

EMU and labour market flexibility

EMU study



HM TREASURY

EXECUTIVE SUMMARY

1 Labour market flexibility describes how labour markets function. A flexible and efficient labour market implies higher employment, and so an economy that is fairer (in terms of, for example, reducing social exclusion), as well as more competitive and more productive. It also implies an economy that is better able to adapt to the changing economic environment.

2 Labour market flexibility is a central element in determining the overall performance of the UK economy, irrespective of whether the UK decides to join Economic and Monetary Union (EMU).

3 However, a low level of flexibility could be more costly within EMU than outside it, since neither an independent monetary policy nor the sterling-euro exchange rate could be adjustment mechanisms in the face of economic shocks. Recognising this, an appraisal of labour market performance was a central element of the Treasury's 1997 assessment of the five economic tests. That assessment concluded:

“In the UK, persistent long-term unemployment, lack of skills and in some areas insufficient competition indicates insufficient flexibility to adapt to change and to meet the new challenges of adjustment that a single currency would bring”. (HM Treasury, 1997, page 24.)

4 This study returns to the issue, building on and expanding the analysis undertaken in the 1997 assessment. It analyses the flexibility of the UK labour market and also flexibility in existing euro area economies, particularly developments since 1997. It does not, however, attempt to judge whether the level of labour market flexibility is sufficient for the UK to adjust to changes in the economic environment within the constraints of a monetary union. This issue is considered in the assessment of the flexibility test – the second of the Government's five economic tests for EMU entry.

Concepts of labour market flexibility

5 Although labour market flexibility has been discussed widely, it has been defined in a number of different ways. This study identifies two related concepts of labour market flexibility. The first relates to how the labour market adjusts to a period of disequilibrium. This is achieved through a combination of adjustments in wages, the supply of labour and the demand for labour. In this interpretation, flexibility is characterised by the rapid redeployment of labour between industries, occupations or regions, ensuring that any disturbance to the labour market is short-lived.

6 The second concept relates to the institutional factors that determine the structural level of unemployment. In this interpretation, flexibility is characterised by high employment and low structural unemployment rates. The two concepts are related because the long-term unemployed can often find it harder to re-enter employment than those who have been unemployed for short periods. Since slow adjustment tends to raise the level of long-term unemployment, it also tends to raise the level of structural unemployment and may lead some workers to withdraw from the labour market altogether.

7 With this in mind, the analysis in this study uses a new framework that considers the **characteristics, outcomes** and **institutional environment** of the labour market. This framework provides a rounded analysis of labour market performance and its determinants, allowing a consideration of current outcomes alongside indicators of likely future performance, i.e. whether current outcomes are likely to be sustained.

**Characteristics
of flexible labour
markets**

8 Section 2 discusses the different ways the labour market can adjust – the characteristics of flexible labour markets. It looks at labour market adjustment in general but also identifies the specific forms of adjustment that are most relevant to EMU. It is not necessary for a well-performing labour market to be highly flexible on all of these counts, since high flexibility in one dimension may help to compensate for low flexibility in another. Nonetheless, greater flexibility in each dimension will enable the labour market to operate more effectively and increase its ability to adapt to changing economic conditions.

9 In most markets, price adjustment is an important factor enabling the market to function effectively. The labour market is no exception, with wage levels a major determinant of the supply of and demand for labour. Adjustment in the labour market primarily consists of ensuring a smooth transfer of labour out of contracting industries and into expanding ones. The level of **relative wage flexibility** needs to be sufficiently high to provide the necessary incentives for labour to move.

10 Relative wage flexibility appears to be reasonably high in the UK. While the rate of inflation remains a key benchmark in wage negotiations, there is considerable scope for variations in wage settlements to reflect conditions in individual industries and regions. Wages appear to have adjusted to regional labour market conditions in the UK and the level of responsiveness seems to have increased over time. That said, some institutional factors act to constrain relative wage flexibility, including the prevalence of national wage agreements in certain industries and sectors.

11 Aggregate **real wage flexibility** determines the overall balance of supply and demand in the labour market and is a key substitute for the adjustment roles of the nominal exchange rate and an independent monetary policy. Although conceptually distinct from relative wage flexibility, the two are likely to be closely related, in particular when labour market adjustment requires a reallocation of labour at the sub-national level.

12 In the past, real wage flexibility has appeared relatively weak in the UK, and may have contributed to the high unemployment experienced in the 1980s and early 1990s. But there is emerging evidence that the level of real wage flexibility has improved, including new econometric work undertaken for this study. The fact that unemployment has declined sharply in recent years without igniting inflationary pressures in the labour market suggests that the improvement is genuine. There is also some evidence of greater wage moderation in the euro area.

13 **Nominal wage rigidity** can arise as a particular source of real wage rigidity, relating to the fact that wages are adjusted at set intervals. Wages are generally adjusted annually in the UK, providing scope for a relatively high degree of nominal flexibility. The bonus component of wages has also allowed private sector earnings to adjust in recent years. Downward nominal rigidity could be a particular concern, since employees are naturally resistant to nominal wage cuts, and employers reluctant to impose them. In recent years, RPIX inflation has been close to its target of 2½ per cent a year and average earnings have increased by around 4½ per cent a year, providing considerable scope for movements in real and relative wages even where there is resistance to nominal wage cuts. However, this potential constraint could be more severely tested if the UK were to join EMU since greater nominal wage flexibility may be needed to compensate for the fact that the exchange rate would be fixed.

14 While the analysis suggests there is a high degree of wage flexibility in the UK, this has not been fully tested in recent years, and there has been a relatively more stable macroeconomic environment than in the past. Wage flexibility could be more severely tested if the UK decided to join EMU, where price movements would need to play a greater role in adjustment to shocks.

15 Wage flexibility is not the only adjustment mechanism operating in the labour market. Other characteristics serve to complement wage flexibility, by influencing the degree to which movements in relative or real wages induce changes in labour supply and demand. In particular, adjustment can occur through the reallocation of the workforce, between different employers, different locations or different tasks.

16 **Geographic labour mobility** appears to be relatively low both between and within European economies. This has been cited as evidence that the euro area might have insufficient flexibility to adjust to shocks. However, geographic mobility is an imperfect substitute for monetary policy given the latter's role in responding to shocks that are more cyclical in nature. The importance of geographic mobility as an adjustment mechanism also depends on the level of flexibility in other dimensions. For example, high relative wage flexibility, functional flexibility and employment flexibility may reduce the need for geographic mobility.

17 **Employment flexibility** represents the ability of employers to adapt working patterns to meet the demands of prospective employees, and hence boost the available labour supply. The UK and other parts of Europe score well on this measure. A wide variety of working practices including part-time and flexible working arrangements enable employees to combine employment with other activities and responsibilities.

18 The ability of the labour force to acquire and apply different skills, enabling them to adapt readily to technological change, is described as **functional flexibility**. The 1997 assessment expressed concerns that skill shortages might constrain the ability of the UK to respond to the structural changes and increased competition that EMU might bring. Since 1997, the steady decline in UK unemployment, including long-term unemployment, suggests that functional flexibility has been less of a constraint than the 1997 assessment suggested it might be.

19 However, skill imbalances remain, in particular regarding the low level of intermediate skills in the UK and correspondingly high numbers with low skill levels. There is a modern role for trade unions to play in delivering functional flexibility, especially in the development of skills. Employers, employees and the Government will need to continue to work together to ensure that recent improvements are maintained.

**Outcomes in
flexible labour
markets**

20 The effectiveness of these adjustment mechanisms will be reflected in labour market outcomes, as discussed in Section 3. Labour market performance in the UK was poor during the 1970s and 1980s. Wage pressures in the labour market contributed to the poor inflation performance during the 1970s, while ILO unemployment averaged around 9½ per cent of the labour force between 1981 and 1996. The Treasury's 1997 assessment of the five economic tests noted that the economy was then reaching a critical point in the economic cycle where, in the past, wage inflation would have accelerated, and that it remained too soon to tell whether the performance of the labour market had improved or would revert to past patterns. It concluded that:

“In labour markets particularly, the UK has not yet achieved sufficient flexibility to meet the challenges of EMU membership.” (HM Treasury, 1997, page 7.)

21 The performance of the UK labour market since 1997 shows more concrete signs of improvement. ILO unemployment has fallen further to slightly over 5 per cent of the labour force and the employment rate is close to 75 per cent. Meanwhile wage pressures have remained moderate and consistent with the Government's inflation target and trend productivity growth.

22 This improved performance has carried through to the UK regional level where there has been a reduction in the regional dispersion of unemployment rates, as the labour market has been better able to match the supply of and demand for labour in individual regions. Regional claimant unemployment rates ranged from 2.4 per cent to 12.8 per cent in April 1990, but this range had fallen to 1.7 per cent to 4.7 per cent in December 2002. However, challenges still remain to ensure employment opportunities for all.

23 The 1997 assessment also emphasised the importance of ensuring that specific groups did not become permanently detached from the labour market and, in particular, highlighted the level of long-term unemployment as a key failing of the UK labour market. The level of long-term ILO unemployment has fallen substantially from an annual average of 710,000 in 1997 to 316,000 in October 2002. Moreover, since 1997 there have also been increases in the employment rates of youth workers, older workers and lone parents. However, there remain significant challenges to reduce persistent economic inactivity and repeated periods of worklessness, and to raise levels of employment in the most deprived areas and among people from ethnic minorities.

24 Overall, the evidence on outcomes is consistent with a reduction in the non-accelerating inflation rate of unemployment (NAIRU). Estimates of the structural rate of unemployment in the UK, which abstract from movements in the cycle, have fallen over the 1990s to a level similar to the US, suggesting that there has been a structural improvement in the UK labour market.

25 The 1997 assessment also noted that Europe as a whole needed to create jobs and respond to structural change. Between 1997 and 2001 over 10 million jobs were created in Europe, and unemployment fell by 4 million, albeit from a high starting point. However, performance has been mixed, with falls in the structural unemployment rate more evident in some of the smaller EU Member States. The European employment strategy is now reviewed and coordinated on an annual basis under the Luxembourg Process. This strategy was reinforced at the Lisbon European Council in 2000, when EU leaders agreed a strategy to enable Europe to become *“the most competitive and dynamic knowledge-based economy in the world, capable of sustaining economic growth with more and better jobs and greater social cohesion”*. Labour market reform needs to be pursued with renewed vigour in order to ensure that the objectives of the Lisbon Programme are met and that EMU is a success.

The institutional environment and labour market flexibility

26 The recent improvement in the UK labour market is attributable to a number of institutional and policy factors, which are examined in Section 4. The design of the tax and benefit system is critical to the operation of the labour market, with potential effects on both the demand for and supply of labour. Care needs to be taken to provide an adequate level of social insurance while ensuring that the operation of the tax and benefit system does not erode the incentive to seek work. Since 1997, the Government has implemented a number of reforms to the UK tax and benefit system in order to make work pay, including reforms to income tax, national insurance contributions and the introduction of a system of targeted tax credits. OECD figures show that the UK has replacement rates (the ratio of out-of-work to in-work income) comparable to the US and lower than in many other European countries.

27 Labour market flexibility can be enhanced by active labour market policies, which provide incentives for employers to take on the long-term unemployed, and help the unemployed with their job search and the acquisition of new skills. Since 1997, the Government's New Deal programmes have focused on raising employment rates, especially among groups where employment rates have traditionally been below average. A number of studies have found that these schemes have enhanced participants' ability to find employment and have increased total employment and reduced total unemployment.

28 Well designed employment protection legislation (EPL) offers clear benefits to employees and employers. But badly designed EPL can impose excessive costs on employers and deter them from offering jobs where the returns from creating the job are too low in relation to the expected cost. Where this is the case, EPL acts as a barrier to labour market flexibility. Measuring the impact of EPL on labour market flexibility is not straightforward, and the results need to be interpreted with care. Overall, EPL in the UK is less strict than in many other OECD countries, and more conducive to labour market flexibility.

29 The National Minimum Wage was introduced in 1999 and underpins the Government's tax and benefit reforms. Because the National Minimum Wage sets a floor to wage levels, it is potentially a barrier to labour market flexibility. The Government recognises that there is a trade-off between ensuring that it is sufficiently high to provide employees with an adequate minimum wage guarantee and making sure that it is not so high that it deters employers from offering jobs.

30 The evidence to date suggests that the National Minimum Wage has not compromised the flexibility of the labour market. The UK Government would still be able to determine the level of the National Minimum Wage within EMU and ensure that it was set at a level that provided a fair minimum income from work to recipients, without generating disincentives to job creation.

31 Building on the results of econometric studies of the determinants of labour market performance, this study constructs a new indicator of labour market flexibility that combines a variety of institutional factors in the labour market. This measure suggests that the institutional environment in the UK labour market compares favourably with that in many other countries, and suggests that the improved labour market performance observed in recent years is well founded.

Conclusions 32 The analysis of characteristics, outcomes and the institutional environment contained in this study provides a range of evidence which taken together points to an improvement in the functioning of the UK labour market since 1997. There have been significant falls in the level of overall unemployment, long-term unemployment and the regional dispersion of unemployment. Macroeconomic stability has undoubtedly contributed to these favourable outcomes, but another important element has been that the institutional environment has fostered labour market flexibility.

33 But, despite evidence of improvement in the UK labour market, major challenges remain. More progress is needed to advance the Government's long-term goal of employment opportunities for all; in particular, to reduce persistent inactivity and repeated spells of worklessness. In addition, wage flexibility has not been fully tested in recent years and could be more severely tested if the UK decided to join EMU.

34 Progress across the rest of Europe has been mixed, with more concrete signs of improvement being evident in some of the smaller EU Member States. Progress in the larger EU economies has been slower and starts from a weak position in terms of unemployment and employment levels. Continued progress on structural reform will ensure that all of Europe's labour markets work to their full potential, raising employment and reducing unemployment to the benefit of Europe. Improved labour market flexibility will also enable the existing and prospective euro area members to better reap the potential benefits of EMU.

35 These issues are considered in the assessment of the flexibility test – the second of the Government's five economic tests for EMU entry.