

Welfare-to-work and the New Deal*

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Welfare-to-work is on trial in many countries. In Britain it has become the government's most important policy for lowering unemployment and expanding labour supply. But can 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.
- But people need a proper income.
- So you should help them to earn their income by working. You should spend more money on that, and in consequence spend less on supporting inactivity.

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 5 % 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.

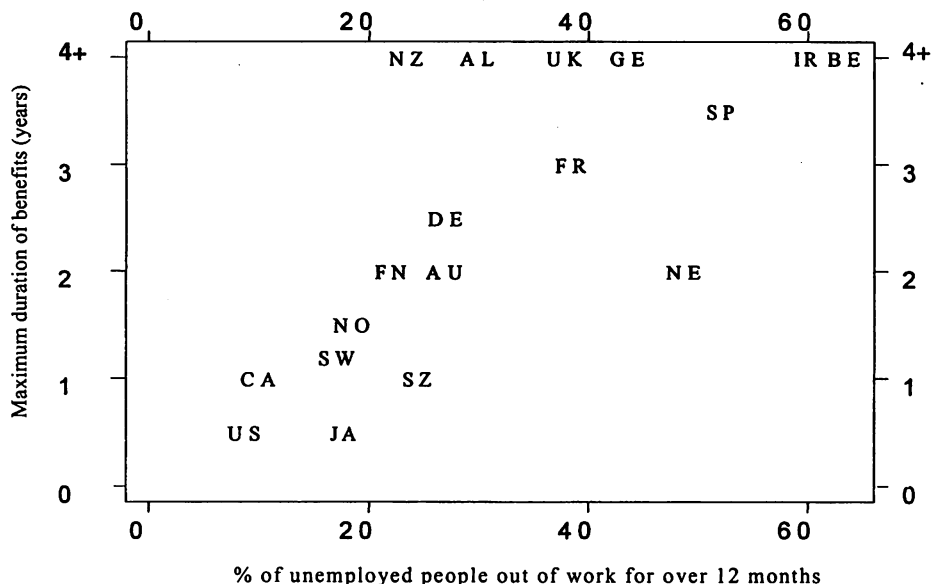
The position is illustrated in Figure 1. The vertical axis shows how long it is possible to draw unemployment benefit, and the horizontal axis shows how long people are actually unemployed, as measured by the percentage of unemployed who are out of work for over a year. The association is close, and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

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The layout has been adopted for this article.

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1. See S. Nickell and R. Layard in O. Ashenfelter and D. Card, *Handbook of Labor 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).

Figure 1: Long-term unemployment and the duration of benefits²

This long-term unemployment is a tragic experience for those who suffer it and it is also 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 kind of approach is now being used more and more in Britain, Denmark, the Netherlands and Sweden and of course in the U.S. for single mothers on welfare.

CONDITIONALITY

The “stick” has always been there in principle, but often little in practise. The rules always 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

2. Benefit duration is 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.

job-seekers at job centres. From 1986 however the work test began to be used again and the system 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 under 6% 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 is this. We ought to offer everybody on the threshold of long-term unemployment a choice of activity for at least 6 months. And at that point 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 greater? Evidence on substitution and replacement is by its nature difficult to obtain. In the past it has been mainly got 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? (“Dead-weight”)
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,³ and often implies that net job creation is only 20% of the total number of jobs subsidised. Yet these estimates

3. See for example J. Stern et al, OECD Wage Subsidy Evaluation: Lessons for Workstart, NERA, November 1995.

of substitution and deadweight 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 previously excluded. And changes in the effective supply of labour will cause equal changes in the non-inflationary level of employment.

That is the fundamental argument for welfare-to-work. Changes in labour supply do indeed cause equal changes in the non-inflationary level of employment. Since 1850 the British labour force has grown by 240% and the number of jobs has grown by, guess what, 240%. 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 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, re-training, 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.

Figure 2: Labour-force participation rate (15–64) and unemployment rate, 1998 (%)

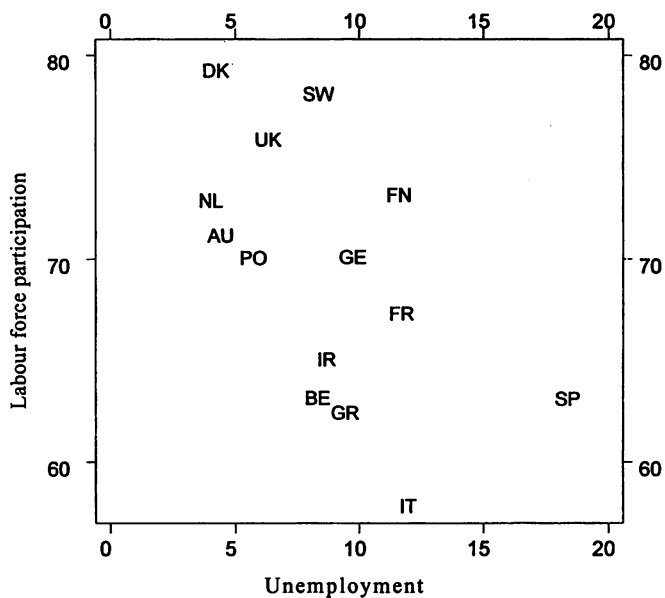
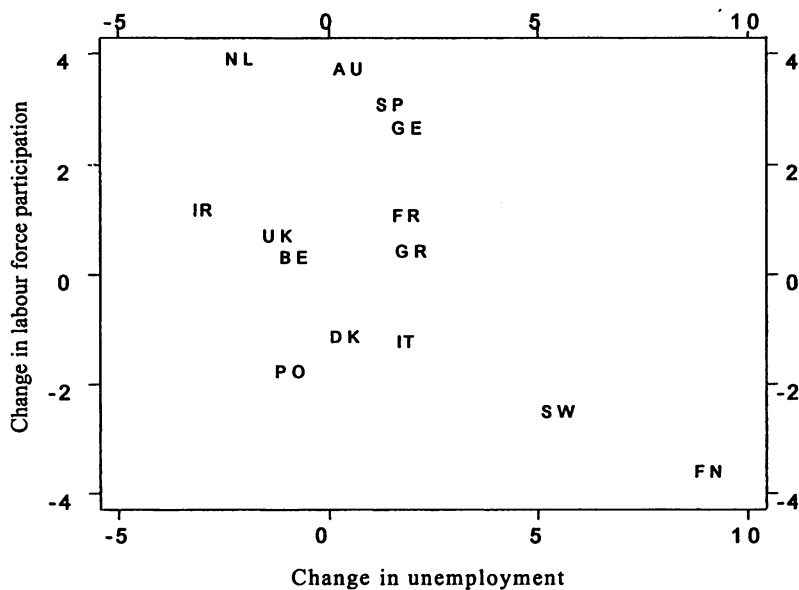


Figure 3: Change in labour force participation rate (15–64) and change in unemployment rate, 1990s compared with 1980s (% points)



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 (while receiving benefit plus £15 a week)
- work experience in an environmental project (ditto)
- full-time vocational education (while receiving benefit)

All the options include training for at least a 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 annual flow of people past the 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 is a “stock” of people who are already unemployed that have to be handled when the policy is first introduced. The initial stock of young people unemployed for over 6 months was 120,000. Thus the task in the first year is roughly twice as hard as it becomes later on.

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

April 1998 – March 1999	£250 m
April 1999 – March 2000	£350 m

How well has it 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 analysis of the overall effects of the New Deal is by the National Institute for Economic and Social Research.⁴ It finds that by April 1999 the New Deal had reduced unemployment by some 30,000 and increased regular employment by some 20,000. They also concluded that “our analysis of the budgetary implications of the New Deal for Young People indicates that it will be close to self-financing as the extra activity that it generates leads to higher government revenue.”

To get an updated impression, one can look at Table 1. This shows that from the beginning of the New Deal to last December unemployment of people aged 30–49 fell by 0.5 percentage points. By contrast the unemployment rate of people under 25 fell by 2.4

4. R. Anderson, R. Riley and G. Young. “The New Deal for Young People: First Year Analysis of Implications for the Macroeconomy”. Employment Service, Research & Development Report, ESR33 December 1999.

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 nearly 2 percentage points – or nearly 70,000 people.⁵ If we treat the New Dealers on options (other than the employer option) as unemployed, the corresponding fall in unemployment was less – about 35,000, most of whom are in employment. These figures will be exaggerated if the New Deal raised the unemployment rate of older people.⁶ But they suggest that the National Institute's estimate (which related to April 1999) was no exaggeration.

What is really encouraging is that short-term youth unemployment has not increased. Thus most 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.

TABLE 1
Claimant unemployment rates: by age (%)

	April 1998	December 1999	Change
40–49	3.7	3.2	–0.5
30–39	4.3	3.8	–0.5
18–24			
Claimants only	9.5	7.1	–2.4
Under 6 months	6.2	5.9	–0.3
Over 6 months	3.3	1.2	–2.1
Claimants plus people on non-work options	9.5	8.0	–1.5
Under 6 months	6.2	5.9	–0.3
Over 6 months	3.3	2.1	–1.2

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 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 of these. And, to

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

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 phased in from April 2001.

But there are other groups too for whom the Welfare-to-Work approach is highly relevant. 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-focussed” 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 which 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 power to 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 i.e. the NIESR figures plus an allowance for further advance beyond the end of the first year. 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

- (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 the present size is as follows

		<u>£m</u>
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
– 0.3x 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.