological innovation; and the effect of new technology on the availability of low cost transport and communication is one of the main explanations for the growth in international trade.

The Challenge of New Technology

3.06 There is strong evidence that the growth in demand for skilled workers has been associated with the spread of microcomputers and computer-based technologies over the last couple of decades. Although the pace of technological change is certainly not new, it may be that there are particular features of the current wave of technical progress that leaves poorly educated workers at a disadvantage relative to those with skills. The tasks which computers currently perform well are routine tasks, such as data handling and analysis. They have so far been less good at performing tasks involving judgement and face to face communication. We would, then, expect to see new technology shifting the relative demand for labour in favour of skilled workers, while increasing overall levels of growth and productivity.

3.07 The best evidence in support of this view is that the increasing demand for skills is very broadly-based, occurring within industries and within establishments, rather than just between industrial sectors. Those industries relatively sheltered from international competition have seen changes in the demand for skill, as well as those that are not. Industries with larger investments in research and development, innovation and use of computers have shown the strongest changes in relative demand for skills. There is also evidence that utilization of more skilled workers is complementary with investment in physical capital and the introduction of new technology. The central point here is the evidence suggests the IT revolution, in particular, may be making many traditional unskilled jobs redundant, while increasing the employability of those with the skills to make best use of it.

3.08 There are a number of studies which have attempted to measure directly the effects of computerisation on employment and the earnings distribution. Many of the studies are based on US data, and typically find that computers and new technology can explain up to about a half of the change in the demand for skills¹⁸. Studies of the UK confirm the important role of new technology: there is evidence that new technology and skills are complementary¹⁹; that workers who use computers at work receive higher wages; and that - as in the US - a large part of the

¹⁸ For example, Krueger, A (1993) *How Computers have changed the Wage Structure: Evidence from Microdata, 1984-1989*, Quarterly Journal of Economics; and Autor, DH, Katz, LF and Krueger, AB (1997) *Computing Inequality: Have Computers Changed the Labor Market?*, Industrial Relations Section, Princeton University .

¹⁹ Machin, S; Ryan, A and Van Reenan, J (1996) *Technology and Changes in the Skill Structure: Evidence from an International Panel of Industries*, Centre for Economic Performance Discussion Paper.

change in the demand for skills can be attributed to various measures of technical ability²⁰.

3.09 New technology and innovation are the engine of economic growth. Slowing down technical progress offers no route to higher employment. On the contrary, it would only reduce productivity growth and so retard the growth in living standards. But there is a clear need to match the supply of skills to demand and make sure all individuals are equipped with the necessary basic skills to participate in the new labour market.

The Challenge of Globalisation

3.10 The world economy is becoming more integrated, probably at a faster pace than at any time in the post-war period. The reduction of artificial barriers to economic exchange between countries have ensured the virtual abolition of tariffs on manufactured goods. Advances in travel have shrunk economic distances, while advances in communications and information technology have made it easier for firms to coordinate production across several countries. As computing power gets ever cheaper, and telecommunication systems more advanced, service companies have been increasingly sourcing routine tasks, such as data input, in developing countries. In 1995, world export volumes were 10 times higher than they were in 1955. Trade in the developing countries has risen from around 33 per cent of their GDP in the mid-1980s to around 43 per cent today, and from a position in the 1950s where developing countries were mainly exporters of primary products, manufactured exports have risen sharply. While in the US, imports from developing countries amount to almost half of total imports, in the UK the equivalent figure is only a fifth²¹. So trade can only be a partial explanation for the decline in demand for unskilled labour.

3.11 This increasing openness of economies to trade and investment flows is a major driving force for rising world prosperity. Long established economic theories tells us that all countries, regardless of their relative productivity, are able to participate in and gain from international trade. Countries produce and export the goods they can produce relatively cheaply, and import the goods that are relatively expensive for them to produce. As developing countries are relatively abundant in low skilled labour, their comparative advantage lies in the production of goods produced by low skilled workers. Therefore the developing world will tend to produce and export low skill-intensive products, while the developed world concentrates on the production of high skill-intensive products.

Social and demographic change

3.12 In the last twenty years the average number of working-age adults per household has been falling, and the number of single adult households rising.

3.13 The number of households has also outstripped the growth in the working age population. Since 1981, and particularly since 1989, the ageing of the baby boomers, more frequent family breakdown, and a general move to independent living have produced a rapid increase in the number of households. Other things being equal, these trends ought to have increased the supply of labour; as the increasing number of single-adult families seek to support themselves. This has not, however, turned out to be the case.

3.14 But, while overall employment rates have remained broadly constant, the labour market participation of women has grown dramatically - as shown by chart 3.3. This is one of the most important economic and social trends of the late 20th century. The fact that the labour market has absorbed these new workers is a great success story for the UK economy. Chart 3.4 shows that the growth in female employment has been particularly strong amongst those of child-

²⁰ Bell, B.D. (1996) *Skill-Biased Technical Change and Wages: Evidence from a Longitudinal Data Set*, Centre for Economic Performance Discussion Paper

²¹ ONS (1997) *Globalisation: scope, issues and statistics*, Economic Trends, November.

bearing age. It is no longer the case that the usual pattern of female labour supply is to leave the labour market while their children are growing up.

Chart 3.3: Working age activity rates for Great Britain 1971-1997 ¹

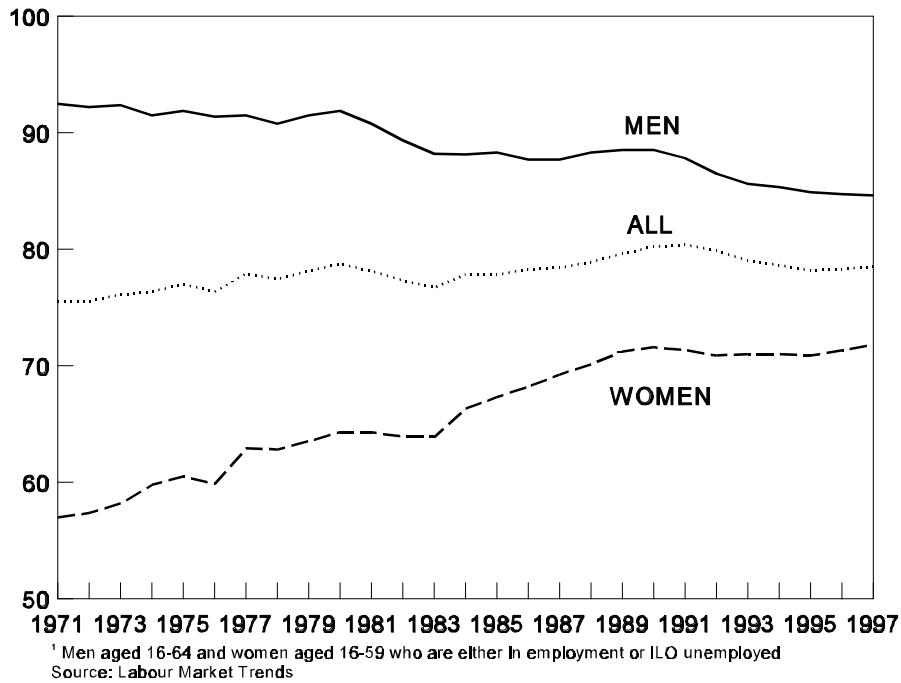
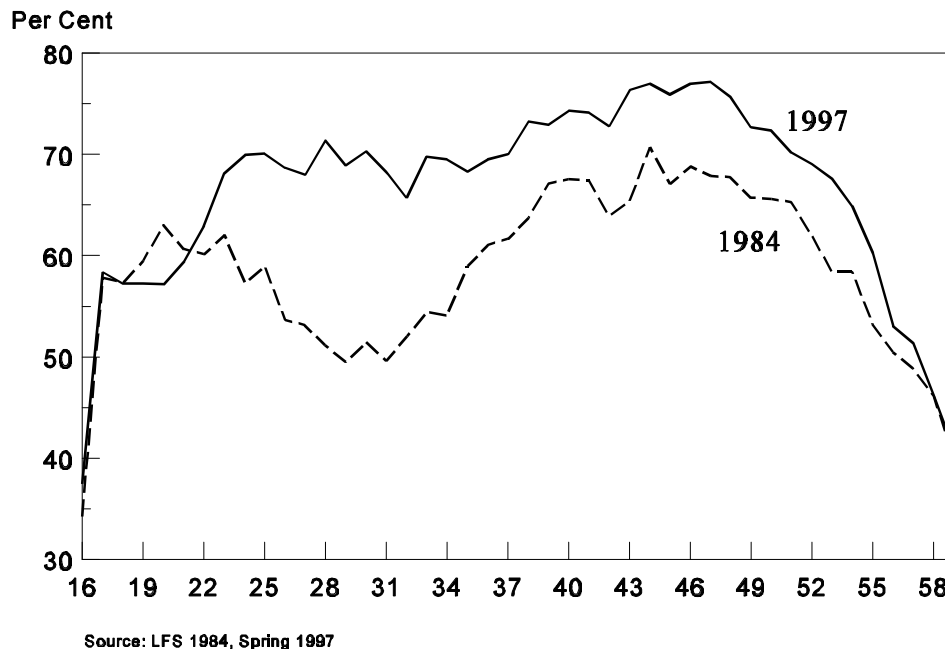


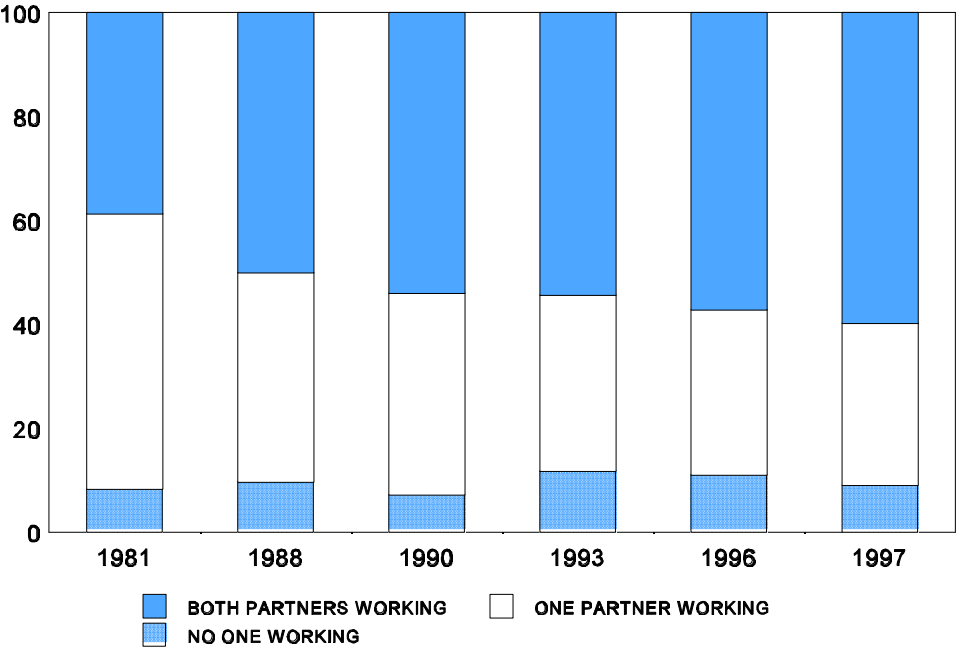
Chart 3.4: Employment rates for women by age ¹



3.15 Looking in more detail, there are some significant exceptions to the overall pattern of growing female labour market participation. The evidence in chapter 2 shows that the employment rate of lone mothers has been falling. Chart 3.4 shows that the growth of female employment has occurred disproportionately among households where the husband was already

in work. This pattern of household labour supply is leading to a polarisation of work - increasing the numbers of no-earner and all-earner households, at the expense of the traditional single male breadwinner.

Chart 3.5 The Polarisation of work by household
Distribution of employment within two adult households with children



Source: Labour Force Survey

3.16 Another challenge that the UK labour market will have to face in future years is a decline in the numbers of people of working age as a proportion of the total population. With greater numbers reaching retirement age, and life expectancy improving further, we can expect the proportion of people of working age to decline, particularly from the year 2020. These trends are relatively modest compared with many other countries, where the “bulge” of fertility following the war was even more significant, and perhaps also modest compared with the other social changes set out in this chapter. But the ageing of the population does mean that, in order to prevent the proportion of workers in the population from falling by 2050, the proportion of people of working age in work would need to rise by about 5 percentage points - equivalent to nearly 2 million new jobs.

Changing Patterns of Work

3.17 The nature of work is also changing. While average hours worked have not changed a great deal in the past twenty years, traditional working patterns - based around the 9 to 5 job - have become less common. More diverse working practices have developed²². These have taken a number of forms, including:

- **Part-time work.** Today, about 25 per cent of employees are in part-time employment, compared to about 20 per cent in 1981. This is a long-standing trend. In most cases,

²² More evidence on flexible working practices is set out in Casey, B, Metcalf, H, Millward, N (1997) *Employers use of flexible labour*, Policy Studies Institute.

the decision to take part-time employment is voluntary. Only about 1 in 8 part-time workers take a part-time job because they could not find full-time employment.

- **Variable hours.** More than half of all employees in the UK now work variable numbers of hours from week to week (compared with a third in 1984), either because they work varying amounts of overtime, or because their basic hours of work are flexible.
- **Temporary work.** The number of employees in temporary work increased by 43 per cent between 1990 and 1997. This includes those on fixed term contracts, seasonal, casual or agency work. It is not clear whether this is part of a long-term trend and, at just over 6 per cent of employees, the extent of temporary work in the UK remains well below the EU average of 11 per cent.
- **Self-employment.** The numbers of self-employed have increased considerably from about 1.9 million in 1979 to over 3.3 million today. The self-employed now represent about 13 per cent of those in employment. Self employment is an important element of the flexible labour market, both because it often offers a route for some individuals out of unemployment and low pay, and because it can be a source of new jobs for others.

3.18 Only 10 per cent now work a 'standard' 40 hour week, compared to 25 per cent in Germany and 45 per cent in France and Italy. The move away from "standard" contracts has been a long-standing trend, a particular feature of the UK, and a defining feature of the labour market in the late 20th century. All the signs are that many of these trends will continue. When the labour market is healthy, and individuals have good overall job prospects, this diversity in work allows people to match their working practices to their needs. It can be an important factor in ensuring high employment rates; even for those with family and other commitments. But, as the previous chapter showed, for those with poor overall employability, the choice of job opportunities can be heavily constrained.

Conclusion

There are powerful trends in society and in the global economy which, if we respond effectively to them, can be engines of prosperity and higher living standards. Resisting the challenges they pose is not a viable option. But they do have important implications for the labour market - and for unskilled and manual workers in particular. The changing nature of work - towards part-time work and self-employment - can also be a positive opportunity for diversity in work; but only where individuals are equipped to exploit the opportunities available.

CHAPTER 4. A NEW APPROACH TO TAX, BENEFIT AND EMPLOYMENT POLICY

The Government has recently reaffirmed the commitment first made in the 1944 white paper to high and stable levels of employment. Employment opportunity for all is the modern definition of full employment for the 21st century. The old policy agenda has become obsolete; and in many cases counter-productive. This section argues that we need a new policy agenda to reflect the changes that have occurred in the labour market, and to broaden out the concept to cover all those without employment opportunities.

4.01 Section 3 set out many of the external and internal pressures on the UK labour market; while section 2 set out the wide range of groups that we need to target so we can achieve employment opportunity for all. In some cases these are new developments. In others they are long standing trends that have built up over decades. Some are unique to the UK - many others are shared with other developed economies. In some cases, changes in the tools of analysis mean we look at old problems with a new perspective - as economists improve their understanding of the way the labour market works, and have access to new sources of information - particularly on households and the experience of individuals over time.

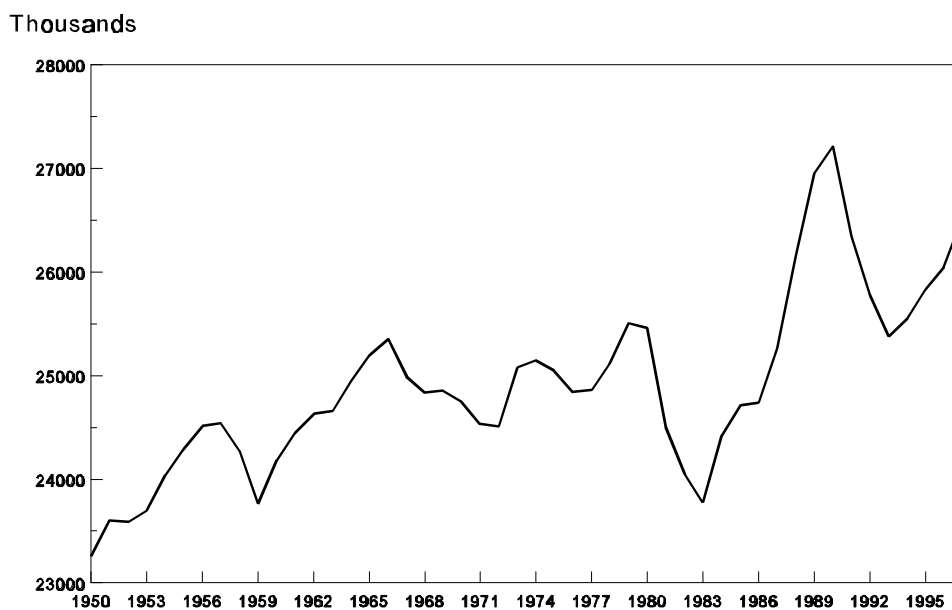
4.02 All this has important implications for policy. The old way to full employment relied heavily on the management of aggregate demand. There was too much emphasis on macroeconomic aggregates, and insufficient attention to the distribution of employment opportunities and the experiences of individuals and families. The analysis was too often static, rather than dynamic. Governments gave inadequate weight to welfare to work policies, work incentives and benefit traps. They failed to recognise the role of basic skills and lifelong learning in making labour markets work more effectively. And for much of the post-war period the focus was almost exclusively on men.

4.03 In the circumstances of the immediate post-war period this approach was able to deliver low unemployment and a high proportion of long-term jobs, with predominately full-time work for men. Skills mattered less when unskilled workers had access to good job opportunities. Flexible working practices mattered less when fewer people needed to balance work and family responsibilities. Welfare to work policies were less important when a high proportion of the unemployed were only out of work for a short time. The focus on the claimant unemployed was valid when those outside the labour market were there from personal choice, rather than lack of opportunity. And, when long-term unemployment was relatively rare, benefits for people of working age could be seen as essentially short-term. But now the old policy agenda has become obsolete; and in many cases counter-productive. We need instead a new approach to tax, benefit and employment policy which reflects the changes that have occurred in the labour market, society and the global economy; and the new understanding on how the labour market works.

Responding to the challenge

4.04 While the focus of reform must be microeconomic, it is vital that the macroeconomic background is conducive. Over the last 25 years, a prominent feature of the UK economy in general - and the labour market in particular - has been instability. The UK has suffered two of the deepest recessions of any industrialised country since the war. As chart 4.1 shows, these fluctuations in national income resulted in unstable levels of employment.

Chart 4.1: Workforce in employment 1950-1997



Source: Economic Trends

4.05 This boom and bust cycle has inflicted immense damage on the labour market. Long and severe downturns - and the destruction of industrial capacity they cause - have led to large numbers of people experiencing periods of unemployment. As chapter 2 showed, for many these periods of unemployment meant long and repeated spells of detachment from the labour market - during which they lost vital skills, motivation and work experience. Employers may also - rationally or otherwise - sift out applications from people without a recent work history. Recessions can also lead to people - particularly older people - giving up the search for work and withdrawing entirely from the effective supply of labour. Young people whose first experience of working life coincides with a recession can find their prospects damaged for years to come.

4.06 This damage to the effective supply of labour can mean that, when recovery comes, the labour force has been less able to meet the needs of the economy, and less able to sustain a recovery without running into skill shortages and wage inflation. So not only has the labour market sustained immense damage from the boom and bust cycle, its structural weaknesses have in part contributed to it.

4.07 So macroeconomic stability has a key role to play. But it is not sufficient in itself to generate full employment. Neither can we simply allow markets to adjust to structural change while doing nothing to help individuals meet the demands of those changes and adapt effectively to them. Analysis of the state of the labour market suggests four further vital elements if the labour market is to meet new challenges while providing employment opportunity for all:

- a flexible and adaptable labour market, underpinned by minimum standards;
- skilled and adaptable individuals;
- policies which encourage the move from welfare to work; and
- a tax and benefit system that makes work pay.

This chapter looks at where we stand on each of these key criteria for success.

A flexible labour market with minimum standards

4.08 There are a number of aspects to a flexible labour market, all of which are important in ensuring that the economy reacts effectively to external pressures and shocks, changing consumer demands and new technology. It means working practices which match the changing needs of both workers and employers. To respond to structural change the economy needs flexibility in relative wages, and to be able to move factors of production - labour and capital - to exploit the new opportunities available. It also needs real wage flexibility - so that wage setting processes are responsive to the level of unemployment.

4.09 Wage bargaining structures have changed significantly in the UK in recent years. Since the end of the last incomes policy in 1979, the determination of wages in the UK has become far more decentralised. National or industry-level pay bargaining has become less common. The proportion of the workforce covered by collective bargaining and statutory wage agreements fell from over 80 per cent in 1980 to less than 50 per cent in 1994 - a sharper fall than in any other major industrialised country. One product of this greater decentralisation has been greater *relative* wage flexibility. Comparability (for example, with the cost of living) remains a key determinant of settlements, but individual firm level factors now play an increasing role. The dispersion of wage rates across industries has increased over time (even controlling for differences in the skills and experience of the workforce). The dispersion of wage settlements in any one year around the most common outcome has also risen over time.

4.10 Employers in the UK have a greater degree of flexibility than in many European countries, to manage their labour force without overburdensome controls. OECD evidence suggests responsive regulatory systems are associated with higher employment rates²³. However, it is not only fair but economically efficient for employees to be treated equitably. Flexibility in wages and working practices are important but must not be allowed to result in exploitation. The UK has not yet got the balance right.

4.11 Lack of flexibility in real wages has been a long standing problem with the British economy. In the mid to late 1980s, for example, wages rose while unemployment remained at unacceptably high levels. One way to measure an improvement in real wage flexibility over time is to look at the trade-off between the change in inflation and the cumulative output gap, i.e. the output cost of reducing inflation. In the course of bringing inflation down, the trade-off in the early 1990s showed no significant improvement on that experienced in the early 1980s. However, the economic policies being pursued by the Government - creating economic stability based on low inflation and low government borrowing, and action to promote competition and increase labour market flexibility - together with responsible private sector behaviour, should deliver a more favourable outcome in the future.

4.12 Flexibility of labour markets is closely related to flexibility in product markets. Firms need to respond to shocks, in terms of their pricing, production and investment decisions, and on deciding whether to enter or exit particular markets. The liberalisation of the product market in the UK has progressed over recent years, although more needs to be done, and improvements in competition policy should further increase the flexibility of firms in the face of structural change. More also needs to be done to complete the single market in Europe.

Skills and Employability

4.13 While there are clear benefits from a flexible and adaptable labour market responding to economic and social change, not everyone is in a position to reap the benefits. To benefit from the flexible labour market, to find work and move up the employment ladder, individuals need to have the necessary skills to remain employable in the face of change. This requires:

²³ OECD (1994) *The Jobs Study*

- good basic skills - literacy, numeracy, communication and IT skills - particularly for those leaving school and entering the labour market for the first time;
- access to lifelong learning - so people can respond to structural change by re-skilling throughout their working life;
- employability - so that people keep in touch with the labour market when they lose their jobs, continue to remain part of the effective supply of labour and avoid long-term benefit dependency.

4.14 Good basic levels of education are essential for all members of the modern labour force. But currently the British position is poor compared to many other countries. In 1996 The Skills Audit compared UK skill levels with France, Germany, the US and Singapore; and found that only at the highest level did the UK perform consistently as well as all the other countries. The problem begins at school, often in the early years. In 1997 no more than two-thirds of 11 year olds gained the expected levels of achievement in english and maths. While that was a marked improvement on 1996, many more children need to reach and exceed the Government's expected levels. The education system needs to ensure that the skills acquired at school help to equip young people for the needs of employers. Given the rapidly changing nature of the modern economy, this means the acquisition of good basic skills in literacy, communication, numeracy and IT. For people already in the labour force, the problem is compounded by the fact that many have not participated in any form of education or significant training for many years. By 1996, 8 per cent of skilled manual workers suffered from low literacy levels and 18 per cent from low numeracy. For the semi-skilled the figures were 15 and 34 per cent respectively, almost the same as for the unskilled.

4.15 The poor levels of education and training achieved in the past are one of the main reasons why significant areas of skill shortage currently exist alongside continuing high levels of unemployment. And low levels of basic education - especially for the one-fifth or so of pupils that leave school with few if any qualifications (a figure that has remained more or less constant throughout the post-war period) - leaves individual workers prone to a much increased likelihood of unemployment, both in terms of frequency and duration.

The tax and benefit systems

4.16 People are understandably reluctant to take work that does not pay. For the vast majority of those in work there are clear financial rewards. But for those facing low potential wages, and especially for those needing to support children, wages alone are insufficient to provide incentives to work. The tax and benefit systems therefore play an important role in determining whether work pays. Over the last century, tax and social security benefits have tended to evolve to meet different objectives. Traditionally, the main aim of the tax system has been to raise revenue, while the benefit system has aimed to address individual and family needs. But both systems can contribute to the same objectives. In particular, they both provide means for promoting work incentives and for relieving poverty - objectives which are particularly important to reconcile in the changing labour market.

4.17 There are real difficulties in designing a system to meet the often conflicting aims of relieving poverty for those out of work, while providing a clear financial gain from being in work (the unemployment trap) and maintaining the incentive for people to move up from low paying entry jobs (the poverty trap); and all at a cost that does not imply higher taxes for everyone. The conclusions of a recent OECD report²⁴, that explores the differing approaches across countries, echo the concerns of the government that a well designed system should ensure that:

- there is a reward from working;

²⁴ OECD (1997) *Making Work Pay: Taxation, benefits, employment and unemployment*

- low wage labour should not be over taxed; and
- an in-work support system should be in place to increase take home income of families, and should facilitate the transition into work by being speedy and accurate, simple and comprehensive.

4.18 Reform must start with an analysis of the problems facing individuals trying to move into work. The table overleaf shows the wide variety of barriers to work that unemployed people themselves say they face. Most people, of course, do not look at the financial incentives alone. Many of the problems identified in the opinion survey concern the, often difficult, transition from welfare into work. But financial barriers are some of the most significant.

What prevents people leaving benefit?²⁵	% mentioning
Work Incentives	
Worries about wages being too low	35
Amount of council tax benefit	32
Losing housing benefit/ mortgage help	31
Losing passported benefits	27
Paying extra costs (e.g. work clothes/ travel)	21
Cost of childcare	18
Paying back loans/ debts	16
Problems making the Transition	
Worries about jobs being temporary	26
Managing until pay day	23
Worries about re-claiming benefit after a short period in work	23
Finding someone to mind the children	14
Hassle of sorting out benefits	11
Waiting for Family Credit	5
Waiting for other benefits	4
Personal Issues	
Not fit enough	19
Job not right	17
Not wanting someone else to look after the children	12
Employer discrimination	11

²⁵ Shaw, A, Walker, R, Ashworthy, K, Jenkins, S and Middleton, S (1996) *Moving off income support: barriers and bridges* DSS Research Report.

Nervous about working	9
Having enough time to care for an elderly or disabled person	6
Something else (including no jobs available)	5
None of these	19

The Unemployment Trap

4.19 Although a number of attempts have been made in recent years to ensure that the tax and benefit system makes people better off in work than out of work, and thus minimise the 'unemployment trap', financial disincentives to work remain. The traditional measure of the unemployment trap is the replacement ratio, which is defined as income out of work as a percentage of income in work. Estimates of the numbers of working people with high replacement ratios are set out in the table below.

Replacement ratio for the working population in 1996-97	
100%+	15,000
90%+	45,000
80%+	195,000
70%+	510,000

4.20 Some ½ million working people had replacement ratios of over 70 per cent in 1996-97. However, this traditional measure almost certainly underestimates the extent of the unemployment trap because:

- it ignores in-work costs, such as the costs of travelling to work and childcare costs;
- it only covers those in full-time work (over 30 hours), which means that it ignores low part-time incomes, making it a poor proxy for estimating the replacement ratios for those out of work. It is unrealistic to expect the potential earnings distribution for the unemployed and inactive to be the same as those in work. As the analysis of the 'low pay-no pay' cycle above made clear, those who have been out of work are likely to face very low entry wages;
- it assumes full take-up of income-related benefits. Take up of Family Credit has improved in recent years but is still only 70 per cent. There is still some stigma associated with claiming in work benefits, and it is possible that some claimants do not associate them fully with the rewards of work, since they are paid neither through the pay packet nor always to the main wage-earner.

The Poverty Trap

4.21 Action to make work more rewarding than welfare must also take into account the existence of the 'poverty trap', which arises when people in work cannot improve their income by working longer hours or for higher pay, because working for more means they simultaneously pay more tax and receive less benefit.

4.22 The Family Resources Survey suggests that at present about 100,000 working people face marginal deduction rates of more than 90 per cent, and 645,000 face rates over 70 per cent (see table below).

Marginal deduction rates in 1996-97	
100%+	5,000
90%+	105,000
80%+	360,000
70%+	645,000
60%+	655,000
50%+	660,000

4.23 The worst cases arise for people working more than 16 hours a week with a low weekly income. As they earn more, they start to pay tax, and they lose entitlement to in-work benefits, such as Family Credit, Housing Benefit and Council Tax Benefit. In the worst incidences of the poverty trap, combined marginal deduction rates can be as high as 97 per cent of an extra pound of wages, over a large range of income levels.

4.24 In addition, there are traps not included in the conventional measure shown in the table, but which also lead to people facing high marginal rates:

- people working less than 16 hours a week - whose entitlement to Jobseeker's Allowance or Income Support is reduced pound for pound if they earn more than a small disregarded element.
- people earning just below the lower earning limit for national insurance contributions (£62 a week), who face a charge of 2 per cent of the full LEL (ie £1.24) when their earnings cross this threshold.

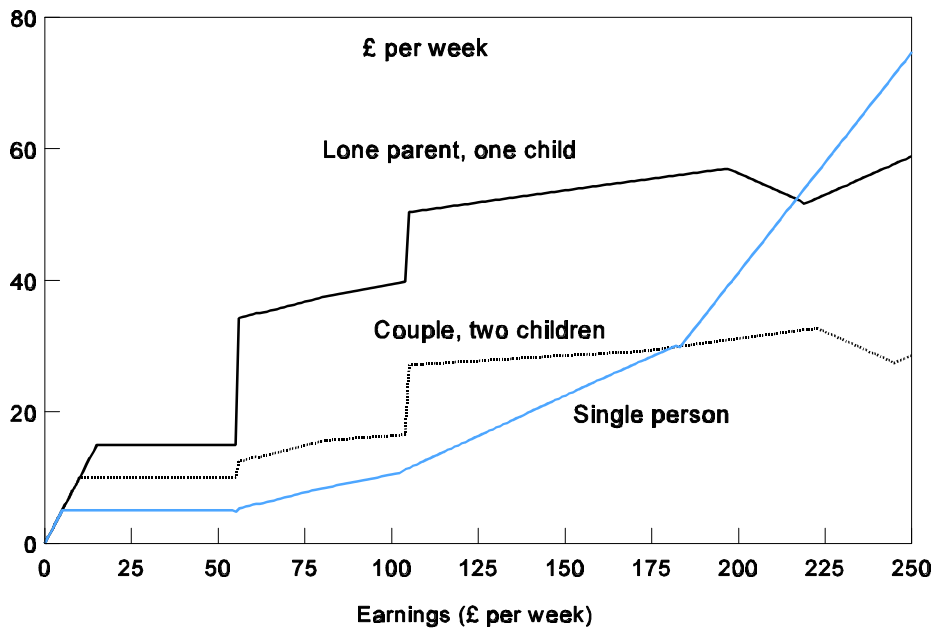
4.25 This poverty trap presents a policy dilemma. Much of the problem is associated with the withdrawal of in work and income related benefits, themselves introduced to tackle the unemployment trap by increasing the rewards to work. So, in seeking to address the latter, for example through greater in work support, there is a risk of aggravating the former, as more of the low paid are drawn into higher marginal deduction rates. More generally, there is a trade off not just at the lower end but across the *whole* income distribution between the severity of marginal rates and the numbers affected by them. And so, although it may be possible to iron out particular anomalies which currently exacerbate the poverty trap, there can be no magic solution which can reduce marginal rates for everybody. But there are steps we can take to make work pay.

Income tax and work incentives

4.26 One area which has provoked debate in recent years is the respective merits of reducing the starting rate of income tax and increasing personal allowances. The distributional issue is important. But the issue the Government has posed is between higher personal allowances and a 10p starting rate combined with appropriate changes to the benefit system. A lower starting rate of tax, combined with changes to the benefit system, is likely to have a more positive effect on work incentives, because a greater number of low paid workers would see a reduction in their marginal rates, and also a better distributional impact. A lower starting rate of tax is therefore likely to have greater dynamic potential, in terms of promoting work and fairness.

Does work pay?

Chart 4.2: How much better off are people in work than out of work ?¹



¹ Difference in cash income, assuming a typical private sector rent, children aged under ten, earnings of £3.50 an hour, no other income or capital

4.27 As chart 4.2 shows, the poverty and unemployment traps currently interact to make it very difficult for people on low pay to be significantly better off in work than out of work. Although most people are better off in work, they may be only a little better off, and face on-going difficulties in rising up the income ladder. Of course, most unemployed people do not take decisions about work opportunities on the basis of financial incentives alone. But, taken together, these financial disincentives amount in some cases to a significant barrier to work - particularly where people can expect only low earnings and high in-work costs. They also send out entirely the wrong messages about the value society places on work.

Rights and responsibilities

4.28 The administration and delivery of benefit payments can be as important a determinant of labour supply as the financial incentives. Over the last decade the benefit regime facing the claimant unemployed has become progressively stricter. As well as receiving a relatively low level of benefits by international standards, the claimant unemployed must demonstrate that they are actively seeking and available for work as a condition for receiving social security payments. The government's New Deal programme will in the future provide new opportunities to the long term unemployed and, for young people unemployed over 6 months, will remove the option of life on full benefit from those who turn down an offer of help.

4.29 Other groups of benefit recipients face different sets of support and obligations. For lone parents, spouses of the unemployed and recipients of long term sickness and disability benefits, the benefit system implicitly assumes that they are totally unable and unwilling to work. Until the introduction of the New Deal, it offers little information and support for those who do want to work and - in the case of those on disability-related benefits - penalises them if they do. The system does not set conditions for benefit receipt related in any way to the opportunities to work. This compares with benefit systems for lone parents and spouses of the unemployed in many other countries, which take a different view of the balance between rights and responsibilities.

Conclusion

The new labour market requires a new approach. The old solutions were able to sustain full employment for the first few decades of the post-war period. But the modern approach needs to address a wider problem with different solutions; and needs to involve a much broader range of policy approaches and priorities.

CHAPTER 5. IMPLEMENTING THE STRATEGY

This section sets out the government's strategy, and the policies through which it intends to meet the commitment to high and stable levels of employment.

5.01 In the modern labour market the government retains important responsibilities. It must:

- provide a framework for **macroeconomic stability and growth**, which prevents the swings in output that destroy jobs and create a pool of long-term unemployment;
- promote a **flexible and adaptable labour market**, backed up by a framework of minimum standards, and ensure that firms and their employees respond effectively to structural change;
- encourage **investment in education and skills**, so that people start off their working life with the basic skills required for a lifetime of work, and can learn through life and remain employable as the labour market changes;
- help move people from **welfare to work**, by focussing help on the unemployed and those detached from the labour market, and developing a framework of rights and responsibilities;
- **make work pay**, through a national minimum wage and a tax and benefit system that promotes work incentives.

5.02 Considerable progress has already been made on the key elements of this strategy:

- **Macro stability and growth.** The previous Budget set out a deficit reduction strategy to put the public finances on a sustainable path. Operational independence for the Bank of England will also ensure stability in monetary policy, and help to encourage investment and growth. This macroeconomic strategy is crucial for the success of the government's wider objectives too; because a stable economy is an essential precondition for social cohesion and for the success of the welfare to work strategy.
- **Flexibility and adaptability.** The Government is promoting greater flexibility in the UK economy and setting in place a framework of minimum standards to ensure fair treatment at work. It is promoting this agenda in Europe through the "Getting Europe to Work" initiative. It is also introducing new competition legislation, and working for the completion of the single market.
- **Investment in education and skills.** An extra £1 billion has already been allocated to schools from the 1998-99 contingency reserve, along with £1.3 billion over the parliament from the receipts of the Windfall Tax to renovate school buildings, with expenditure linked to increased standards. A new Skills Taskforce will advise on the extent and nature of skill shortages, and the measures needed to ease them. It will also aim to identify the skills needed in the years ahead. The *Excellence in Schools* white paper²⁶ sets out the Government's approach to raising standards of attainment for all pupils. Over time, we will see many more people joining the labour force with good basic skills. But the Government is also concerned to help people develop their skills throughout life. The University for Industry will bring new learning opportunities to the home, workplace and community. Individual Learning Accounts will help people plan their learning, financed from £150 million from TEC resources for up to one million

²⁶ Department for Education and Employment (1997) *Excellence in Schools*

people. Reforms to Higher Education funding allow the cap on student numbers to be lifted, and the government has set a target for an extra 500,000 people going into further and higher education by 2002. Further details of the Government's strategy for lifelong learning will be set out in a White Paper early next year.

- **Welfare to work.** The previous Budget set out a New Deal for young people and the long-term unemployed and lone parents, financed by the Windfall Tax. The New Deal for young people starts in January in pathfinder areas, with the national start in April 1998. The New Deal for the long-term unemployed will start in June 1998, and the Government is introducing new **employment zones** - innovative new approaches in areas where long term unemployment is concentrated. The New Deal for lone parents, the first serious national attempt to help lone parents into work, started in eight areas this year, and is showing very encouraging early results. The Government is extending this approach to those on long term sickness and disability benefits who want to work. The Government has also announced that it is developing a **national childcare strategy**. This will set targets for the expansion of childcare provision, enabling more parents to be free to reconcile work and family life, as well as helping more children to develop the basic skills that can help their employment prospects in later life. The Government is also introducing a more coordinated approach to the problem of **social exclusion**.
- **Making work pay.** The Government will introduce a **national minimum wage**, to prevent the worst cases of exploitation, promote greater decency and fairness in the workplace, and underpin the tax and benefit system. The Government will decide on the level and coverage of the national minimum wage when it has received and considered the recommendation of the Low Pay Commission. In reaching its decisions the Government will take into account the wider effects on the economy and seek the right balance between promoting fairness and avoiding any adverse effects on employment or inflation.

Tax and benefit reform

5.03 The minimum wage needs to be seen as part of an overall strategy to make work pay; accompanied by **reform of the tax and benefit system**. Last May, a Task Force was set up under Martin Taylor's chairmanship to assist in delivering the Government's pledge to streamline and modernise the tax and benefit system to fulfil the objectives of promoting work incentives, reducing poverty and welfare dependency, and strengthening family and community life.

5.04 With the help of the Taylor Task Force, the Government is considering a coordinated strategy of tax-benefit reform, focusing in particular on four key areas:

- First, a new tax credit paid to families on low incomes, directly through the wage packet. In principle, a **working family tax credit** has a number of attractions. It could reinforce the effect of the minimum wage by making work pay. It could build on the success of Family Credit, increasing potential in work incomes and therefore the incentive to work. As a tax credit rather than a welfare benefit it should result in higher take up, while its clear link with the pay packet and the tax system should demonstrate the rewards of work over welfare. A working family tax credit could provide a highly effective way of targeting help at low income families: as well as improving work incentives, it could also help reduce poverty and strengthen the family. A critical test will be whether it can be delivered effectively and efficiently.
- Secondly, **national insurance contributions**, the current structure of which places a heavy burden on low paid workers and risks distorting the labour market. There is scope for bringing the national insurance structure more into line with income tax to ease administrative burdens on employers, to improve work incentives and to encourage the hiring of additional employees. However, the pace of reform must depend on the availability of resources.

- Thirdly, the **10p rate of income tax** which the Government is committed to introducing as soon as it is prudent to do so. A lower starting rate of income tax would create a fairer tax system, reducing the tax burden on the low paid.
- Fourthly, the Government is determined that the working poor should benefit from the 10p rate and any future reductions in income tax. It is therefore considering what action is necessary on the **tapers** and other features of the benefit system to ensure that a lower starting rate of income tax benefits all the low paid.

Conclusion

The government's commitment to high and stable levels of employment must be as strong now as at any time in the post-war era. But, as the labour market changes, and as we learn more about the way the economy works, we need new policies and new approaches. Employment opportunity for all - the modern definition of full employment for the 21st century - means providing people with the skills to adapt to changing circumstances, and through a framework which rewards and encourages work. We also need to ensure that, once in work, people have the opportunity to progress up the earnings ladder, and can continue to develop their skills and adapt to the changing demands of today's dynamic labour market.