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## Article

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## An Employer of Last Resort Scheme which Resembles a Free Labour Market

By Ralph S. MUSGRAVE<sup>†</sup>

**Abstract.** The idea that government should act as employer of last resort (ELR) is an old one. That idea is often referred to nowadays as “job guarantee”. Many ELR schemes to date have been confined to the public sector. There is no good reason for that limitation: i.e. the private sector should use ELR labour as well. A second common characteristic of ELR schemes has been that (like the WPA in the US in the 1930s) they involve specially set up projects or schemes as distinct from subsidising temporary employees into work with EXISTING employers. The “existing employer” option is preferable. Once those two common defects in ELR are removed, the result is a system where the unemployed are subsidised into temporary and relatively unproductive jobs with existing employers till better jobs appear. And that in turn is what the unemployed tend to do in a totally free market: a scenario where there are no minimum wage laws and unemployment benefit, and where the unemployed tend to get temporary low paid jobs in both public and private sectors pending the appearance of better jobs. In contrast to a free market, under ELR, take home pay is maintained at socially acceptable levels. Assuming that free markets maximise GDP, it follows that the sort of ELR system advocated here will also maximize GDP. That free market style ELR system actually resembles the ELR system that the UK has at the time of writing, namely the Work Programme. The latter “free market” / Work Programme system is not free of faults, but as long as ELR employees do not displace regular employees to too great an extent, that “free market” ELR system is better than traditional ELR.

**Keywords.** Employer of last resort, Job guarantee, Work project administration.

**JEL.** J60, J63, J64, J68.

### 1. Introduction

A large number of different schemes have been implemented in the developed world in recent decades under which government acts as employer of last resort (ELR). The sheer number of different schemes indicates a lack of agreement on the logic behind them. Hopefully this paper sorts out some of the logic and false logic.

The usual argument behind ELR is that there are a near infinite number of useful jobs to be done and that government could have the unemployed do those jobs. That idea is as old as the stars. Pericles implemented the idea in Ancient Greece around 2,600 years ago (see [Garraty, 1975](#): 4<sup>th</sup> para, Ch2). The work houses in Europe and North America in the 17th to 19th century were based on this sort of idea. And the “Work Project Administration” (WPA) and similar schemes in the US in the 1930s were similar in nature. The more active advocates of this idea in the last decade or two include Mosler ([1997](#)), Mitchell ([2001](#); [1998](#)) and Wray ([1998](#); [1999](#)).

The traditional ELR idea normally consists of two basic elements. The first is that the work concerned is public sector in nature (e.g. weeding flower beds in a

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public park) rather than private/commercial sector. The second is that these schemes are separate from existing or regular employers (public and private). That is, these schemes consist of specially set up projects employing only or mainly ELR people. Both of those two basic elements are shown to be flawed in the paragraphs below.

Once those two flaws are removed, ELR turns into a system where the unemployed are subsidised into short term jobs with existing employers, public and private.

## **2. The Flaws in Traditional ELR - Special Projects.**

The alternative to subsidising the unemployed into to work in the latter sort of special projects is to subsidise them into work with EXISTING employers (public and/or private). The “existing employer” option is arguably better for the following reasons.

ELR employees are bound to be similar if not identical to the unemployed: relatively unskilled. Obviously there are some skills among the unemployed, but finding the right skill at the right time at the right place can be difficult for employers, especially when unemployment is low.

Also those doing ELR work will turn over far more quickly than employees working for normal or regular employers. Indeed, assuming ELR employees search for normal employment with the same effort as when unemployed, then these employees will turn over at much the same rate as the unemployed.

Unless the work concerned is going to be disastrously inefficient, unskilled employees (especially rapidly turning over unskilled employees) need permanent skilled supervisory labour - and other factors of production: materials and equipment.

If ELR employs no other factors of production (OFP), output will be pathetic. If small amounts of OFP are employed, output will still be pathetic. On the other hand if OFP rises to anywhere near the level that obtains with regular employers, private and public, then ELR becomes little different to a regular employer! The distinction between ELR and normal employers then becomes meaningless. The “special project” option is in check mate. (Incidentally, the above theoretical reasons for supposing that output on ELR schemes tends to be low is illustrated by the nickname that the 1930s ELR scheme, the WPA acquired: we piddle around - not that all WPA schemes were disastrously inefficient, and more on that below.)

In short, whatever an ELR project does, it is clearly best for it have the OFP to temporary unskilled labour ratios that obtain with normal employers.

Incidentally, any readers who think that some original 1930s WPA schemes were reasonably efficient, and thus that reincarnations of the idea today, nearly a century later, can be equally efficient, please see Note 1 at the end.

Another incidental point is that having said above that finding skilled labour when unemployment is low is difficult, that means ipso facto that finding skilled labour is relatively easy when unemployment is higher than normal. And from that it might be tempting to argue that ELR in the form of special projects would be justified in those circumstances.

The answer to that is that when unemployment is relatively high, much the best solution to unemployment is a straight rise in demand: that creates more regular or “normal” jobs. I.e. when unemployment is high, ELR is not the best solution to unemployment, though there is no reason ELR cannot be expanded a bit when unemployment is high. Put another way ELR really comes into its own at NAIRU: put yet another way, ELR is a way of reducing NAIRU.

## **3. A diversion relating to NAIRU.**

There is an obvious problem involved in dragging NAIRU into the argument, which is that the whole NAIRU concept has become controversial of late (e.g. see [Farmer, 2013](#)).

Luckily however, one of the main critics of NAIRU, namely Mitchell (2009) himself finds the concept indispensable, and gets round that obvious self-contradiction by using his own term for the concept namely “inflation barrier” (IB). The acronym IB will therefore be used here for the most part instead of NAIRU since it would seem that will keep a large number of people happy.

As to exactly what is meant by IB/NAIRU, the term is used in its conventional sense namely (as intimated above) to refer the level of unemployment at which inflation becomes excessive. As to whether inflation ACCELERATES (which is what the “A” in NAIRU stands for), that is not of any importance for the present discussion. That is, the simple statement that “inflation becomes excessive” will do for the present purposes.

Note that the fact that the human race does not actually know at what level of unemployment inflation becomes excessive is not necessarily important. Reason is that where there are good reasons for thinking some variable does in fact have a specific value, despite the human race not knowing what that value is, it is perfectly legitimate, and in fact common practice in the sciences to write equations or get involved in discussions in which a specific value, like X or Y, is given to that variable. Indeed, the originators of “NAIRU” never claimed that NAIRU had a very precise and knowable value. See Musgrave (2017) and Modigliani (1975) for more on that.

Note also that IB will vary with changes in relevant labour market characteristics, like the efficiency of training, and indeed whether an ELR type scheme is in place. In fact Modigliani pointed out that NAIRU/IB varies with the above sort of changing or variable labour market characteristics.

### 4. The ‘at IB’ assumption.

Given that where unemployment is above IB, the best remedy is to raise demand, rather than rely on ELR, the discussion henceforth is on the basis that unemployment is at IB. But this is not to suggest (to repeat) that ELR type schemes cannot help when unemployment is above IB. Indeed the above trio of authors (Mosler, Mitchell and Wray) advocate using ELR to deal with unemployment even where unemployment is relatively high, i.e. in a recession/above IB.

To put the above paragraph another way, the ideal is to raise demand to deal with ‘above IB unemployment’. But we live in a ‘non-ideal’ world. That is governments cannot raise demand at the flick of a switch and by a precise amount. Moreover, no one knows with any certainty what level of unemployment corresponds to IB. It is thus desirable to have a form of employment that aims to reduce both ‘above IB’ and ‘below IB’ unemployment, and this is exactly what ELR can do.

### 5. Where does OFP come from?

Assuming ELR does employ some OFP, this will include skilled supervisory labour. This labour cannot come from the ranks of the unemployed and for the following reason. If a set of unemployed individuals change from being ‘unemployed jobseekers’ to being ‘permanently employed ELR supervisors’, then aggregate labour supply to the normal or regular jobs market is reduced, which is inflationary (given the above “at IB” assumption). Therefore this skilled supervisory labour must be withdrawn from the regular employed workforce, which is a fatuous move because the net effect would be to create ELR jobs at the expense of regular jobs. Likewise, the ‘non human OFP’ (i.e. materials and equipment) employed alongside ELR labour cannot be obtained simply by placing orders for materials and equipment with the private sector. This is because any extra demands placed on this sector will also be inflationary (given the above “at IB” assumption).

In short, demand stemming from orders for ELR materials and equipment has to displace other demand: it cannot be additional to other demand.

In short, if “special project” ELR is going to have decent amounts of OFP, it has to steal that from existing employers, which is fatuous. Much better to simply subsidise ELR people into work with existing employers which ought to result in an increase in aggregate employment plus a slight reduction in the “OFP over unskilled labour” ratio for those employers.

### 6. The similarities of public and private sectors.

Advocates of ELR normally advocate ELR just in the public sector rather than in the private sector as well. Normally no reasons are given for that idea. But presumably the thinking is that expanding the public sector will not be inflationary because output of the public sector is mostly given away rather than sold, and increasing the output of goods that are given away requires no increase in demand, whereas increasing the output of goods that are sold does require an increase in demand, which is potentially inflationary. Of course the “give away” sector does not coincide PRECISELY with the public sector, but for the purposes of the argument here it will be assumed that those two sectors do in fact coincide.

However, plausible as that “demand / inflation” point might seem, it is actually very questionable, and for reasons which are best illustrated by considering a hypothetical ELR scheme as follows.

ELR systems have numerous variable characteristics: generosity of the wage paid, the degree of coercion used to get people to work on such schemes, etc. The latter can be described as the “workfare” element: the word workfare being used here to refer to a system where the unemployed are faced with a choice along the lines of “do this subsidised ELR job else your unemployment benefit gets reduced”.

The wage paid and degree of coercion are important for the following reason.

If people are simply attracted to ELR work because of the generous wage, that ipso facto reduces the attractions of regular jobs, which in turn reduces aggregate labour supply, which in turn is inflationary (given the above “at IB” assumption). In fact there just has to be some sort of workfare element in ELR schemes (if ELR employment is not to displace regular employment) otherwise there is no way round the latter aggregate labour supply reduction point. The Swedish labour market economist, Calmfors referred to the latter fact that there has to be some element of coercion in ELR as his “iron law of active labour market policy”. Most advocates of ELR, who as already mentioned are not too clued up, are blissfully unaware of Calmfors’s iron law.

At any rate, let’s assume that the wage and workfare element in our hypothetical ELR scheme are such as to avoid the above “aggregate labour supply reduction” effect. Let’s also assume that ELR labour is allocated to both public and private sector employers.

The second assumption behind our hypothetical ELR scheme is that the newly available “cheap labour” is sufficiently attractive for employers that they are induced to expand production solely by employing more of that labour rather than by ordering up more OFP.

Third, and to keep things simple, let’s assume that the ENTIRE wage of ELR employees is paid by the state.

### 7. The inflationary effect of public and private sector ELR.

As far as the public sector goes, no inflation will occur in the above hypothetical situation. The hypothetical ELR scheme gives rise to no extra shortage of labour supply for the regular job market. As to extra demand, there isn't any.

As far as the PRIVATE sector goes, and as regards labour supply goes, the same applies: there is no inflationary effect. As to demand, that has to be increased to enable private sector employers to take on ELR employees, but as per the above assumption, that demand does not spill over into demand for more OFP. Thus there is no inflationary effect.

Of course the above assumptions can be altered. For example we could assume that ELR employees are sufficiently unproductive that employers are in fact induced to order up some more OFP, given an increase in demand. But there is no obvious reason why that should be more of a problem with the private sector than the public sector, so again, there is no obvious reason why private sector ELR should be more inflationary than public sector ELR.

As to whether public sector employers actually do order up more OFP when told to increase output under ELR, that obviously depends on the exact rules governing those employers. But certainly public sector employers, just like private sector employers are under pressure to cut costs, and are given some freedom as to how they achieve that cost cutting. Thus it is a reasonable assumption that when a public sector employer is told that ELR is up and running and that they are expected to increase output, they will at least to some extent increase output by ordering up more OFP if that seems to them the most cost effective way of increasing output.

Incidentally, having said above that demand needs to be increased to create private sector ELR jobs, there might not actually need to be an increase in demand via the normal methods, e.g. an increased deficit. Reason is that if ELR labour is free, that cuts employers' costs, which in turn gives rise to falling prices (or less fast price increases than would otherwise be the case), which in turn means a given number of dollars' worth of demand will be higher in real terms than it otherwise would have been.

The conclusion is that private sector ELR is not necessarily any more inflationary than public sector ELR despite the obvious difference between the two, namely that extra demand is required to get private sector ELR up and running whereas that is not required for public sector ELR.

### **8. Unskilled labour.**

Apart from private sector ELR being not necessarily being more inflationary than public sector ELR, there is a further reason for private sector ELR. This is that the private sector is much better at employing unskilled labour than the public sector, plus people who have had a spell of subsidised employment in the private sector appear to fare better in the following years than those who have had a spell of subsidised employment in the public sector – see Gerfin (2002a; 2002b).

Conclusion: it looks as though ELR labour should be allocated to existing employers public and private. In short, ELR should take the form of a temporary employment subsidy with existing employers, public and private. For that reason, ELR as advocated here will henceforth be referred to as “temporary employment subsidy (TES), while “ELR” will still be used, but in reference to the broad range of ELR type schemes that have been implemented over the last century or so.

### **9. Confining ELR to the public sector can be purely political.**

Of course there are many who think that private sector employers should not benefit from employment subsidies. However that belief is purely political: it has no rational economic basis and for reasons which can be illustrated as follows.

Take two schools which are identical in all respects except that one is public and one is privately owned. The strictly economic effect of letting them employ ELR labour must be the same in each case. Ergo so far as economics goes, which is what we are concerned with here, there is no reason for any sort of preference for the publically owned school. Conclusion: the motive for confining ELR to the public sector is political, not economic.

### **10. ELR imitates a totally free labour market.**

ELR in the form advocated here amounts, to repeat, to a temporary employment subsidy: that is, those concerned are subsidised into short term jobs which only last till those concerned find a regular, i.e. unsubsidised job.



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It is worth noting that TES is similar to what happens in a totally free labour market. Reasons are as follows.

Minimum wage rules, union wage rates and unemployment benefits are not free market phenomena. Or to be more accurate, while PRIVATE unemployment insurance would occur in a totally free market, state sponsored unemployment insurance would not.

And in a totally free labour market (i.e. in the absence of the latter three phenomena) the unemployed would tend to get relatively low paid temporary work on becoming unemployed, instead of doing no work, while engaged in job searching. Indeed, the evidence is that this actually happens: that is, in countries where social provision is weak, the unemployed have a greater tendency to get these temporary low paid jobs than where social provision is strong (Werner, 1998).

Now this should ring a bell. Temporary and relatively unproductive work is more or less what TES is. Put another way, TES more or less IS the free market (as pointed out in Musgrave (1991) with the difference that while in a totally free labour market some of those doing temporary and not desperately productive jobs might get starvation wages, under TES, the state guarantees a socially acceptable take home pay.

And finally, in a totally free and perfectly functioning labour market (a very theoretical construct, of course!) there is almost by definition no unemployment. TES is a movement of a sort towards a perfect labour market, therefore TES ought to reduce unemployment.

It is also worth noting that TES very much resembles the UK's Work Programme. Some readers may be tempted to respond to that by pointing out that the Work Programme has significant problems, high administration costs for example.

The answer to that is that this paper does not argue that TES is on balance worthwhile: the argument is simply that if ELR in some shape or form is worthwhile, then something resembling TES or the Work Programme is the best way to go. Put another way, there are some decent theoretical arguments behind the Work Programme.

TES (plus the Work Programme) also resemble some Swiss ELR schemes in that those Swiss schemes subsidised the unemployed into work with existing employers (see Gerfin, 2002a; 2002b).

### 11. TES acts as a marginal employment subsidy.

Another piece of theory which backs TES is that it acts as a marginal employment subsidy in the following sense.

As unemployment falls it gets increasingly difficult for employers to find suitable labour: that is the output of each succeeding person hired declines as unemployment falls. And that fall, at least in theory, continues till the output of the marginal employee falls to the minimum wage/union wage or similar. At that point, employers are tempted to bid up the price of labour (or give in more easily to union demands) with a view to attracting labour, which of course is inflationary.

However, if the cost to employers of marginal employees can be cut via some sort of subsidy, then clearly aggregate employment will rise, or to be more accurate, IB will fall.

### 12. Fraud and the rules governing TES.

There would be an obvious temptation for employers to try to have some employees who they would have employed anyway subsidised by TES. Various measures would be needed to minimise such abuse.

Some measures are set out below, none of them perfect. However, this imperfection must be set against the defects that exist under the alternative to TES: unemployment benefits. The unemployed while still in receipt of benefits often

work for cash for rogue employers, or to act as entrepreneurs, that is do casual work on their own account.

The necessary anti-fraud measures are simple, at least in principle: a series of rules are required that make employers and TES people behave more or less as they would in a totally free labour market. There are numerous possible rules that would induce something approximating free market behaviour. The following are just a few suggestions.

In a totally free labour market, temporary labour has a habit of disappearing for another job at a more or less random point in time (very roughly, two months after getting the temporary job on average). Thus if a rule of the game is that the time TES employees stay with a given employer is limited to a few months, this would imitate the market.

A possible and more realistic imitation would involve removing TES labour from employers at random moments in time. And another possibility, which would be an even more sophisticated imitation of the free market, would be for public employment agencies to withdraw a TES employee from the current employer where it appeared that some other employer was prepared to bid more for the services or skills of the relevant employee.

An important side effect of withdrawing TES employees from their existing employer after a fixed or random period of time is that this prevents employers putting employees onto the subsidy where the subsidy is not required. If there is one thing employers treasure above all else, it is their most valuable employees. Employers will not put their more valuable employees onto the TES subsidy because that means losing them! In addition, TES employees get relatively low pay, and valuable employees are not normally happy with low pay.

Another obvious fraud would involve an employer putting an employee onto TES until the employee was removed by those running the TES system, and then hiring the employee soon afterwards as a normal employee. However there is an easy counter measure: outlaw such 're-hires' – or make the relevant employer repay a few month's worth of subsidy.

Indeed, this latter rule effectively makes TES work as an introduction subsidy. That is, TES in this mode operates in line with a policy normally adopted by private employment agencies: if the new employee proves their worth, i.e. stays with the relevant firm more than some minimum period of time, then the firm pays the employment agency a fee. In contrast, if the employee is not up to the job, and leaves soon after starting the job, then no fee, or a reduced fee is paid.

In addition to working more or less automatically as an introduction subsidy, it would be easy to make TES work as a redundancy delaying subsidy as well. Just one additional rule is needed along the lines of: "employers can put existing employees onto TES".

Another simple anti fraud measure would be to limit the number of TES people with a given employer to small proportion of the employer's workforce.

In addition to anti fraud measures, the workfare element in any ELR system and the overall size of the system are elements that can be varied. Diminishing returns doubtless applies to ELR systems: the larger the system, the less productive is each employee.

As for the workfare element, that is very much a political question. At one extreme, we could refuse all benefits to anyone not turning up for an ELR type job.

### 13. Training.

One ever popular myth is that training can be incorporated in ELR type schemes. Unfortunately the evidence is that training just doesn't mix well with such schemes. I.e. there may well be an argument for more training, but that is most efficiently done in the normal way: apprenticeships, courses at colleges or universities and so on.



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For evidence on the questionable merits of “ELR associated training”, see Calmfors, (2002); Bogdanor (2004); Bolvig, (2003); and Gerfin (2002a) and (2002b).

Also Booth, (2000) found evidence that those prepared to do temporary jobs fared better in their subsequent employment history than those not prepared to do such jobs. This of course does not support the above ‘TES versus training’ point, but it is evidence that supports temporary work in general (and hence TES).

### 14. Conclusion.

ELR schemes in which the unemployed are subsidised into temporary jobs with existing employers are better than traditional ELR schemes like the WPA where the unemployed were subsidised into work on specially set up projects. A weakness in all ELR schemes is that they tend to steal factors of production other than temporary unskilled labour from the regular (i.e. non-ELR) economy. Assuming that weakness in “existing employer” ELR is no worse than in the case of traditional ELR, then existing employer ELR is preferable to traditional ELR.

### Notes

*Note 1. Some 1930s WPA schemes were efficient, so why are they criticised above?*

Kesselman (1978) cited some evidence that productivity on some 1930s WPA schemes was at least 75 per cent that of comparable private sector employers. This might tempt some readers to conclude that reincarnations of the idea today, nearly a century later could be equally efficient. The flaw in this argument is that in the 1930s unemployment was at catastrophically high levels, a situation where it is easy to find skilled labour. But in that situation, ELR is not the best solution to unemployment: the best solution is a straight rise in demand. I.e. ELR really comes into its own where unemployment is low, i.e. when it is difficult for employers to find specific skills.

*Note 2. Is the fact that a country issues its own currency relevant? No.*

This is a short incidental point, which is that Wray (1998; 1999) claimed that the fact that a country issues its own currency is of relevance to ELR. The argument being roughly along the lines that ELR can always be funded simply by printing more money. Sawyer (2005) criticised and effectively demolished that later argument.

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