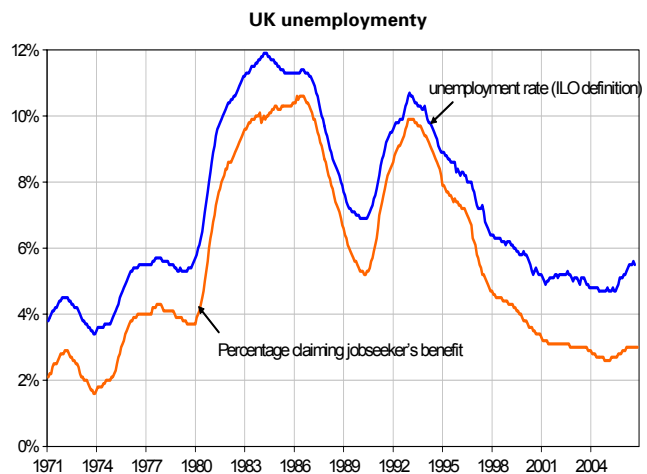




UK labour market performance

- UK unemployment has fallen sharply since it peaked at slightly over 10% in 1993, dropping to 4.7% in mid-2005, its lowest level in 35 years. This fall in unemployment may be viewed as exemplary by comparison with the other large European economies.
- UK labour market performance stands out from that of the eurozone in a number of respects: the decline in unemployment has gone hand in hand with a high level of activities and a steep fall in long-term unemployment; activity and employment rates are high at either end of the age spectrum and among women; finally, wage restraint has been maintained despite historically low unemployment.
- This performance stems from a combination of structural reforms over the past 25 years and special circumstances that have worked to the UK's advantage at certain periods. The structural reforms have deregulated the labour market, brought down employers' social insurance contributions, and introduced policies to encourage jobseekers to return to work rapidly. These reforms have taken effect progressively.
- Other factors have also played their part: the UK economy has grown twice as fast as the continental European countries since the 1990s. Further, there was a massive outflow from the labour market, and no doubt situations of long-term unemployment, resulting from growing recourse to disability benefit mechanisms, between 1993 and 1998. In addition, growth in public sector employment, which has notably resumed since the start of this century, has unquestionably contributed to the fall in unemployment over this period.
- Recent developments suggest a reversal of the trend, however; rising unemployment since mid-2005 could be due to a combination of cyclical and structural factors and could therefore persist in the course of the coming months.

This study was prepared under the authority of the Treasury and Economic Policy General Directorate and does not necessarily reflect the position of the Ministry of the Economy, Finance and Industry.



Source: Office for National Statistics (ONS)

1. UK labour market performance since 1993

1.1 Unemployment has fallen sharply, both in historical terms and relative to the other G7 countries

British unemployment has fallen steeply since it last peaked in 1993 in the wake of a sharp recession. Thereafter it declined from 10% - as defined by the International Labour Organisation (ILO) - in 1993 to 5% in 2001. It then continued to edge down, reaching 4.7% in mid-2005 (Chart 1). This downtrend in unemployment has come together with a fall in long-term unemployment. The trend has affected all age groups, but it has been especially pronounced for men (Chart 2). Unemployment has picked distinctly in recent months, however, rising back up to 5.5% in the third quarter of 2006.

The decline is still more spectacular in terms of the percentage of persons claiming jobseeker's benefit, which by the start of 2005 had fallen to a level close those seen before the first oil shock.

Compared with the other European countries, the UK unemployment rate at the beginning of the 1990s was close to the rates in Italy and France. Today Britain's unemployment is among the lowest in the G7 and the European Union (Chart 3). In addition, UK unemployment rates for the age groups at either end of the spectrum (ages 15-24 and over 55) are the lowest for any of the large European countries. Long-term unemployment is a well below that in the other large European countries (Chart 4).

1.2 The fall in unemployment is due to large-scale job creation

For more than ten years now, the activity rate (i.e. the ratio of economically active population, i.e. those in work and

jobseekers, to total population) has remained fairly stable at a high level in the United Kingdom. During the same period the employment rate, i.e. persons in employment as a percentage of the working-age population, has risen significantly and is now the highest in the G7, according to the OECD. **One feature specific to the UK is that the decline in unemployment stems entirely from the rise in the employment rate** (see Table 1: the population aged between 15 and 64 is the "working-age population").

This inertia in the UK's overall activity rate nevertheless obscures a number of structural changes, in particular a rise in female labour force participation, offsetting the decline in male activity rates. Other effects, such as population ageing and the shift in activity rates for the youngest and oldest sections of the population, could theoretically have had a direct impact on the unemployment rate by modifying the structure of the economically active population. **Yet a simple calculation¹ shows that these structural variations in the economically active population have had only a limited impact on the unemployment rate.** In fact they appear to have contributed only 0.3 percentage point to the 4.7 percentage point fall in UK unemployment recorded between first-quarter 1994 and first-quarter 2006.

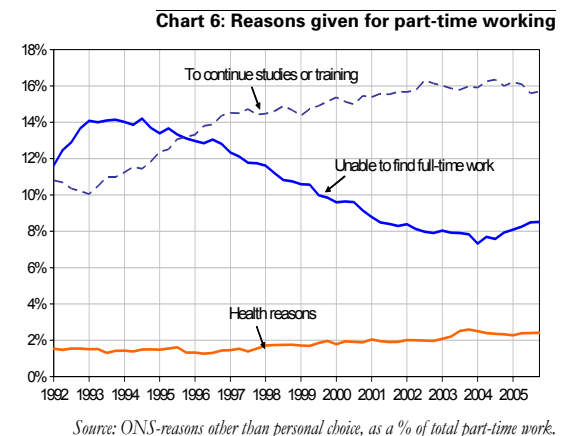
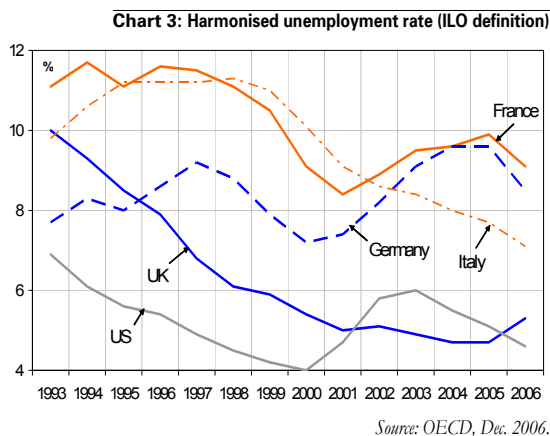
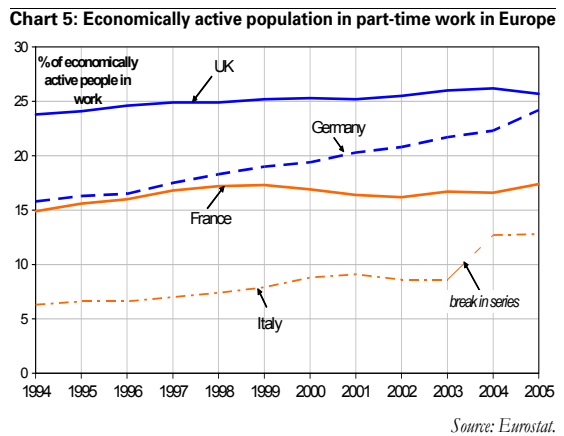
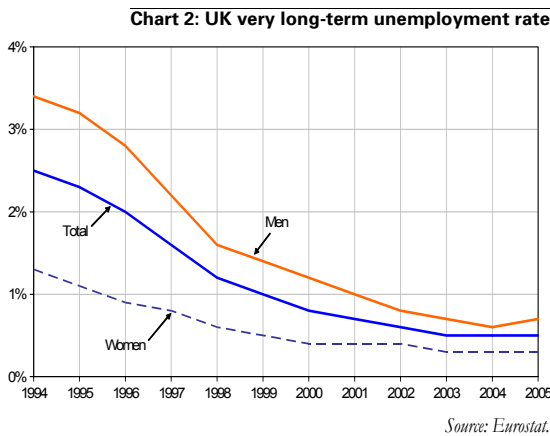
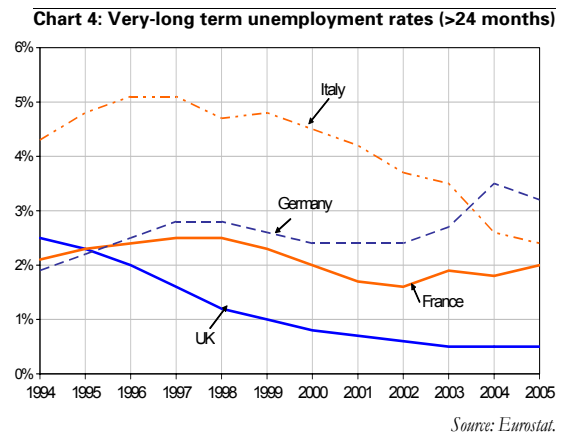
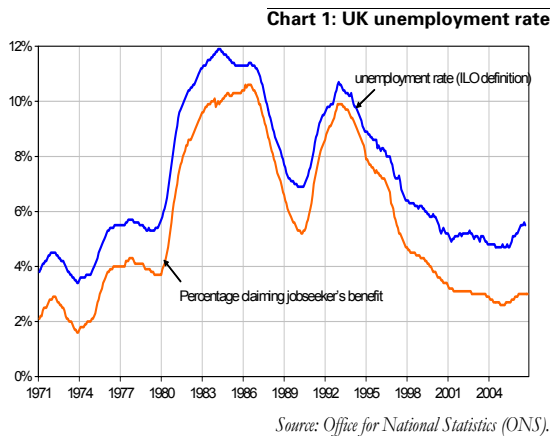
Another peculiarity of the British labour market is that employment rates for the extreme age groups are relatively high. This situation needs to be seen in the context of a pension system that is relatively ungenerous on the whole², and the number of youngsters leaving the educational system prematurely which is high.

Table 1: Activity and employment rates in the G7 countries

	Unemployment rate ^a			Activity rate			Employment rate		
	1994	2001	2006	1994	2001	2006	1994	2001	2006
United Kingdom	9.3	5.0	5.3	76.0	76.1	76.4	68.9	72.3	72.3
Germany	7.3	6.9	8.0	72.9	76.3	78	66.7	70.3	71.8
France	12.4	8.8	9.1	66.6	69.5	68.7	58.4	63.3	62.5
Italy	10.6	9.1	7.1	57.6	60.5	63.2	51.5	55	58.8
Eurozone	14.0	11.0	8.0	66.2	69.9	71.8	56.9	62.2	66.1
Sweden	8.0	4.0	5.3	77.6	78.4	78.4	71.4	75.2	74.3

a. Activity rate: economically active population as a % of the working-age population -Employment rate: economically active people in work as a % of the working-age population. Thus: employment rate=activity rate*(1-unemployment rate). The change in the unemployment rate over a given period can thus be broken down as follows: (change in activity rate-change in employment rate)/activity rate.

- (1) Unemployment rates can be calculated on a "like-for-like" basis: either by applying the unemployment rates observed in 1993 to the different classes of economically active population observed in 1993 and 2006; or by applying to them the unemployment rates observed in 2006. The differences between aggregate unemployment rates calculated in this way and those effectively observed represent the impact on unemployment of changes in the structure of the economically active population between these two dates.
- (2) See on this point the current debate over the need to reform the British pension system (cf. the Turner Commission).



According to Eurostat, in 2004 only 60% of Britons aged 18 were still in education, compared with 77% of Italians, 80% of French youngsters and 85% of Germans³.

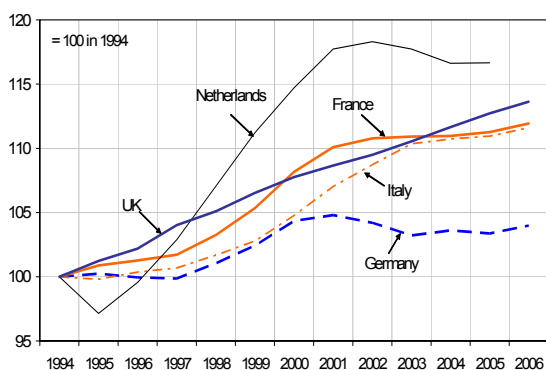
Part-time work was very widespread in the 1990s, but this no longer appears to be growing, even though it surely accounts for the high levels of employment among women and younger age groups in the UK. However, massive recourse to part-time work is not peculiar to the UK. Other countries in Europe (in particular the Netherlands, and more recently Germany) have also

tended to make greater use of this type of employment. In the case of the United Kingdom, it looks (based on studies by the ONS) as if part-time work is less and less an involuntary form of under-employment (see Chart 6).

This analysis needs to be qualified, no doubt, by considering another feature of the UK labour market, namely the wide discrepancy between the number of jobs (nearly 31 million) and the number of economically active people in work (around 29 million). This is accounted for by the high proportion of employees holding down more than one job. Nor is this phenomenon a new one.

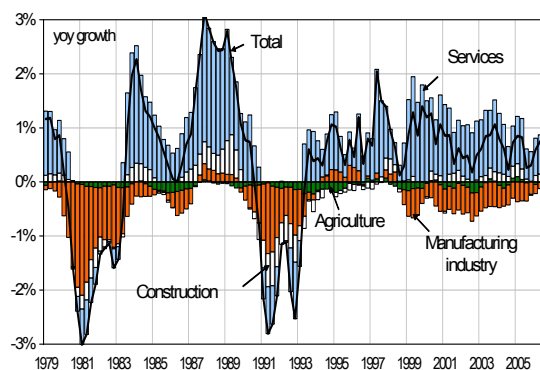
(3) Encouraging young people to remain in education in order to improve their employability and more generally to boost labour productivity is a major theme of the structural reforms now in progress in the United Kingdom.

Chart 7: Number of economically active people in work in Europe



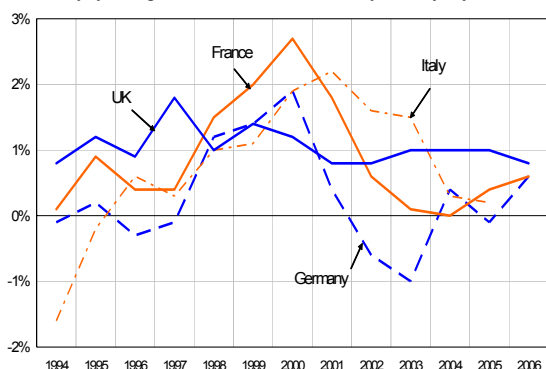
Source: Eurostat.

Chart 9: Contributions to job creation from the different sectors



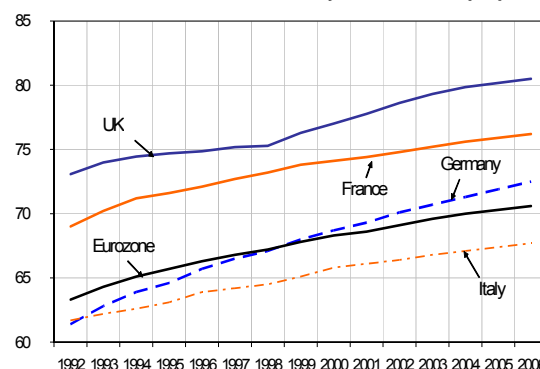
Source: ONS (Labour force survey).

Chart 8: yoy change in number of economically active people in work



Source: Eurostat.

Chart 10: Share of service jobs in total employment



Source: Eurostat et ONS, DGTPE estimate.

1.3 Yet the number of jobs created is comparable to that observed in the other large European countries, and is just as concentrated in the services

In relative terms the growth in jobs (measured by the number of economically active people in work) has been comparable to that of the eurozone in the course of the period 1994-2005. However, UK job creation has slightly outpaced the figures recorded in France and Italy, and above all in Germany, where total employment has trended downwards since 2001. Moreover job creation has been relatively stable over time. This trend probably needs to be seen against the background of more regular and vigorous growth in activity in the UK. In the 4th quarter of 2006 the UK recorded its 58th consecutive quarter of real GDP growth, with an average of 0.7% per quarter over the period.

Most of the job creation in recent years has taken place in the service sector. Manufacturing has been losing ground since 1980, leading to a net destruction of jobs: 1.2 million manufacturing jobs were lost in the United Kingdom between first-quarter 1998 and first-quarter 2006. Nor is this trend specific to the United Kingdom, since it has occurred in most of the large European countries. However, the share of services in total

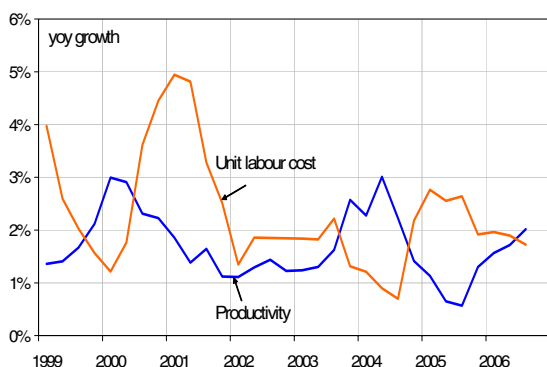
employment in the UK is a good deal higher than elsewhere in Europe due to its productive specialisation (with many jobs in the banking and financial sectors in the UK). More recently the construction industry has been a net creator of jobs thanks to the boom in the real estate market.

1.4 The fact that real wages have not accelerated reflects a pronounced decline in the equilibrium unemployment rate

According to the ONS, there has been no rise in the job vacancy rate in the UK in recent years. The reverse would have been a sign of labour shortages and a situation of "full employment".

Inflation was low in the UK in the period 1997-2000, during which sterling appreciated sharply. British households' purchasing power benefited in the form of imported disinflation. It presumably helped to abate wage demands at a time of dwindling unemployment. Thereafter, as unemployment fell more slowly and inflation remained subdued, wage rises tended to stabilise around 4% annually in nominal terms and around 2% in real terms.

Chart 11: Wage costs and productivity



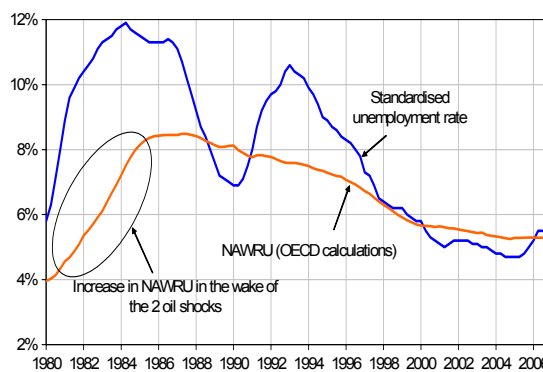
Source: ONS, DGTPE calculations.

This rise in nominal and real wages corresponds to a rise of around 2% in unit wage costs. The rise in costs was accompanied by slowing productivity gains (see Chart +11).

Nor have rising oil prices and more generally the increase in inflation in recent years prompted a sharp acceleration in wages, despite the continuing (albeit more marginal) decline in unemployment. The absence of any surge in

real wages in recent years therefore reflects a fall in the "equilibrium unemployment rate" (the unemployment rate beyond which wage and inflationary pressures arise). Several studies⁴ have confirmed this finding. This is also the conclusion to emerge from the calculation made by the OECD in seeking to estimate the rate of unemployment in the UK that would not raise wage and inflationary pressures (i.e. the Non-Accelerating Wages Rate of Unemployment-NAWRU. See Chart 12).

Chart 12: Unemployment rate and NAWRU



Source: OECD Employment outlook.

2. How to account for the UK's performance in jobs and unemployment?

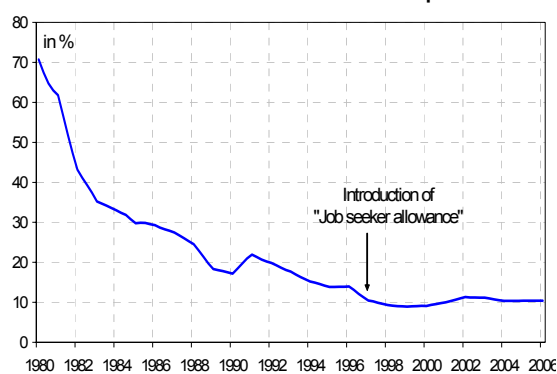
2.1 Part of the explanation lies in the structural reforms undertaken since the late-1970s

Cuts in employers' social insurance contributions and labour market deregulation may have contributed to this structural shift.

Successive governments from the late-1970s to the mid-1990s undertook sweeping labour market reforms aimed at rolling back mass unemployment. These measures drew their inspiration from so-called "neo-classical" economic theory, which argues that unemployment is the result of labour market rigidities, notably when real wages are too high relative to actual labour market conditions. This formed the theoretical background to the UK labour market reforms. To achieve full employment therefore presupposed pushing down real wages more or less significantly such as to boost demand for labour and the supply of goods (by stimulating profits). The reform sought to deregulate the labour market as far as possible, and to raise incentives to hiring and work (see Appendix).

Thus in the early-1980s the UK witnessed a fall in the rate of income replacement by jobseeker's allowances, which pushed down the "reservation wage" below which employees will not accept work. This therefore constituted a powerful incentive for jobseekers to return to work.

Chart 13: Replacement rate



Source: DGTPE calculations.

NB: Average wage replacement rate by jobseeker allowance for jobseekers claiming benefit.

2.2 "Social measures" and public-sector jobs also helped bring down unemployment

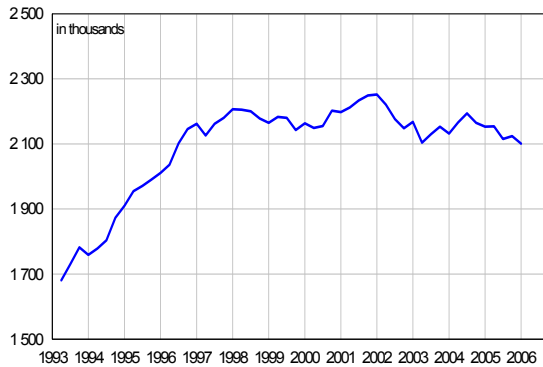
There were massive departures from the labour market and situations of long-term unemployment in the 1990s.

The UK increasingly resorted to disability benefit mechanisms in the 1990s. The number of beneficiaries rose by around 500,000 between 1993 and 1998⁵, with unemployment falling by 1.2 million over the period compared with a net increase in the economically active population of just 200,000. The stock of people aged 16-64 who are economically inactive for health reasons has tended to

(4) According to S. Nickell (former member of the Bank of England Monetary Policy Committee) and G. Quintini, the UK's equilibrium unemployment rate fell from 9.6% of the economically active population in the period 1986-1990 to 5.0% in the period 1997-2000 - in "The recent performance of the UK labour market" - *Oxford Review of Economic Policy*, 2002 vol. 18 No.2.

stabilise since 1998 (at between 2.1 and 2.2 million, or approximately 7% of the economically active population) (see Chart 14). Consequently this mechanism appears to have ceased contributing to the decline in unemployment (and to the activity rate also) since that time.

Chart 14: Persons economically inactive for health reasons (aged 16-64)



Source: ONS.

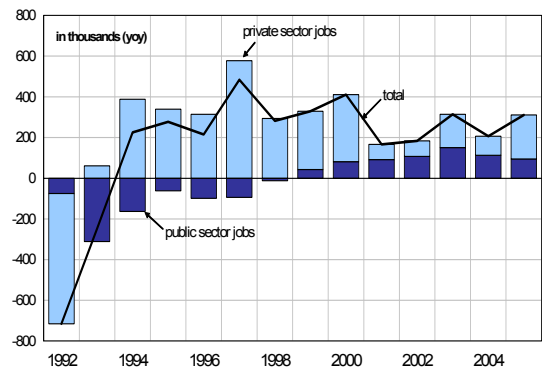
Public-sector employment has picked up since 2000

The impact of public-sector job creation in the period 2001-2005 is not to be overlooked, since it significantly supported the British labour market when economic growth faltered (in 2002).

While, since 1997, New Labour initially continued to pursue a strategy of fiscal consolidation implemented by previous governments⁶, restoring a fiscal surplus by 1998. The Government thereafter embarked on a spending policy aimed at reversing the accumulated shortfall in investment and public services, leading to large-scale hiring in the public sector⁷. During the period 2002-2004 more than one job in two created in the United Kingdom (55%) was in the public sector, with 368,000 public sector jobs out of a total of 675,000 new jobs. This trend is unlikely to persist (see Chart 15 and initial figures for 2006), given the deterioration in the UK public finances

(the general government deficit exceeded 3% for the third straight year in 2005).

Chart 15: Employment trends



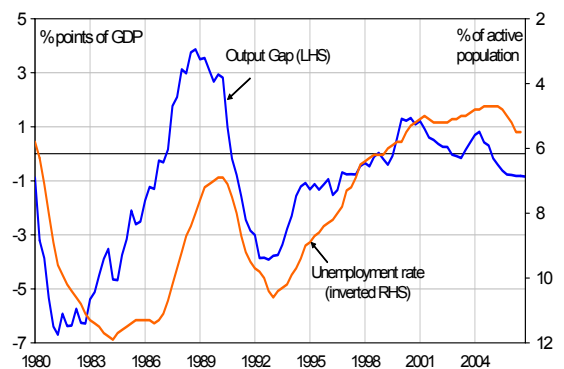
Source: ONS

2.3 The recent rise in unemployment casts a cloud over future prospects

A cyclical phenomenon

The rise in unemployment may stem from the slowdown in activity and the widening output gap. In which case the recent pick-up in growth should help stabilise unemployment in the short term.

Chart 16: Output gap and unemployment rate



Source: OECD

- (5) Cf. B. Bell and J. Smith (2004): "Health, disability insurance and labour force participation", *Bank of England Working Paper No. 218*.
- (6) 800,000 public-sector jobs were cut in the United Kingdom in the period 1992-1997. Then, between 1998 and 2001, 200,000 jobs were created in the civil service, against 1.1 million in the private sector.
- (7) See P. Taillepié (2005): "Évolution de l'emploi public en France et au Royaume-Uni depuis 1980 : éléments de comparaison" (Public-sector employment in France and the United Kingdom since 1980: elements of comparison), *DPAE n°83*.

Tableau 2 : UK minimum hourly wage since its implementation

	Adult rate (salaried workers aged 22 and over)		Development rate (workers aged 18-21)		16-17 year-old rate
April 1999	£3.60		£3.00		
October 2000	£3.70	+2.8%	£3.20	+6.7%	
October 2001	£4.10	+10.8%	£3.50	+9.4%	
October 2002	£4.20	+2.4%	£3.60	+2.9%	
October 2003	£4.50	+7.1%	£3.80	+5.6%	
October 2004	£4.85	+7.8%	£4.10	+7.9%	
October 2005	£5.05	+4.1%	£4.25	+3.7%	£3.00
October 2006	£5.35	+5.9%	£4.45	+4.7%	£3.00

Rising inward migration: cyclical or structural?

The recent rise in unemployment could also be attributable to the growth in "inward" migration into the United Kingdom in recent years. For although the medium-term impact of this immigration adds to the country's growth potential (the Treasury estimates the boost at 0.4 percentage points out of a potential annual growth rate of 2.75% over the coming years), this could have negative impact on the labour market in the short term and lead to a temporary rise in unemployment.

Net inward migration is estimated at around +150,000 per year between 1998 and 2003. It has since risen sharply (+225,00 in 2004, +185,000 in 2005) according to initial ONS estimates, notably due to EU enlargement.

In a recent study, the Department for Work and Pensions found that the UK's decision to allow free access to the British labour market for citizens of the new EU member states added around 135,000 to the total economically active population from 2003 to 2005, compared with a total estimated increase in the economically active population of 225,000 per year on average between 1998 and 2004. The number of Commonwealth citizens entering the country also rose rapidly during the period.

Another consequence for the British economy of these inward flows could be the persistence of wage restraint and the absence of labour shortages in certain sectors of activity.

The impact of certain structural reforms

As the country seeks to restore the public finances and reform its pensions system, social insurance contribu-

tions on wages could rise, which could in turn push up unemployment.

Moreover, in order to roll back the widening inequalities that occurred mainly in the period 1985-1995 (according to the OECD) but which continued into the 2000s, the Government has implemented a series of policies aimed at reducing "poverty traps". Leaving aside targeted aids aimed at helping the long-term jobless and especially vulnerable sections of the population (e.g. young people, lone parents, disabled workers, etc.) back into work, other measures among those introduced could adversely affect the unemployment rate.

In particular the introduction of a minimum wage in 1999, and its recent relatively hefty rises (see Table 2) have pushed up wage costs and could lead to an increase in jobless numbers. An unduly sharp rise in the cost of labour could thus evict certain low-skilled workers from the labour market. However, these aids concern only a relatively small proportion of workers and will thus not make a major impact on the structure of employment. For example, in the UK only 5.1% of the 25 million salaried workers are on the minimum wage. The latest minimum wage rise had no significant impact on the wage rate. Indeed the rise in the minimum wage added a mere 0.1% to the total wage bill, which has been rising by an annual average of 4%. Consequently, despite the array of aids, the distribution of added value between wages and profits remains stable.

Julie ARGOUARC'H, Jean-Marie FOURNIER

Annexe : key labour market reforms in the United Kingdom

From the late-1970s to the early-1990s for the most part, the United Kingdom undertook a structural reform of unprecedented scope of its labour market. In addition to promoting self-employment, temporary work and part-time work, this reform consisted in:

The introduction of hiring incentives

- Working hours are relatively unregulated and, like paid holidays, are governed by the employee's job contract. The UK does not apply the European Working Time directive in full, having maintained an "opt-out" allowing people to work up to 48 hours a week by agreement between employer and employee.
- Wage bargaining has been decentralised as union power has ebbed and since the abolition of the Wage Councils (which until 1985 fixed wages and working hours in sectors of the economy such as shops and catering, etc., where SMEs predominate).
- The cost of labour to the employer is low thanks to cuts in social insurance contributions, with the reduction in employers' and employees' contributions, the elimination of the National Insurance Surcharge in 1985 (which represented around 3.5% of the wage bill) and the raising of employers' contributions thresholds for low-paid workers.
- Dismissal costs are low: employers can dismiss employees at short notice, and employees are entitled to compensation only after two years with the firm.

Incentives to work and to return to work

- Measures have been introduced to reduce the tax wedge (including social insurance contributions) depressing take-home pay, including reductions in social insurance contributions and a sweeping tax reform aimed at cutting tax rates on households.
- Jobseeker's allowance reforms have sought to reduce the duration and scale of jobseekers' allowances with a view to lowering the jobseekers' reservation wage^a.
- A variety of measures comprising a "welfare to work" strategy have sought to "activate" the unemployed. Since 2002, a single window in the form of the Jobcentre Plus established a stricter linkage between payment of the jobseeker allowance and effective efforts to seek work. The New Labour Government has in addition put in place a series of so-called "New Deal" programmes aimed at speeding the return to work for the long-term unemployed and particularly vulnerable sections of the population such as the young, lone parents, disabled workers, etc.^b. Under these programmes each jobseeker is assigned a personal adviser and beneficiaries are required to resume work or training if they have been unemployed beyond a certain period of time.

a. The rules governing entitlement to the jobseeker allowance were changed 32 times between 1978 and 1998. In its present form, the jobseeker's allowance is currently limited to 6 months. This is a means-tested, flat-rate benefit calculated according to the jobseeker's family situation.

b. Details of these programmes are obtainable at http://www.jobcentreplus.gov.uk/JCP/Customers/New_Deal/index.html

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