Working Notes

facts and analysis of
social and economic issues

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Rory O'Farrell

Introduction

In 2013, unemployment in Germany, at 5.3 per cent, was at its lowest level since reunification. In the same year, Spain's unemployment rate, 26.4 per cent, was at its highest level since at least the 1960s, before which reliable statistics are more difficult to come by. Austrian unemployment is also low at 4.9 per cent, and though Ireland's nearest neighbour, the UK, has unemployment of 7.6 per cent this is simply on a par with previous recessions, such as during the early to mid 1990s.[1]

Given the different circumstances in different countries, unemployment is not a crisis across all of Europe. However, it can still be regarded as a European crisis. Many of the problems facing countries such as Greece, Spain, and Ireland can be seen in the context of failures in European institutions, most notably in the implementation of a single currency. That said, long-term differences in unemployment can best be explained in terms of the differences between national economies, and though the EU has a role with regard to reducing national unemployment rates, this role is limited.

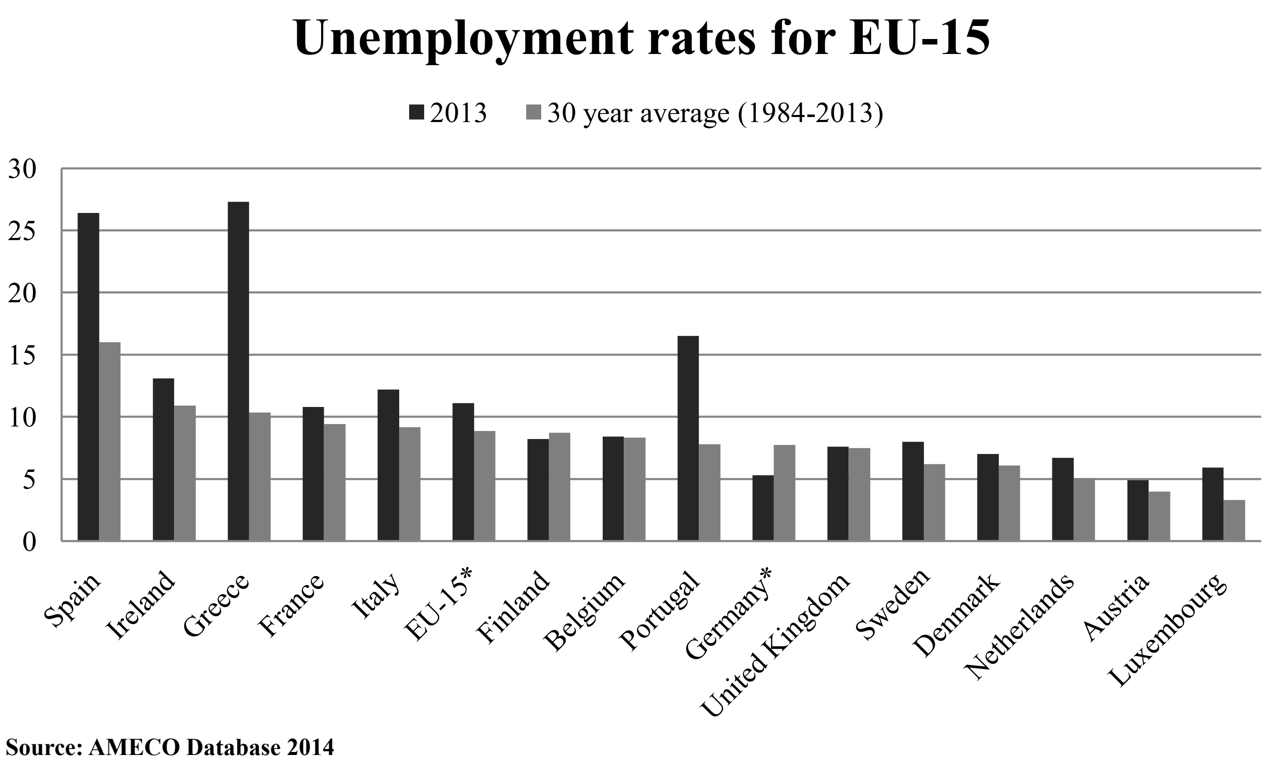
Causes of Unemployment

There are three main sources of unemployment: frictional unemployment; structural unemployment; and cyclical unemployment.

Frictional unemployment exists even during times of economic prosperity and occurs when people are simply 'between jobs'. This form of unemployment exists because workers must take some time to search for jobs and submit applications, and employers take time to advertise jobs and process applications.[2] The solution to such unemployment is largely technological and administrative, improving the efficiency by which workers can be matched with job vacancies.

Structural unemployment is long-term and persistent in nature and requires long-term

Figure 1:



Source: AMECO Database 2014

**Data for West Germany only was used for the period 1984 to 1990.*

**Member States which entered the EU from 2004 are excluded due to lack of data.*

solutions. It can happen when there is a fundamental mismatch between the skills of a worker and the skills sought by employers, such as during a time of deindustrialisation. The decline of industry in areas such as the Ruhr in Germany, or the north of England, led to a persistent increase in unemployment. Solutions to this include retraining workers and attracting new industries into areas of decline by pursuing an active industrial policy.

Cyclical unemployment is more short-term in nature and is the increase in unemployment which occurs during a recession. As an economy recovers, the demand for labour increases and unemployment falls. However, there is no clear distinction as to what is the 'short-term' and what is the 'long-term'. Moreover, if short-term unemployment is allowed to fester it can become structural. Workers who are unemployed for a long period can lose their skills, become depressed, and be less attractive to employers. Therefore, tackling short-term unemployment is an important element in preventing structural unemployment.

Effects of Currency Union

As shown in Figure 1, there are long-term differences in unemployment across the EU, and given that Member States face the same EU institutions it would be unfair to blame the EU for long-run differences across countries. However, the severity of unemployment in some EU countries can be at least partly blamed on a failure of EU institutions, in particular the euro zone.

When a country has a free-floating currency (that is, the currency is not pegged to another currency) its currency tends to depreciate during a recession. This has the effect of making imports more expensive (so residents are more likely to buy domestically-produced goods than the now more expensive imports) and exports become relatively cheaper, boosting the export sector. This has the effect of boosting demand in the economy, mitigating some of the effects of the recession. During the early 1990s the Irish pound was pegged to a basket of other European currencies, but in 1993 the government of the day decided to devalue the currency. This move boosted the Irish economy and was, therefore, at least partially responsible for the subsequent falls in unemployment.[3]

In a currency union, such action is not possible and thus one mechanism for reducing cyclical unemployment is unavailable. In other currency unions (such as the United States) institutional mechanisms are in place to substitute for this. Federal-level social security and other Federal spending programmes transfer money from relatively prosperous regions to those with high unemployment. This money is spent in the local economy, boosting local demand, and mitigating the effects of unemployment. By comparison, the EU budget is a fraction of that of the US, meaning there is no significant method to alleviate the increase in unemployment. In 2014, around €143 billion is budgeted for at an EU level[4] – roughly the equivalent of one-twentieth of the US federal budget.

While EU macroeconomic policy has tended to focus on preventing major imbalances occurring, little has been put in place for when such imbalances do occur. Imbalances are inevitable given the different natures of economies across the EU, and need not be due to the policy failures of a particular government. For example, the current crisis in Ukraine could lead to gas supply issues for countries in Central and Eastern Europe, but would have a far smaller effect on Ireland. EU macroeconomic policies are focused on maintaining the stability of the euro and can help countries to continue to borrow (which offers some help in maintaining demand in a country). However, they offer little that would help mitigate the fall in employment in exchange for the loss of the option of devaluation.

The EU policy-making process aims to achieve consensus, and therefore can be slow. This leads to a focus on long-term policies to boost employment and reduce unemployment. As can be seen from Figure 1, some countries have been more successful than others at keeping unemployment low over the long-term, suggesting there is room for countries to learn from one another. However, policies and institutions to deal with unemployment over the short-term have not been pursued, and the short-term policies that do exist have arguably worsened the unemployment situation.

EU Institutions and Unemployment

There are two EU Directorate Generals (similar to government departments at a national level and overseen by a European Commissioner) which deal with matters related to unemployment: the Directorate General for Economic and Financial Affairs (commonly referred to as ECFIN) and the Directorate General for Employment, Social Affairs and Inclusion (which will be referred to as DG Employment in the remainder of this article).

Until recently, issues related to employment and unemployment were dealt with at a European level by using the 'Open Method of Coordination', which is intergovernmental in nature. This is a form of 'soft law' and so is not binding on governments. This method is based on voluntary coordination of areas that are within the competence of Member States – areas such as employment, training, education, and social protection. The European Council (which is made up of Heads of Government or State from the different Member States) sets objectives and benchmarks countries against one another. The role of DG Employment is largely limited to monitoring what is being achieved by Member States. The European Parliament has almost no role in this area.

Spain's unemployment at hightest level since 1960s © iStock

As a result of the recent economic crisis, DG Economic and Financial Affairs has taken on a greater role in relation to employment. In December 2011, in response to the then serious risk of the euro zone collapsing, a series of new measures, referred to as the 'six pack', was introduced. The aim of these measures is to strengthen economic governance within the EU, including the ability of the EU Commission to impose penalties on Member States which do not keep to EU rules on macroeconomic policy. One element of the 'six pack' is the 'Macroeconomic Imbalance Procedure' (MIP). A total of eleven indicators are included in the MIP Scoreboard. Among these is the average rate of unemployment over the previous three years, with Members States supposed to keep this below a threshold of 10 per cent.

Twenty-six 'auxiliary' indicators are also monitored under the MIP. Five of these relate to employment, including the year-on-year percentage change in employment, the percentage of the population in work or actively seeking work (for ages 15–64), the long-term unemployment rate, the youth unemployment rate, and the proportion of young people not in employment, education, or training. If imbalances persist, the 'Excessive Imbalance Procedure' comes into play, which can lead to fines if a Member State repeatedly fails to take agreed action to correct the imbalances.[5] However, what these policies may be is not predetermined.

EU Employment Policies

Interlinked with the notion of unemployment is that of employment. Unemployment is usually defined as the state of being out of work yet 'available for work' and 'actively seeking work'. Employment is simply having a job. Unemployment can therefore be reduced either by creating jobs, or by creating a situation by which people are not available for work or actively seeking work – for example, by introducing full-time training programmes for those out of work.

In addition, people may not be available for work due to structural reasons. For example, Ireland has a lower average rate of female participation in the labour market than the EU-15 (the 15 Member States of the EU prior to the 2004 enlargement). However, in Ireland female unemployment is lower than male unemployment despite fewer women being in employment, simply because fewer women are available for work or actively seeking work.

It is for such structural reasons that EU policy typically targets employment directly, rather than unemployment.

The broad strokes of EU policies regarding employment are set out in *Europe 2020*, which is the EU's ten-year strategy (adopted in 2010) for economic development and growth. The Strategy aims to increase employment in the EU as a whole to 75 per cent of the working-age population (those aged 20–64). Different targets are set at national level. For example, the target for Ireland is 69 to 71 per cent, due to Ireland being in a relatively weak situation (in 2013, the employment rate in Ireland was 65.5 per cent). Although the guidelines are voluntary, they do have a real impact on how EU funds are spent.

Policies of DG Employment

The three *Europe 2020* initiatives that fall under the remit of DG Employment are 'Youth on the Move'; 'Agenda for new skills and jobs', and the 'European platform against poverty and social exclusion'.

The 'Youth on the Move' initiative helps young people to gain work experience or study abroad so as to improve their chances of finding a job. It also aims to make education and training relevant to the needs of young people and to ease the transition from education to work within countries. The 'Agenda for new skills and jobs' aims to accelerate reforms so as to improve 'flexibility and security' in the labour market, equip people with appropriate skills, and improve the quality of jobs and working conditions. The aim of the 'European platform against poverty' is to increase social and territorial cohesion throughout the EU and specifically to enable the achievement of the headline target of lifting 20 million people out of poverty and social exclusion by 2020.

The 'European Employment Strategy' is developed under the framework of the 'Open Method of Coordination'. Inspired by the overall aims and headline targets of *Europe 2020*, the Employment Strategy is based on the 'Annual Growth Survey' which sets EU priorities for the coming year, in terms of boosting growth and job creation. Of the five priorities for 2014, the fourth priority is 'tackling unemployment and the social consequences of the crisis'. However, it can be argued that this is undermined by the first priority: 'Pursuing differentiated, growth-friendly fiscal consolidation'.[6]

The European Employment Strategy involves several distinct elements. These include the development of **Employment Guidelines** – common priorities and targets for employment policies – which are proposed by the Commission and then adopted by the EU Council. As part of the Annual Growth Survey, a **Joint Employment Report** is published by the Commission (and adopted by the EU Council). This Report is based on assessing the employment situation in the EU, how Employment Guidelines have been implemented, and analysis of the draft **National Reform Programmes** prepared by national governments. The Commission issues **country specific recommendations** based on its assessment of the National Reform Programmes.

Policies of DG Economic and Financial Affairs

It is, however, the policies of DG Economic and Financial Affairs which have been dominant in terms of impact on employment, in particular the effects of policies aimed at strengthening the surveillance mechanisms in the euro zones countries. (Besides the 'six-pack', already referred to, these include two new Regulations, the 'two-pack', which entered into force at the end of May 2013, and which increase EU surveillance of the budgets of euro zone Member States.)

Though the objective of these policies is to prevent imbalances occurring within countries (which can lead to unemployment) they do little to reduce unemployment when it occurs. In contrast to the policies of DG Employment which are largely voluntary, the policies of DG Economic and Financial Affairs are backed by the power to impose fines.

This leverage was even greater over the 'programme countries' (such as Greece, Ireland, and Portugal) that were subject to the programme of the Troika (the European Commission, the European Central Bank and the IMF). The focus of these programmes is clearly on encouraging national governments to repay debts. This focus on 'fiscal discipline' is, however, contradictory in nature, reducing demand and therefore demand in an economy. Suppressing domestic demand has the effect of suppressing prices, wages, and increasing unemployment. Similar to currency devaluation this has the effect of promoting exports; meanwhile, the fall in demand reduces imports. However, instead of money being spent on domestically produced goods it is required to be spent on reducing debt. Therefore, unemployment is viewed more as an inevitable outcome rather than an imbalance that must be overcome.

What Can be Done?

It is somewhat ironic that although the EU institutional framework plays a role in increasing relatively short-term cyclical unemployment, EU employment policy is focused on long-term structural issues. The benchmarking of countries to reduce structural unemployment is useful and should continue. However, cyclical unemployment, which is increased by the relatively new institution of the euro currency, requires a new European policy response.

The single currency is of benefit to economies, helping to promote trade and efficiency. However, it comes with the cost of removing one of the stabilisers that help to reduce unemployment in a recession. Institutions to replace this are required. Effectively, the economies of Member States in the euro zone are operating with one 'invisible hand' tied behind their backs.

Imbalances work both ways; for every deficit there is a surplus. So far, policy has focused on Member States in a current account deficit, rather than on those with a surplus (a current account surplus is the trade surplus – i.e., exports minus imports – less 'current' payments abroad, such as interest payments and the repatriated profits of firms). An example of the way policy is tilted in favour of those with a surplus is the fact that the Macroeconomic Imbalance Procedure Scoreboard allows Member States have a current account surplus of up to 6 per cent, but a deficit of only 4 per cent (averaged over three years).

The Commission states that 'the large current account surplus does not raise risks similar to large deficits'.[7] However, with a free-floating currency such a surplus would be reduced by a currency appreciating in value. Therefore, the emphasis on adjustment is placed on the country that is in a (perhaps only temporary) weaker situation. The Netherlands, for instance, was found to have an excessive current account surplus.[8] Policies such as wage increases would reduce the surplus in countries such as the Netherlands, but also help countries such as Spain reduce their deficit (for example, if Dutch wage earners increased the number of holidays taken in Spain). A reformulation to achieve a more balanced Macroeconomic Imbalance Procedure is required.

Another proposal that can help reduce unemployment across Europe is a recovery and investment plan – a 'Marshall Plan for Europe', as it were.[9] This proposal would involve increasing investment across the EU by 2 per cent of GDP per year over a ten-year period. For example, in 2013 this would be equivalent to around €260 billion, or roughly one and a half times the size of the Irish economy. This initiative (proposed by the European Trade Union Confederation) would have the effect of boosting demand (and so reducing the effects of austerity) in the short-term, and increasing the productivity of the European economy over the long-term. Such investment could also help address some of the differences in productivity between southern and northern Europe, and help reduce trade imbalances.

Finally, and perhaps the most ambitious proposal, would be the introduction of a European unemployment insurance scheme. This idea received some consideration during 2012,[10] but has since been largely dropped. Such a measure would help replace the 'invisible hand' of the market with an 'automatic fiscal stabiliser'. It would mean that when a Member State's unemployment increased it could receive money from a central European fund to finance unemployment payments; this additional funding could serve 'as a complement or partial substitute to national unemployment insurance systems'.[11] This would help maintain demand and employment, mitigating the effects of recession (and making up for the inability to devalue).

Conclusion

Policies regarding unemployment remain largely the competence of national governments. This is appropriate, especially with regard to long-run structural patterns in unemployment, as it is in the interest of national governments to keep unemployment low. Low structural unemployment in one country does not lead to high unemployment in another, so there is no particular need to centralise policy to prevent 'beggar thy neighbour' policies. This is in contrast to other areas of EU policy, such as fisheries, whereby the actions of one Member State (such as over-fishing) can directly harm another. Voluntary benchmarking across states to see which policies best lead to sustainably low unemployment is an appropriate course of action, and is what is being done at present.

However, the current economic crisis has highlighted some of the problems of having a single currency. In particular, the inability to devalue can lead to a level of unemployment in a recession that is higher than would otherwise be the case. Rather than mitigate this, current macroeconomic policies (with their focus on austerity) are magnifying the effects of recession. National governments are caught in a vice created by an inability to devalue their currency and EU policies leading to greater austerity. In order for the euro to remain socially as well as economically sustainable, policies are required that can stabilise unemployment in countries facing a recession.

At present there are tentative signs of European economic recovery. However, while a future recession is inevitable a future unemployment crisis is not, so long as appropriate policies and institutions are put in place.

Notes

1. European Commission, Directorate-General for Economic and Financial Affairs, *AMECO Database 2014.*
2. See for example: Dale T. Mortensen and Christopher A. Pissarides, 'Job Creation and Job Destruction in the Theory of Unemployment', *The Review of Economic Studies*, Vol. 61, Issue 3, July 1994, pp 397–415.

3. It must be noted that devaluation can have negative effects, particularly for those who spend a large proportion of their income on imports.
4. European Commission, *Multiannual Financial Framework 2014–2020 and EU Budget 2014*, Luxembourg: Publications Office of the European Union, 2013.
5. European Union, 'Regulation (EU) No 1174/2011 of the European Parliament and of the Council of 16 November 2011 on enforcement measures to correct excessive macroeconomic imbalances in the euro area',*Official Journal of the European Union*, L306/8, 23.11.201. (http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32011R1174&from=EN)
6. European Commission, *Annual Growth Survey 2014*, Communication from the Commission, Brussels, 13.11.2013, COM(2013) 800 final. (http://ec.europa.eu/europe2020/pdf/2014/ags2014_en.pdf)
7. European Commission, Directorate-General for Economic and Financial Affairs, *Macroeconomic Imbalances: Netherlands 2014*, Brussels: Directorate-General for Economic and Financial Affairs, European Economy Occasional Papers 185, March 2014.(http://ec.europa.eu/economy_finance/publications/occasional_paper/2014/pdf/ocp185_en.pdf)
8. European Commission, *Alert Mechanism Report 2014*, Report from the Commission to the European Parliament, the Council, the European Central Bank and the European Economic and Social Committee, Brussels 13.11.2013, COM(2013) 790 final.(http://ec.europa.eu/economy_finance/publications/occasional_paper/2014/pdf/ocp185_en.pdf)
9. European Trade Union Confederation, *A New Path for Europe: ETUC Plan for Investment, Sustainable Growth and Quality Jobs*, Adopted at the meeting of the ETUC Executive Committee, 7 November 2013. (http://www.etuc.org/sites/www.etuc.org/files/EN-A-new-path-for-europe_3.pdf)
10. *Towards A Genuine Economic and Monetary Union*, report to the European Council prepared by Herman Van Rompuy, President of the European Council, in coloration with José Manuel Barroso, President of the European Commission, Jean-Claude Juncker, President of the Eurogroup, and Mario Draghi, President of the European Central Bank, 5 December 2012.http://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/en/ec/134069.pdf
11. *Ibid*., p. 11.

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