

Active Labor Market Policies and Measured Unemployment in Europe

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With the unemployment rate in the European Union near 10 per cent and the rate in several EU countries in the double digits, the need to combat unemployment often takes center stage in policy circles throughout the continent. Unfortunately, as with many other policy issues, attempts to address this particular problem focus more on political goals than economic ones.

The European unemployment problem and the Aeuosclerocis@ that plagues so many countries are inextricably linked to the way that European governments treat unemployment. Recent work has shown that heavy handed labor market regulation can have seriously deleterious effects on both a country=s unemployment rate and the duration of unemployment (Bierhanzl and Gwartney, 1999). Furthermore, because of the lengths to which government interventions distort the labor market, the measurement itself of the unemployment rate may be suspect. In many European countries the various training, public sector employment subsidized employment, and early retirement programs that are often lumped together under the heading of Active Labor Market Policies (ALMPs) lead to a significant understatement of the unemployment rate. This is particularly significant, as many European countries, both transitional economies and established economies, have begun to rely more heavily on Active Labor Market Policies in their unemployment strategies.

Active labor market policies

ALMPs are Aactive@ in the sense that they involve participation by both recipients and governmental agencies, and Aare aimed at improving the functioning of the labor market by:

enhancing labor market mobility and adjustment, facilitating the redevelopment of workers to productive activities and, generally, enabling people to seize new job opportunities as they arise (OECD, 1993). This is in contrast to passive policies characterized by simple income transfers. Although passive policies have long been the standard method for providing relief for the unemployed, active policies have increasingly been gaining popularity in Europe.

The support that active policies have received has been given both a political and an economic justification. Economically, there is some theoretical work that shows under certain circumstances active policies could be helpful in moving unemployment workers back into productive jobs. Politically, active policies provide better cover for politicians who wish to appear to be doing something about unemployment, lowering the measured rates so that progress appears to be made.

ALMPs are obviously a response to unemployment. But they can be a cause of unemployment as well. Active policies create the same incentives and have the same effect as such passive policies as unemployment insurance. In as much as active policies reduce the costs associated with unemployment spells, they will likely cause spells to be longer and more frequent. This effect of passive policies is well known as is, in fact, the whole point of having policies like unemployment insurance. Unemployment is made less costly, thereby encouraging efficient search among workers who might otherwise be driven to a quick but inefficient pairing of worker and job.

The significant difference between passive and active policies in this regard is that because of registration requirements, participants in passive policies are generally counted as unemployed, just as if they were searching but not receiving payments. Participants in active policies, however, may or may not be counted as unemployed and may or may not even be counted as in the labor force. Active policies therefore can have a much more profound impact on measured unemployment. In practice, that bias is clearly in the direction of understating the unemployment rate.

Why active policies?

The treatment of Active Labor Market Programs in the literature proceeds along a line that is familiar to most economists. In theory, properly designed ALMPs should, under certain circumstances, be able to reduce unemployment. Evidence on actual results, however, is mixed. This paucity of demonstrable effects on employment is no doubt due to the complexity and variety of programs that are administered throughout Europe. A straightforward theory of unemployment reduction becomes complex and ineffectual in the hands of policymakers and bureaucrats.

The OECD *Employment Outlook* (1993) provided an examination of the macroeconomic and microeconomic impact of expenditures on ALMPs, and finds that on both counts evidence of positive effects from ALMPs is weak. This weak link is emphasized by the variety of studies that have found conflicting evidence of the effects of ALMPs. The OECD chapter even devotes an appendix to casting doubt on the significant negative relationship between active expenditures and the unemployment rate found by Layard, Nickell and Jackman (1991). These mixed results are emphasized again in the OECD's *Job Study* (1994) which reviewed the current trends in ALMP expenditures.

Within a number of OECD publications, a familiar refrain develops. There is little evidence that ALMP expenditures have contributed significantly to achieving the stated goals of reducing unemployment and increasing output. The attention of policy makers, therefore, has been directed to efforts to improve the performance of ALMPs by more precisely targeting individuals' needs, by improving management of the Public Employment Service, and by paying closer attention to the incentives and disincentives that various programs create. Unfortunately, all of these issues have been identified before as stumbling blocks to unemployment policy reform, yet little progress has been made.

An alternative to this technocratic view of labor market policies has arisen in a growing body of work that addresses the political aspects of ALMP expenditures. This public choice view sheds considerable light on the workings of ALMPs and on their likely economic impact. Gilles Saint-Paul (1996), for example,

identifies an obstacle that inhibits the introduction of effective reform of not only active labor market policies, but of labor policy in general; Most economically sound policy reforms are not politically feasible. Conversely, programs with wide political support are often of dubious economic value.

The political nature of ALMPs cannot be ignored. Fortunately, economic analysis is being applied to cut through the policy fog created by the myriad of programs and discern the likely impact of these policies on output, employment, and growth. The implications suggested by this public choice analysis are discussed below.

A Broad@ unemployment

To understand the significance of the distortions in measured unemployment introduced by active labor market policies, it is necessary to take a very broad view and examine the importance of employment itself. Since consumption is the ultimate justification for production, economists are generally careful to distinguish between Aemployment@ and Aproduction.@ There is not necessarily any welfare benefit to an increase in the number of persons employed per se. In other words, it is not strictly true that more employment is always generally beneficial. Enhancements to a country=s ability to produce valuable goods and services, on the other hand, are generally regarded as beneficial because they represent an increase in the quantity and quality of goods available for consumption, and therefore represent a potentially positive contribution to citizens= standard of living.

This is a distinction that is generally lost on politicians, who seem to believe that one job is as good as another, and that the best job is one that is created by said politician=s own employment legislation. Witness the popularity of government make-work programs and public employment as a means of addressing labor market surpluses.¹ This reality makes the problem of active labor

¹This is, of course, the same AFetish of Full Employment@ that Henry Hazlitt (1979) presented in *Economics in One Lesson* as an illustration of a common economic fallacy. Unfortunately it is a fallacy to which many still succumb.

market policies twofold. Not only do these policies result in a mismeasure of unemployment, even when an employed worker is correctly identified, but this employment will not necessarily correlate with increased output and growth.

Even though there is little evidence that ALMPs permanently increase private sector employment, they will influence the measured unemployment rate. Since persons involved in training programs are not looking for work, they are not counted among the unemployed. Persons induced into early retirement are moved out of the labor force. Subsidized private employment and sheltered government employment not only reduce the observed rate of unemployment, they also add to the number counted as employed. Comparisons between the standard unemployment rate and the broad unemployment rate illustrate this point. In addition to persons counted as unemployed, the broad unemployment concept adds the number of working-age persons involved in government training programs, subsidized employment, early retirement, and disability programs. When calculating the broad unemployment rate, the number of persons involved in these programs is added to the number unemployed in the numerator and the number in the labor force in the denominator. The OECD has recently begun using the concept of broad unemployment to illustrate the severity of the unemployment problem in several European countries (OECD 1996c, OECD, 1997a).

For countries with sizeable expenditures on ALMPs, the differences between the standard and broad rates of unemployment are striking. Furthermore, as expenditures on ALMPs have increased since the 1970s, the gap between the broad and standard rate has widened. To a large degree the ALMPs of European countries conceal both the severity of the employment problem and the degree to which the situation has worsened. Progress toward reducing unemployment and enhancing growth in Europe will be impossible until the full scope of the problem is understood, and steps are taken to divest governments of their stranglehold on the labor market.

The unemployment problem in Europe is certainly well known, but is European unemployment even worse than it looks? Comparing the OECD standardized unemployment rates with broad

unemployment rates can give some indication of the extent to which the unemployment problem is understated. While the OECD itself admits that there are some problems with the measure of broad unemployment, it can nevertheless be a useful addition to the economist=s diagnostic tool kit. Some illustrations can show how broad unemployment measures can provide information that may be concealed by standard unemployment rates, employment ratios, or labor force participation rates.

Figure 1 shows a comparison of the broad and narrow unemployment rates for both Belgium and Luxembourg for several years over the past decade. Although the levels differ between countries, it is clear that the broad unemployment rate is from two to five times the standard narrow unemployment rate in all cases. For a country like Belgium, where standardized rates are already high, this puts broad unemployment rates consistently above twenty percent.

This dramatic difference between traditional measures of unemployment and the OECD=s calculation of broad unemployment

Figure 1

is created by the hundreds of thousands of people whose economic standing, as it were, has been changed by the introduction of government programs. This includes people who have been exempted from job search for various reasons, people on special leave, workers participating in government-sponsored early retirement programs, and those who are participating in direct job creation schemes. In Belgium, the number of people in these categories fairly exploded in the late 1970s, going from just one or two percent of the broad labor force up to fifteen percent in 1991 before falling back to the 12 percent range (OECD, 1997a).

While narrow unemployment rates in Luxembourg are low by European standards, examination of the broad unemployment rate in Figure 1 clearly shows that there are substantial numbers of potential workers who have moved out of the labor force. Broad unemployment rose from 11.8 percent to 14.3 percent between 1990 and 1995. In fact, the low narrow unemployment rates (between one and three percent) are in part an artifact of the Luxembourg labor market policies. Dramatic declines in industrial employment over the past two decades have moved large numbers of workers to the disability and early retirement programs. These programs, which do not require job search, have drawn substantial numbers of people out of the labor force who might otherwise be available for work. Luxembourg is below the OECD average for the employment/population ratio with the sharpest difference coming for workers in the 55-64 age group (OECD 1997a).

A similar pattern has emerged in the Netherlands, where the Dutch problem is of a magnitude more like Belgium than Luxembourg. Since the mid-1980s, the narrow unemployment rate has been between six and twelve percent while the broad rate has generally exceeded twenty percent. By 1994, although the standard unemployment rate was only 7.1 percent, the broad rate was 27.1 percent. This difference results in large part from the generous disability program that exists in the Netherlands. Between 1970 and 1990 the working age population increased by about 26 percent while

the number of people participating in the disability program mushroomed by nearly 300 percent. The OECD (1996c) concedes that, A...the disability scheme seems to have been used by both employers and employees as an alternative to employment,@ and estimates that this Ahidden unemployment@ may account for as much as half of the persons on disability.

Figure 2 illustrates the changing composition of broad unemployment in the Netherlands since 1975. It includes both workers in subsidized unemployment, and working age people who are receiving social security benefits and who are not in the labor force. Of course, not all the people who appear in these categories would be in the labor force in the absence of government intervention. Nevertheless, it is clear that the existence of extensive active labor market programs leads to a substantial understatement of labor market slack.

Long term unemployment measures

In addition to the problem that Europe is experiencing with unemployment in general, there is also, in many countries, a problem with long-term unemployment. In 1997 in the European Union 68.2 percent of unemployed persons were unemployed for six months or longer and fully half of unemployed persons were unemployed for over one year (OECD 1998). There is evidence that the actual long-term unemployment problem is even worse than this, because the rate of long-term unemployment is likely to be understated in countries with extensive Active Labor Market Policies. It is important to remember that when workers participate in ALMPs such as job training, subsidized employment, or make-work public employment, they will generally be counted in the labor statistics as employed (or at least Anot in the labor force@). This means that when the program ends, participants are once again qualified to receive other unemployment benefits.

Figure 2

The political appeal of this type of system is obvious, but equally is the substantial distortion that is created in measured long-term unemployment. A worker who cycles back and forth between training or subsidized work programs and traditional unemployment benefits will generate unemployment statistics reflecting several short spells of unemployment. The labor market reality, however, is that this worker represents one long-term period of non-productivity. The very fact that the worker remains unemployed after a spell of training or subsidized work indicates that the time spent in that program did not contribute significantly to that worker's value in the labor market.

Measuring the magnitude of this problem is difficult since it would require tracking of individuals to determine how their time is spent during the intervals between spells of unemployment. Nevertheless, the direction of the bias created in long-term unemployment statistics is clear. It is also clear that the policy using Active Labor Market Policies merely to requalify participants for benefits is a political reality. For example, the OECD (1996a) Economic Surveys 1995-1996 for Denmark points out that ALMPS... have been used to restore benefit rights for unemployed persons, thus giving rise to a number of persons who alternate between benefits and participation in active labor-market programmes. And a few pages later, Active labor market policies... often made little contribution to enhancing the employability of job seekers, as they often served as a vehicle for restoring benefit rights. This is at a time (1990 - 1997) when between 45 and 55 percent of unemployed persons were unemployed six months or longer, and between 27 and 32 percent of unemployed persons were officially out of work one year or longer (OECD 1998). The fact that these numbers are biased *downward* is revealing of the serious problems that exist.

The incentive structure that exists creates what Tito Boeri (1997) has called *policy circles* as individuals move from unemployment compensation programs to a brief stint in a subsidized job (courtesy of ALMPS) and then back onto the unemployment compensation rolls. This phrase gives rise to a vivid, if not encouraging, image: Europe's vast reserve army of

unemployed turning circles as their job creation and economic growth rates turn south.

To a large degree the ALMPS of Denmark, the Netherlands, Belgium, Luxembourg and other European countries (particularly those in the North) conceal both the severity of the employment problem and the degree to which the situation has worsened. This is true for both unemployment in general and for the proportion of unemployment that is long-term. The popularity of ALMPS is understandable. They permit politicians to project the image that they are fighting unemployment, and they may temporarily make the statistics look a little better. But they do little to improve incentives or remove the fundamental obstacles hindering the operation of the labor market. The programs mask the problem of workers who possess few valuable skills, but who might otherwise acquire training and become productive parts of the labor force.

Implications for economic growth

The extent to which a country uses its labor resources productively obviously has a significant impact on that country's growth. The distortions that ALMPS create in measured unemployment statistics means that labor force problems are even worse than they first appear. It is no coincidence that Europe has demonstrated poor rates of employment growth. Between 1985 and 1995 employment growth in the EU averaged 0.4 percent while the United States, without restrictive labor market policies, managed a 1.5 percent employment rate (OECD, 1998).

An additional complication introduced by ALMPS is an amplification of the insider-outsider problem in European labor markets. Gilles Saint-Paul (1996) examines this view and concludes that ALMPS are attractive to policy makers because, they can lower unemployment statistics *without* exerting downward pressure on wages (italics in original). Policies reduce measured unemployment, but since they do not move significant numbers of workers into jobs, there is no increase in labor supply that would ordinarily depress wages. The insider-outsider importance of wages is also noted by Saint-Paul (1998) where he finds that, an inefficient labor market policy is then a way for insiders to prevent the long-term unemployed from underbidding them, which allows them to increase negotiated

wages.@ This is more likely to be true when the unemployed are paid higher benefits (which is certainly the case in Europe). Calmfors and Lang (1995) also note that if ALMPs reduce the cost of unemployment this may lead insiders to push for higher wages. It would be no surprise then, to find that policies that actually raise the level of unemployment are advocated by politically well-organized insiders and supported by policy makers. The ability of the market to efficiently allocate labor resources is diminished, but traditional unemployment numbers fail to capture the loss.

Ultimately, countries with extensive Active Labor Market Policy programs are likely to have measured unemployment rates that provide, at best, a misleading picture of the extent to which labor resources are being used efficiently. If this were only a technical point to be debated by economic statisticians it might be of minor importance. It is given great importance, however, when unemployment and unemployment rates become a driving force behind policy. In this case, understated unemployment will bias policy makers away from potentially efficiency-enhancing policy. And it will give politicians, and ultimately citizens, a false sense of progress, opportunity, and hope.

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