Abstract

This paper addresses two questions:

- Can Welfare-to-Work expand employment and
- Has Britain's New Deal for young people actually done so, and have its benefits justified the cost?

There is ample evidence that unemployment (and employment) is affected by how the unemployed are treated. Other things equal, countries that offer unemployment benefits of long duration have more unemployment (and less employment). This is because employment depends on the effective supply of labour. Cross-sectional and time-series evidence is presented.

The British New Deal for Young People is a policy that prevents young people from entering long-term unemployment. To get a crude estimate of its overall effects on the unemployment (and employment) rate of young people, we can take the change in the rate between April 1998 and April 2000 and subtract from it the change in the rate for adults aged 30-49. The estimated effect is then a fall of 70,000 in unemployment - and a rise of 35,000 in employment. This compares with the NIESR's latest estimates of 45,000 and 25,000 respectively.

For illustration we perform a forward-looking social cost-benefit analysis, using figures of 50,000 and 25,000 respectively. The net social benefit per year is estimated at £100 million (this compares with the gross Exchequer cost of about £350 million a year). On any reasonable assumption the policy passes the social cost-benefit test.

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Welfare-to-Work and the New Deal

Richard Layard

Now that we have learned to control inflation, the key macro-economic question has become how to lower the sustainable unemployment rate. Provided this can be done without an equivalent resource cost, this would raise the potential output of the economy.

But how? In Britain welfare-to-work has become the government's most important policy for lowering unemployment and expanding labour supply. But does it work? And what lessons does Britain's experience provide for other countries?

The rationale for welfare-to-work is simple. If you pay people to be inactive, there will be more inactivity. So you should pay them instead for being active – for either working or training to improve their employability.

The evidence for the first proposition is everywhere around us. For example, Europe has a notorious unemployment problem. But if you break down unemployment into short-term (under a year) and long-term, you find that short-term unemployment is almost the same in Europe as in the U.S. – around 4% of the workforce. But in Europe there are another 4% who have been out of work for over a year, compared with almost none in the United States. The most obvious explanation for this is that in the U.S. unemployment benefits run out after 6 months, while in most of Europe they continue for many years or indefinitely.

The position is illustrated in Figure 1. The vertical axis shows how long it is possible to draw unemployment benefit, and the horizontal axis shows how long people are actually unemployed, as measured by the percentage of unemployed who are out of work for over a year. The association is close, and it remains close even when we allow statistically for all other possible factors affecting the duration of unemployment.[1]

This long-term unemployment is a huge economic waste. For people who have been out of work for a long time become very unattractive to employers and easily get excluded from the world of work. So it often happens that employers feel a shortage of labour even when there are many people long-term unemployed, with the result that inflation rises even in the presence of mass unemployment.

Thus a major objective must be to reduce or eliminate the long-term unemployment caused by welfare dependency. There are two possible approaches – "stick" and "carrot". The evidence suggests that much the best approach is a combination of the two. This combined approach is now being used increasingly in Britain, Denmark, the Netherlands and of course in the U.S. for single mothers on welfare. In consequence in these countries there have been dramatic falls in unemployment consistent with a given level of vacancies – which in most other countries continues to rise.

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[1] See S. Nickell and R. Layard in O. Ashenfelter and D. Card, *Handbook of Labour Economics*, Vol 3C, 1998, North Holland. Employment protection is a further factor raising long-term unemployment but the evidence suggests it plays a much smaller role. In some regions of Europe the problem is further exacerbated by wage rigidities (*e.g.* Southern Italy, Southern Spain and East Germany).

Conditionality

In most countries the "stick" is always there in principle, but often little in practise. The rules say you should only draw benefit if you are trying to find work and failing - in other words there is a "work test". But in many countries this is very weakly applied. In Britain for example from 1982-6 people on benefit were not even required to register as job-seekers at job centres. From 1986 however the work test began to be used again and the system in Britain tightened. The benefit offices and job centres were reunited. In 1986 six-monthly Restart interviews began, and since 1990 benefit recipients have been formally expected to be "actively seeking work". Under the Job Seeker's Allowance introduced in 1996, job-seekers can be given explicit directions by their adviser. Failure to comply with the rules can lead to loss of benefit for up to six months.

These changes are part of the reason why unemployment in Britain has been able to fall as it has without inflation rising. In 1989, when unemployment fell to 7%, inflation took off; today unemployment is 5½% but inflation is still level. The unemployed that we have now are more active in job search. So it is easier for employers to fill their vacancies and inflation remains under control.

But the stick has its limitations. We do not want a society in which the unemployed are ground into the dust, cycling from one lousy job to another. And in any case the work test is quite difficult to apply unless you have something positive to offer a person – only then can you tell if he is a real refusenik.

Active Help

These ideas make one focus on the intense need which many unemployed people have for active help to overcome the barriers to employment. The main kinds of "active labour market policies" that can be used are these:

- Job-search assistance, advice and matching to the available vacancies. Good controlled experiments in Sweden show how unemployment has been reduced in areas where the job centres have more staff.

- Training. This has a mixed record but the right education and training can clearly set a person on a new path in life.

- Employment subsidies. These can induce employers to give a chance to hard-to-place workers and thus expand the size of the effective workforce. A good example is the Jobstart programme in Australia.

- Work experience. Where no job can be found with a regular employer, work on publicly-useful projects can help improve people's work habits and give them work records which help in finding regular jobs.

These programmes can help and have been around for a long time, though usually on a small scale. But unless they are universal, they tend to be used by people who already had the best chance of finding work.

Thus the big new idea in Labour's New Deal is this. **We ought to offer everybody on the threshold of long-term unemployment a choice of activity for at least a period. And when that happens we should remove the option of life on benefit.**

Rights and Responsibilities

This is a system of stick and "carrot", based on mutual rights and responsibilities. Everyone has the right to offers but in return they have the responsibility to use them – or at least to stop drawing benefits. Rights and responsibilities is a central philosophy of New Labour and of the New Deal.

But can it work or will it simply help one group at the expense of another? Before giving actual evidence for the New Deal, let me discuss the issue in general terms, given that it is totally fundamental to the philosophy of Welfare-to-Work.

Additionality

Many people doubt whether active labour market measures can work owing to "displacement" and "substitution". In the extreme form, these fears derive from the 'lump-of-labour fallacy' which says that there are only so many jobs. So, if we enable Mr. *X* to get one of them, some other person goes without work.

It is easy to see how this fallacy arises. In the most immediate sense, the proposition is true. If an employer has a vacancy and, due to a job subsidy, Mr. *X* gets it rather than Mrs. *Y*, Mrs. *Y* remains temporarily unemployed. But by definition Mrs. *Y* is inherently employable since she would normally have got the job. If she does not get it, she will look for another one. Employers will find that there are more employable people in the market and that they can more easily fill their vacancies. This increases downwards pressure on wages, making possible a higher level of employment at the same level of inflationary pressure.

But how much more employment? Evidence on substitution and replacement is by its nature difficult to obtain. In the past it has mainly been achieved by asking questions to employers. When a subsidy scheme is evaluated, employers are often asked the following:

1. Of the individuals subsidised, how many would you have hired anyway? ("Deadweight")
2. Of the remaining jobs subsidised how many would have been filled by other recruits in any case? ("Substitution")
3. Of those remaining subsidised jobs which represent an increase in your own employment, how many were at the expense of your competitors? ("Displacement")

The net job creation resulting from the subsidy is then said to be the total number of subsidised jobs minus 1, 2 and 3.

Until recently this procedure has been used almost universally, and often implies that net job creation is only 20% of the total number of jobs subsidised.[2] Yet the estimates of substitution and displacement are based on a theory of the labour market which is never used for any other purpose. The theory being used is that, if somebody would have been employed in one place and that opportunity closes down, then unemployment increases permanently – by that amount. This makes no allowance for the possibility (discussed above) that people who find one channel of employment blocked will find another channel. In the meantime the effective supply of labour has been expanded by including people like Mr. *X*, who were

[2] See for example, J. Stern *et al*, OECD Wage Subsidy Evaluation: Lessons for Workstart, NERA, November 1995.

previously excluded. And changes in the effective supply of labour will then cause equal changes in the non-inflationary level of employment.[3]

That is the fundamental argument for welfare-to-work. Changes in labour supply do indeed cause equal changes in the non-inflationary number of jobs. For example, since 1850 the British labour force has grown by 240% and the number of jobs has grown by, guess what, 240%. Similarly, comparing countries, those where the labour force grows most experience the fastest growth in the number of jobs (see Figure 2). Similarly, if we standardise for population size, countries where participation grows most experience no extra unemployment (see Figure 3). Thus jobs do respond to the effective supply of labour.

But the response is not instantaneous. When labour supply increases, the immediate effect is that, with employment constant, inflationary pressure falls. Following this, demand increases **either** spontaneously through lower prices (which may act slowly) **or** as a result of more expansionary fiscal or monetary policy, which is safe in the new climate of expanded labour supply.

One key step is therefore to prevent the process of exclusion which occurs when people are allowed to drift into long-term unemployment. For this reason in November 1997 the European heads of government adopted as their first two European Guidelines the principles that:

- every unemployed *adult* is offered a new start – in the form of a job, training, retraining, work practice or other employability measure – before reaching twelve months of unemployment

- every unemployed *young* person is given such a new start before reaching six months of unemployment.

The same philosophy inspires Britain's New Deal for Young People under 25 which began in April 1998.

The New Deal for Young People

Under the New Deal youngsters who have been unemployed for 6 months enter a "gateway" of intensive counselling with a personal adviser. This can last for a maximum of 4 months during which they should have been placed into a regular job or have entered one of four high-quality subsidised options, lasting at least 6 months.

- a subsidised job with a regular employer (secured by a 6-month subsidy of £75 a week)
- work experience in the voluntary sector (receiving benefit plus £15 a week)
- work experience in an environmental project (ditto)
- full-time vocational education (receiving benefit)

All the options include training for at least one day a week.

The aim of the scheme is to prevent any young person remaining unemployed beyond the 10th month of unemployment. In other words, the whole annual flow of people past the

[3] For a more formal statement of the argument see R. Layard, "Preventing long-term unemployment: an economic analysis" in D. Snower and G. de la Dehesa (eds) *Unemployment Policy*, Cambridge University Press, 1997.

sixth month (now running at roughly 175,000 per year) have got to be placed. This is the "flow" that will always have to be provided for. But in addition there was in 1998 a "stock" of people who were already unemployed that had to be handled when the policy was first introduced. The initial stock of young people unemployed for over 6 months was 120,000. Thus the task at the beginning was nearly twice as large as it has become later on.

The policy has been well funded by historic standards and the Exchequer cost (including benefits paid to people on options) has been roughly[4]

April 1998 – March 1999	£210 m
April 1999 – March 2000	£320 m

How well has the policy done? Inevitably it is taking time to get the system to work exactly as it should. Too many young people remain in the gateway for over 4 months and too few extra jobs have been mobilised through the job subsidy. These problems are being energetically addressed.

But the overall effect has been striking. The main published analysis of the overall effects of the New Deal is by the National Institute for Economic and Social Research.[5] It finds that by March 2000 the New Deal had reduced unemployment by some 45,000 and increased regular employment by some 25,000. It also concluded that the government recovered in benefit savings and higher tax receipts about 60% of what it spent on the New Deal. For the economy as a whole, benefits exceeded cost.

To get an understanding of what has happened, one can look at Table 1. This shows that from the beginning of the New Deal to April 2000 unemployment of people aged 30-49 fell by 0.6 percentage points. By contrast the unemployment rate of people under 25 fell by 2.2 percentage points. If we assume that the New Deal had no effect on the older age group, this suggests that the New Deal cut youth unemployment by over 1.5 percentage points – or over 50,000 people.[6] If we treat the New Dealers on options (other than the employer option) as unemployed, the corresponding fall in unemployment was less - about 30,000, most of whom are in employment. These figures will be exaggerated if the New Deal raised the unemployment rate of older people.[7] But they broadly confirm the National Institute's findings.

What is really encouraging is that short-term youth unemployment has not increased. Thus many of those who find work earlier than they would otherwise have done appear to have kept it. And those who did not find work directly from their options appear to have done so fairly soon after.

Benefits and Costs

The aim of the New Deal is three-fold. It is first to eliminate the economic waste incurred when thousands of people are producing nothing at considerable expense to the taxpayer. This is a pure efficiency issue. Second, it is to reduce the considerable side-effects which follow from high unemployment – crime, family break-up, drug dependency and the scarring

[4] H.M. Treasury, *Budget 2000*, HC 346, p. 72.

[5] R. Anderson, R. Riley and G. Young, "The New Deal for Young People: Implications for Employment and the Public Finances", Employment Service, *Research & Development Report*, ESR No 62.

[6] At the same point in the previous cycle (July 1989 – July 1990) youth and adult unemployment fell by the same 0.3 percentage points.

[7] The evidence works against this, since the New Deal is most likely to have damaged the 25-29 year old group and their unemployment fell by 1.1 percentage points.

effects of unemployment upon people's subsequent productivity and employment. But, third, there is the issue of social justice, when people who have little get a chance, even if it involves some cost to people better off than them.

A full analysis of costs and benefits would involve all three aspects. And, to be adequate, it would await the accumulation of more evidence on the New Deal's effects. But it is interesting to do some back-of-the-envelope calculations to check that the results do indeed justify the substantial public outlay. The calculations are in a Note at the end, and cover only the simple efficiency effects. They strongly confirm how worthwhile the policy is.

New Deals for Other Groups

There is therefore every reason to press ahead with a New Deal for over 25s that includes the same principles – a gateway for all those who reach a certain length of unemployment, followed by a mandatory period of activity if people have not already found a job. Gordon Brown has announced that such a New Deal will be introduced from April 2001.

But there are other groups too for whom the Welfare-to-Work approach is highly relevant – given the distortionary incentives set up by state subsidisation of inactivity. We have at present some 4 million adults of working age who are economically inactive and living on state benefits. These include about 1 million single parents with children under the age of 16, and 3 million people with long-term health problems. Many in each group would be better off if they were working, and in future any new person claiming these benefits will have to claim at a single "work-focused" service known as the One service, where the possibilities of work will be discussed in a rigorous way. This will include a thorough discussion of the total income that a person could hope to earn in work, and of what childcare if any they could get.

The drive against unemployment and inactivity is central to the drive against child poverty in Britain. In Britain, heads of households are almost as likely to be unemployed as anyone else, and on top of this there are the 1 million single parents who are inactive or working only short hours. Thus altogether one fifth of all Britain's children live in households in which no one is working. It is a major government objective to reduce this.

Conclusions

Thus the Welfare-to-Work approach has the potential to make our society significantly more efficient and more fair – by mobilising many of those who are currently not working but living on state benefits. It will expand employment and transform the lives of millions, by making them self-sustaining rather than dependent – a hand-up not a hand-out. But it requires extreme sensitivity. The help must be of really high quality and the spirit of the policy must be visibly in the clients' interest. The New Deal has been an extraordinary success from that angle – with very high levels of client satisfaction. It is a good example for other countries to follow. But each future step must be as sensitive as the last.

NOTE

Cost-Benefit Analysis of the New Deal

In this illustrative analysis, we shall assume that the New Deal for Young People has reduced claimant unemployment by 50,000 and increased regular employment by 25,000. This result has been caused by money spent on the flow of unemployed people past the 6-month threshold **plus** money spent on the stock of people already unemployed for over 6 months. However, looking to the future, the stock has now been largely eliminated, so in future money will only have to be spent on the flow. Thus in our forward-looking cost-benefit analysis we can safely assume that the above reduction in unemployment could be sustained by proper help given to the flow.

To compute the associated benefits and costs we can assume that young people in employment produce an amount equal to the corresponding wage (say £8,000 a year). Thus one clear social benefit is the net change in employment (25,000) times £8,000 per year. Other benefits are (a) the gross output of the voluntary and environmental options and (b) the value of training obtained through the full-time education and training option (to which we return shortly). Turning to the real direct social cost, there is no time cost of participants to be included since we have counted as a benefit the **net** change in employment, after allowing for any participation in the New Deal of people who might otherwise be employed ("deadweight"). So the social costs of the New Deal are:

(i) the inputs into the voluntary and environmental option
(ii) the inputs into full-time education and training, and
(iii) the (mainly administrative) costs of the gateway

We shall assume that (i) is offset by the value of the output of these options, and (ii) is offset by the present value of the training received. This leaves as costs in our calculation the social cost of the gateway, plus the excess burden of any Net Exchequer Cost of the New Deal.

The Net Exchequer Cost for an unemployed flow of roughly the present size is as follows:

		£m
Gross cost	175,000 flow p.a. x £2,000	350
- Benefit and tax saving	50,000 stock x £3,500	-175
Net Exchequer Cost		175

Reverting to the social cost-benefit calculus, the net efficiency gain is the output gain from jobs **minus** the real cost of the gateway **minus** the excess burden of the Net Exchequer Cost. Taking the excess burden for £1 of tax revenue as £0.3, this gives the net social benefit per year as:

		£m
Extra output from jobs	25,000 stock x £8,000	200
- Cost of gateway	175,000 flow x £300	-50
- 0.3 x Net Exchequer Cost		-50
Net Social Benefit		100

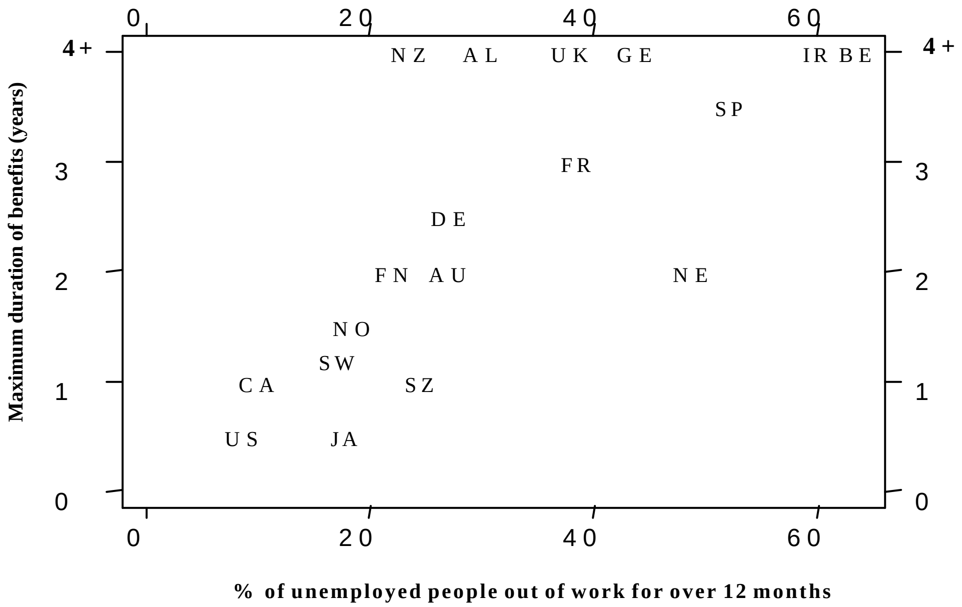
This puts no value on any benefits like reduced crime, teenage pregnancy, and so on, nor on the fact that those who benefit are mainly poor and excluded, while those who pay are mainly better off than them. Needless to say all these calculations are very preliminary, given how new the New Deal is.

TABLE 1

Claimant unemployment rates: by age (%)

	April 1998	April 2000	Change
40-49	3.7	3.1	-0.6
30-39	4.3	3.6	-0.7
18-24			
Claimants only	9.5	7.3	-2.2
Under 6 months	6.2	5.8	-0.4
Over 6 months	3.3	1.5	-1.8
Claimants plus people on non-work options	9.5	8.1	-1.4
Under 6 months	6.2	5.8	-0.4
Over 6 months	3.3	2.3	-1.0

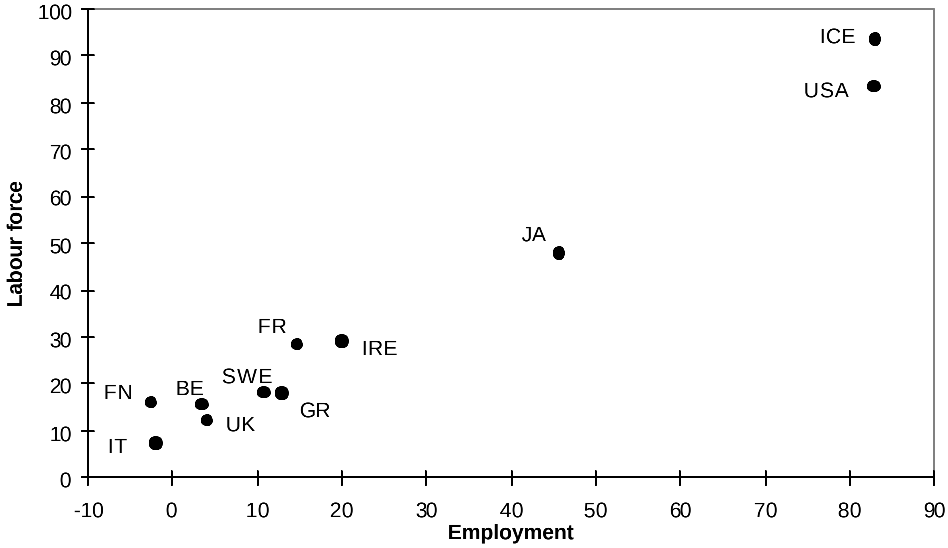
Figure 1
Long-term unemployment and the duration of benefits[8]



[8] Benefit duration from Nickell and Layard (*op.cit*) relates to 1992. LTU data relate to 1989-98 and are based on tables at the end of OECD, *Employment Trends.*

Figure 2

Percentage change in the labour force and in employment, 1960-1995



Source: OECD.

Figure 3

Change in labour force participation rate (15-64) and change in unemployment rate. 1990s compared with 1980s (% points)