

THE PERSISTENCE OF UNEMPLOYMENT: LESSONS FROM OVERSEAS EXPERIENCE

In this article, prepared mainly by Andrew Bascand, recent international experiences with persistent unemployment, and its causes, are examined.

Executive Summary

New Zealand's unemployment rate has risen sharply over the past year, but using internationally comparable data, remains lower than the OECD average unemployment rate, and significantly lower than the unemployment rates of many European countries.

During the 1980s several European countries experienced a sharp rise in the number of persons unemployed as a consequence of adverse demand and supply shocks. However, despite renewed growth in aggregate activity unemployment rates in many European countries have remained persistently high.

The protracted nature of European unemployment has been in contrast to the experience of the United States, and economists have recently been attributing high European unemployment rates to structural problems in the labour market. Specifically an important factor that has been identified is the inability of the unemployed to price themselves back into jobs due to a deterioration in the skills of the unemployed, employers' screening practices and a failure of the wage bargaining process to account for unemployed persons.

This article concludes that there is tentative empirical evidence derived from overseas data which supports the introduction of specific policies aimed at alleviating the structural labour market problems that gave rise to hysteresis effects. Further research should be conducted in a New Zealand context to determine the extent of need for similar policies to be pursued here. However, it is clear that a major cause of high unemployment in this country has been a widespread failure of real product wages to adjust in response to the level of unemployment, which suggests a need for greater representation of the unemployed in the domestic wage determination process.

Unemployment in New Zealand has increased markedly in the past year and now ranks in public opinion surveys as the community's most pressing concern. Even though the internationally comparable official measure of unemployment, also known as the Household Labour Force Survey (HLFS)¹ measure, is considerably lower than the less meaningful registered unemployment measure², the rise in the HLFS unemployment rate in the past year has nevertheless been significant – up 51 per cent in the year to the September quarter 1988, taking the total to 95,500 persons unemployed or 6.1 per cent of the labour force. Although not high by international

standards, this level of unemploy-

ment is a post World War II record for New Zealand.

The rise in New Zealand's unemployment rate has occurred in a period when unemployment rates in other OECD countries have been static or falling and undoubtedly has been related to the restructuring and disinflationary policies presently being implemented in this country. When disinflationary monetary policies were pursued in many other OECD countries during the early 1980s, large increases in unemployment also resulted. Subsequently, unemployment has remained high in some of those countries (most European countries) whilst in others (notably, the United States), unemployment has declined.

This article examines international experiences with unemployment in the 1980s and the reasons that have been advanced for the protracted unemployment which has occurred in some countries. On the basis of this examination, tentative conclusions are drawn about some Government policy actions that can be taken to reduce equilibrium levels of unemployment.

¹ The HLFS measure of unemployment includes all persons in the working-age population (i.e., usually New Zealand residents, non-institutionalised, civilian and aged 15 years and over) who during their survey reference week were without a paid job, were available for work and:

(a) had actively sought work in the past four weeks, or

(b) had a new job to start within four weeks. Actively seeking work refers to a variety of activities including contacting an employer, employment agency or the Department of Labour's employment centre. A person whose only job search during the previous four weeks has been to look at job advertisements in newspapers is not considered to be actively seeking work. For more information on the HLFS unemployment measure, see *The New Zealand Labour Force*, which is published quarterly by the Department of Statistics.

² Registered unemployment is inferior to the HLFS measure of unemployment because registered unemployment is less responsive to changing labour market conditions. This lack of responsiveness results from the inclusion in registration data of out of work people who are not actively seeking employment (indeed, they may not even be seeking employment) or who are not available to start a job immediately. In addition, registration data exclude the following groups of people who are actively seeking permanent employment: the unemployed who choose not to register because they are ineligible for the unemployment benefit (e.g. married women); those not wishing to register on principle; and those who think that they are only likely to be unemployed for a short time. The inclusion of some people who are not actively seeking work or available for it and the exclusion of others who are actively seeking work mean that labour market conditions could improve with little reduction in registered unemployment becoming evident. The fact that registered unemployment in New Zealand is so much higher than HLFS unemployment (9.3 per cent of the labour force in September, compared with an HLFS measure of 6.1 per cent in the September quarter) suggests that there are more people included in the registered statistics who are not actively seeking work or who are unavailable to work than are excluded from these statistics. Indeed, the implication of this divergence is that there are many people registered as unemployed in New Zealand who are not actively seeking work or who are unavailable to start work.

For purposes of international comparison, registered unemployment data are also inferior to the HLFS measure. Registration statistics are rarely comparable across countries and depend on the structure and definitions used in each country, the extent to which persons are accustomed to register and the inducements for them to do so. The HLFS measure, on the other hand, conforms closely to the international standard definitions specified by the International Labour Organisation (ILO) and used in most OECD countries' employment surveys. A more detailed discussion of the merits of alternative measures of unemployment can be found in the December 1987 *Bulletin*, pages 319-324.

International Experiences with Unemployment in the 1980s

Following the adoption of disinflationary monetary policies in many OECD countries in 1979/80, the second OPEC oil price shock in 1979 and, at least in the UK, the implementation of a significant economic restructuring programme, unemployment rose sharply in the OECD area (see table 1). The average standardised OECD unemployment rate rose from 5.1 per cent in 1979 to 8.6 per cent in 1983. The growth in UK unemployment was amongst the most dramatic, with unemployment there increasing from 5.6 per cent in 1979 to 12.5 per cent in 1983. New Zealand also experienced a large increase in unemployment at that time although, unfortunately, an absence of internationally comparable (i.e. HLFS) unemployment statistics prior to 1986 prevents direct comparisons.

The unemployment experiences of OECD countries differed markedly during these years. In general, EEC countries fared badly, most other OECD countries had a more moderate but still significant rise in unemployment, while in Japan, unemployment barely rose at all.

The differences in unemployment behaviour which emerged during the early 1980s have, in general, since continued. Unemployment in most EEC countries has only declined moderately from a peak in 1983; indeed, French unemployment continued to rise until the second quarter of 1987 and has since changed little. The major exception to this trend is the UK, where unemployment has declined markedly since 1986. In the US and Canada, on the other hand, large reductions in unemployment from the peak 1983 levels have been recorded; US unemployment has fallen from 9.5 per cent in 1983 to 5.4 per cent in the June 1988 quarter, while in Canada, unemployment has fallen from 11.8 per cent to 7.6 per cent over the same period. Japan has continued to experience unemployment

in the 2-3 per cent range since 1983.

Unemployment in most OECD countries is not generally expected to fall in 1989 from current levels. The OECD, for example, forecasts that unemployment will decline in only one OECD country in 1989 – namely, Portugal – and that for the area as a whole, unemployment will be unchanged in 1989.³

If no further reductions in OECD unemployment are in prospect, it may well be that current unemployment rates should be regarded as being equilibrium or non-accelerating inflation rates of unemployment (NAIRUs). Should this outcome eventuate, Europe (including the UK) will have ended up with much higher NAIRUs than it had before the 1980s, while the US will have a NAIRU that has not changed significantly in recent decades.

Factors Determining an Equilibrium (or NAIRU) Level of Unemployment

A country's NAIRU is assumed in traditional economic analysis to be determined by a variety of institutional and social factors. The legal framework within which the labour market operates is an important factor. For instance, compulsory unionism may reduce the ability of unemployed workers to bargain for wage rates at a level which makes it profitable for firms to engage them in employment. Similarly, a national award system, such as New Zealand has, can reduce the ability of employers to negotiate lower wages with their employees at times when business is poor, rather than making them redundant. Legislation relating to the terms on which workers can be made redundant is another factor which may have a significant bearing on a country's NAIRU, with potential high redundancy payments being a factor inducing firms to employ less labour than they may otherwise.

The relationship between the size

of unemployment benefits in relation to unskilled wages may also be a determinant of unemployment. If the benefit-wage replacement ratio⁴ is high, unemployed people will have little incentive to find new jobs. Social attitudes to living off unemployment benefits will also affect NAIRUs.

Another important factor is likely to be the performance of the education system at providing people with the skills that are in demand from employers. If the education system is not equipping people with these skills and unions and/or high benefit-wage replacement ratios prevent real wages from falling to the levels at which the unemployed could be profitably employed with the skills that they in fact have, then a country's NAIRU will be higher than otherwise.

In general, if a country has legal and social welfare frameworks that severely limit downwards real wage flexibility amongst groups of workers, as occurs in New Zealand, any sustained shock which reduces the demand for unskilled or semi-skilled labour in relation to the supply of such labour is likely to increase that country's NAIRU. For example, a decline in the demand for products which use unskilled or semi-skilled labour intensively would reduce demand for such labour and increase the NAIRU. Moreover, the increase in the NAIRU will be worse if the industries that are adversely affected are in different regions of the country from those in which there are new employment opportunities and if the legal and social welfare frameworks reduce incentives for workers to move to where jobs are available. In addition, the effect of an adverse sustained shock on the NAIRU will depend upon the efficiency with which the Labour Department and other employment agencies are able to match vacancies and unemployed persons.

³ See *OECD Economic Outlook*, No. 43, June 1988, page 33.

⁴ The benefit-wage replacement ratio is the ratio of income derivable from benefits for out of work persons relative to the income derivable from working.

Table 1
Selected Standardised Unemployment Rates for OECD Countries¹

	Annual Average Rates								
	1979	1980	1981	1982	1983	1984	1985	1986	1987
UK	5.0	6.4	9.8	11.3	12.5	11.7	11.2	11.2	10.3
Italy	7.6	7.5	7.8	8.4	9.3	9.9	10.1		
France	5.9	6.3	7.4	8.1	8.3	9.7	10.2	10.4	10.6
Spain	8.5	11.2	13.9	15.8	17.2	20.1	21.4	21.0	20.1
Netherlands	5.4	6.0	8.5	11.4	12.0	11.8	10.6	9.9	9.6
Belgium	8.2	8.8	10.8	12.6	12.1	12.1	11.3	11.2	10.9
Germany	3.2	3.0	4.4	6.1	8.0	7.1	7.2	6.5	6.5
Australia	6.2	6.0	5.7	7.1	9.9	8.9	8.2	8.0	8.1
US	5.8	7.0	7.5	9.5	9.5	7.4	7.1	6.9	6.1
Canada	7.4	7.4	7.5	10.9	11.8	11.2	10.4	9.5	8.8
Japan	2.1	2.0	2.2	2.4	2.6	2.7	2.6	2.8	2.8
New Zealand	..	..	..	..	..	..	..	4.0	4.0
EEC	5.7	6.4	8.2	9.5	10.5	10.8	10.9	10.9	10.7
OECD Average	5.1	5.8	6.7	8.1	8.6	8.0	7.8	7.7	7.4

	Seasonally Adjusted Quarterly Rates ²									
	1986				1987				1988	
	I	II	III	IV	I	II	III	IV	I	II
UK	11.1	11.2	11.3	11.2	11.0	10.6	10.0	9.5	9.0	8.6
Italy	10.6	10.9	10.9	..	..	..	..	..	..	..
France	10.1	10.3	10.5	10.5	10.6	10.7	10.6	10.4	10.4	10.3
Spain	21.3	21.1	20.9	20.7	20.7	20.2	20.0	19.6	19.4	19.5
Netherlands	10.2	10.0	9.8	9.7	9.6	9.6	9.4	9.5	9.5	9.5
Belgium	11.2	11.2	11.1	11.2	11.2	11.1	10.9	10.6	10.4	10.6
Germany	6.8	6.5	6.4	6.3	6.4	6.5	6.5	6.5	6.5	6.6
Australia	7.9	7.8	8.2	8.3	8.2	8.2	7.9	7.9	7.5	7.6
US	6.9	7.1	6.9	6.8	6.5	6.2	5.9	5.8	5.6	5.4
Canada	9.6	9.5	9.6	9.4	9.5	9.0	8.7	8.2	7.8	7.6
Japan	2.7	2.8	2.9	2.8	2.9	3.0	2.8	2.7	2.7	2.5
New Zealand ³	4.2	4.1	3.8	3.9	4.1	4.1	3.9	4.1	5.0	5.3
EEC	10.9	10.9	10.9	10.9	10.9	10.8	10.8	10.5	10.5	..
OECD Average	7.7	7.8	7.7	7.7	7.6	7.6	7.3	7.1	7.0	..

Sources: OECD Quarterly Labour Force Statistics
Department of Statistics Household Labour Force Statistics.

¹ Averages of quarterly or monthly figures.

² Averages of monthly figures or specific month of each quarter.

³ Unseasonally adjusted as series is too short to estimate seasonal factors.

When disinflationary monetary policies were embarked upon in the early 1980s, it was not generally thought that anything had been done to alter countries' NAIRUs. The rise in unemployment consequent upon the move to disinflationary monetary policy was generally regarded as resulting from unintended increases in real wage rates. The mechanism by which such increases could occur during disin-

flation was well known – due to the monetary authorities' lack of credibility, employers and unions would agree to wage rates on the assumption that inflation would be higher than it in fact turned out to be, resulting in a rise in real wages rates and unemployment. Had this factor alone been operative, unemployment would have declined back to the original NAIRU levels after the inflation objectives had been

achieved and inflation expectations had fallen in line with actual inflation out-turns. Such a reduction in unemployment has occurred in the US but seems unlikely to occur in Europe over the medium-term.

The absence of specific institutional changes in Europe during the 1980s that could account for such large increases in NAIRUs has led many economists to ask whether actual levels of unemployment also

affect NAIRUs. In other words, does the maintenance of a high actual level of unemployment increase a country's NAIRU?

A possible mechanism that would account for this phenomenon is the *hysteresis effect*,⁵ so called because actual unemployment fails to fall back to its original equilibrium value when the cause of the shock passes. The key factors through which the hysteresis effect is hypothesised to operate are the *duration* of unemployment and the *representation* of unemployed persons in the bargaining process.⁶

Duration theories note that the long term unemployed exert much less downward pressure on wages than do the short term unemployed. Several factors are advanced as significant influences, namely:

- that skills atrophy with protracted unemployment to the extent that the productivity of workers falls below the wage which employed persons allow firms to offer;
- that job search intensity of unemployed persons declines as their unemployment period continues. The reduction in job search intensity has been mainly attributed to the unemployed becoming discouraged about their prospects for re-employment. Job search intensity is also thought to depend inversely upon the ease of access to benefits, benefit-wage replacement ratios, and the degree of social acceptability in living off the state; and
- that apart from any atrophy effects, many employers treat protracted unemployment as an adverse signal when considering alternative potential employees and often use the duration of unemployment as an initial screen-

ing device.⁷

In sum, the duration of unemployment is thought to affect the willingness and ability of the unemployed to compete for jobs and hence to exert downward pressure on wage inflation. A key criticism of the duration theory is that the increases in those long-term unemployed may reflect the natural selection of the best workers being re-employed first whilst those with lower productivity remain unemployed. Some commentators have therefore argued that increases in the long term unemployed are due to heterogeneity in the labour force instead of the genuine duration effects outlined above.

With respect to the *representation* of the unemployed in the wage bargaining process, it has been argued that the segmentation of the labour market into 'insiders' (i.e. employed persons) and 'outsiders' (i.e. unemployed persons) can also lead to a ratcheting of unemployment. Because the majority of employees and union officials hold secure jobs and control the wage bargaining process on the labour supply side, they have an inherent preference to bargain for higher wage settlements. As a result, marginal 'outside' employees are prevented from bidding to price themselves back into employment. It is therefore possible that wage growth might continue in the face of high unemployment and, therefore, bring about a rise in the NAIRU.

Policy Responses

At a policy level the hysteresis effect suggests that unemployment rates may remain persistently high following adverse shocks. The theory suggests that policies designed to reduce the actual rate of unemployment would probably reduce the equilibrium/NAIRU unemployment level. It would appear that the most efficient policy response would be to address the problem of long term unemployment and examine ways and means of bringing about the

re-enfranchising of unemployed persons.

Overseas, commentators⁸ have suggested action on two fronts to reduce the hysteresis effect. First, policy initiatives should be geared towards long term unemployment across all age groups. For those at the younger end of the age spectrum, programmes should be geared towards training and enhancing their job search activities. It has also been suggested that for those closer to retirement there should be schemes available for retraining, to encourage employers to take on older workers, and that opportunities for early retirement should be available. The important factor is that labour market assistance measures should strike at the heart of the problem; i.e. the discouraged worker effect and the perceived lower productivity of the long term unemployed.

Secondly, wage bargaining procedures should also be altered to incorporate the influence of the unemployed. Specifically, it is clear that a reduction in skills and job search intensity due to long-term unemployment do not sufficiently explain why hysteresis exists in unemployment rates. It is also necessary to have a failure of real wages to adjust downwards reflecting the loss in worker productivity. Therefore policies which can effectively enhance the flexibility of employers and prospective employees in setting wages are required. In the absence of enhanced wage flexibility, a second best solution that has been suggested is to adopt an incomes policy to bring about a reduction in real product wages at times of high unemployment.

Implications for New Zealand

Although the hysteresis effect provides a plausible explanation of the broad trends in unemployment

⁵ In a general sense, 'hysteresis' refers to the failure of a property that has been changed by exogenous factors to return to its original position after the cause of the change has been removed.

⁶ Aside from the duration and representation influences, the hysteresis effect could also be brought about by the prolonged unemployment of physical resources or the premature scrapping of equipment as a result of adverse shocks.

⁷ See for instance Totsch (1988).

⁸ Pissarides (1988), Layard (1987), and Blanchard and Summers (1986a).

among some countries during the 1980s, the theories are still in their infancy. Prior to more general acceptance of the policy implications, the framework outlined above needs further expansion, particularly focusing on developing testable hypotheses at a disaggregated level which examine job search behaviour and wage bargaining procedures.

Tentative and preliminary empirical work conducted to date on UK data suggests that increases in the proportion of long-term unemployed "strongly attenuate the downward pressure on wages exerted by any given level of unemployment".⁹ Moreover, a cross country analysis¹⁰ confirms this result for most European countries, while rejecting the significance of hysteresis in the US and Japan. There is also weak evidence which supports the notion that the persistence of unemployment can be exacerbated by insider-outsider dynamics.¹¹

Clearly, from a local perspective, direct empirical research is necessary to establish the theory's relevance for New Zealand. A cursory examination of the data suggests, however, that some similarities exist between past and present UK labour market experiences and recent New Zealand developments. In particular, a breakdown of New Zealand's official unemployment statistics by age and duration highlights a rise in the proportion of those aged between 20 and 34 out of work for longer than six months (see table 2).

As a proportion of total unemployment, those out of work for longer than six months constituted almost 30 per cent of total unemployment in the June quarter 1988. This level compares with proportions below 20 per cent in the previous two June quarters. However, although there has been a rise in the proportion of those persons unemployed long term in New Zealand,

Table 2
HLFS Official Long-Term Unemployed by Age Group
(Unemployed for longer than six months)
(000s)

Age Group (Years)	June 1986	June 1987	June 1988
15-19	3.6	3.3	5.1
20-34	4.1	4.8	11.5
35-49	2.3	2.6	5.0
50+	1.9	1.9	2.4
TOTAL	11.9	12.6	24.0

Age Group (Years)	(% of unemployment within age groups)		
	June 1986	June 1987	June 1988
15-19	16	17	22
20-34	16	16	30
35-49	20	23	31
50+	38	50	44
Proportion of Total Unemployment	18	19	28

Source: Department of Statistics.

land, the proportion is still low compared with that recorded in the United Kingdom at a similar stage in the disinflation process, where the proportion of those unemployed who were out of work for more than six months averaged 55 per cent between 1982-1985.

Moreover, of greater concern for the British authorities was the dramatic rise in those unemployed for more than a year. By 1985 over 40 per cent of those unemployed had been out of work for longer than a year, more than double the proportion in 1981. A further breakdown of New Zealand HLFS data shows that the proportion of persons unemployed for more than a year rose to 11.5 per cent in June 1988, up from only 7 per cent a year earlier.

If hysteresis effects are relevant in a New Zealand context then the recent rise in long term unemployed in New Zealand is cause for concern. However, in comparison to the UK experience, the scale of the problem is currently much smaller. In addition, via the Department of Labour, the New Zealand Government already has in place a number of labour market assistance meas-

ures designed to enhance job search activities and train those persons identified as being at a disadvantage in the labour market. In particular the ACCESS training initiative has a range of targeting factors which include duration measures as priority criteria. In addition, the Job Opportunities Scheme – a partly subsidised employment scheme paying a range of flat subsidies to assist those having difficulty in obtaining or retaining employment – also has provisions which aim to reduce the disadvantage of unemployment atrophy, by giving preference to the long term unemployed.

It is possible to conclude that New Zealand labour market policies already recognise the problems of the long term unemployed. However, the current schemes have not prevented the recent sharp rise in those out of work for more than six months. Moreover, it is clear that real wages have not been constrained to the extent necessary to halt the rising trend in unemployment.¹² This outcome suggests that wage bargaining procedures in New Zealand do not satisfactorily facil-

⁹ Nickell (1987) reprinted in Cross (1988), pg 279.

¹⁰ See Coe (1988).

¹¹ See Blanchard and Summers (1986b).

¹² See Grimes (1988).

itate interaction between 'insiders', 'outsiders' and employers. A failure to address these problems could lead to New Zealand's unemployment rate remaining high.

Conclusions

Although lower than the OECD average, New Zealand's unemployment rate (using the internationally comparable HLFS measure) has increased markedly in the past year and now ranks as a major public concern. Moreover, unemployment in this country is likely to rise still further before levelling off in 1989. The rise in New Zealand's unemployment has occurred in a period where unemployment in

most other countries is static or falling, suggesting that the causes of the increase in unemployment are domestic. Certainly, other OECD countries also experienced large increases in unemployment when reducing their inflation rates in the early 1980s. In addition, New Zealand has had an extensive economic restructuring programme, which has also resulted in many people losing their jobs.

A return to historic NAIRU rates of unemployment following the achievement of inflation objectives occurred in the United States but not in Europe. The hysteresis effect has been advanced as a possible explanation for Europe's unemployment experience during the 1980s. If the

hysteresis effect is in fact operative, it is important that training be given to the long-term unemployed to prevent the atrophy of their skills and that means be found by which unemployed persons can depress real wage rates so as to gain jobs. The New Zealand Government is already active in focussing training on the long-term unemployed but maintains a legislative framework that attenuates the ability of the unemployed to influence real wage rates. Further measures to provide training for the unemployed and to allow the unemployed to exert downward pressure on real wage rates may be necessary if New Zealand is to regain its traditional low levels of unemployment.

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