

**Comments on Richard Blundell and Costas Meghir:
Active labour market policy vs employment tax
credits: Lessons from recent UK reforms**

Bertil Holmlund*

An important objective of many active labour market measures is to increase the employability of the unemployed. Job search assistance, wage subsidies to employers and training are examples of this. The underlying rationale is often that unemployment is in some sense involuntary and one purpose of the programs is to influence the demand for labour. Earned Income Tax Credits, as practiced in the US and the UK, are based on a slightly different philosophy. The problem in focus is the supply side. Low-income individuals may face weak incentives to work as the returns from market work add little to net income, a problem exacerbated by generous unemployment benefits. A proposed solution is to provide “in-work” benefits, so as to make work pay without sacrificing the basic social protection provided by unemployment insurance.

The paper by Richard Blundell and Costas Meghir offers an interesting review of the recent UK experience of practicing both innovative labour market policies (the New Deal for Young People) as well as in-work benefits (the Working Families Tax Credits, WFTC). Both policies are motivated by weak labour market attachment among low skilled and low-income people, but the programs have somewhat different features. The New Deal, like active labour market programs in general, is individually based, not means-tested and of limited duration. The WFTC is based on family income, means-tested and of indefinite duration.

1. The New Deal

The paper’s evaluation of the New Deal exploits quasi-experimental features of the New Deal to identify the effects on exit rates to employment. Identification is achieved by regional variations in the timing of the introduction, as well as by different age-eligibility rules. The

* *Bertil Holmlund is professor at Uppsala University and chairman of the Economic Council of Sweden.*

results suggest that the policy had a statistically significant and economically non-trivial positive effect on the outflows to unsubsidised employment.

These results capture the net effect of several policy ingredients. Recall that the New Deal has many features, such as job search assistance, employment subsidies and training. Moreover, there is apparently a threat of benefit sanctions for individuals refusing to comply with the requirements.¹ So what is driving the positive results? This can only be a matter of speculation at this stage, but results from other studies indicate that the interaction with the benefit system may be important. In particular, some labour market programs may “work” primarily by raising the cost of remaining on unemployment benefits.

A number of social experiments undertaken in the US provide some relevant evidence in this regard. For example, the Maryland experimental study, presented in Benus and Johnson (1997), involved random assignments of benefit claimants to four treatment groups and two control groups. The control groups were required to follow the standard requirements at the time, including a report of at least two employer contacts per week (although without any review of verification of the contacts). Participants in one of the control groups were informed that they were part of an experimental study. The treatments were as follows: (i) increased work-search requirements by requiring workers to make at least four employer contacts per week; (ii) requiring two employer contacts per week but without any requirement of documentation; (iii) a requirement that workers should attend a four-day job search workshop early during the unemployment spell; and (iv) information to the claimants that their reported employer contacts would be verified

The results from the Maryland study suggest that increased search requirements can have non-trivial behavioural effects. Increasing the number of required employer contacts from two to four reduced the duration of benefit receipt by 6 per cent. Informing claimants that their employer contacts would be monitored reduced the duration of benefit receipt by 7.5 per cent. Participation in the job search workshop reduced the number of benefit weeks by 5 per cent, a finding

¹ The New Deal website (<http://www.newdeal.gov.uk/>) expresses the threat of sanctions as follows: “Because the options offer real opportunities, there will be no “fifth option” of remaining on benefit. You will be expected to play your part by showing commitment to your option.”

broadly consistent with results from other experiments undertaken in the US. The effect could reflect enhanced skills in job search but may also reflect higher perceived costs of remaining on unemployment benefits (as the workshop reduced the time available for leisure). In fact, the Maryland study suggests that the latter interpretation may be the most plausible. The effect is largely driven by a sharp increase in exit rates from unemployment *prior* to the scheduled workshop.

A recent study by Black et al. (1999) also provides evidence in favour of the hypothesis that the mere *threat* of being placed in a labour market program can reduce the time spent on unemployment benefits and boost job finding. The paper examines the effects of a randomised experiment undertaken in Kentucky in the early 1990s. The experiment involved a random assignment of unemployed individuals into mandatory employment and training services. Participation in those services was required in order to continue as a benefit recipient. Positive human capital effects aside, the treatment may have raised the costs of continued benefit claims. Black et al. found that treatment reduced the mean unemployment duration. The effect was primarily driven by a marked rise in reemployment in the first and second quarters after filing the benefit claim, in most cases taking place *before* the possible receipt of reemployment services. This suggests that the mere threat of being exposed to the services induced a rise in exit rates.

In summary, it seems possible that the effect of the New Deal is, in part, due to higher costs of remaining on benefits. It would be interesting to examine the time paths of exit rates from unemployment so as to ascertain whether there is any pre-program effect of the kind noticed in other studies. In addition, we would expect some effects from the mere introduction of a time limit on benefit receipt (to the extent that the New Deal represented a significant policy change in this respect).

2. Earned-income tax credits

The paper's evaluation of the WFTC is mainly based on ex ante simulations of estimated labour supply models (absent post-reform data). The results indicate that the policy has had a modest positive effect on employment among the target groups, i.e. low-income families. These findings are largely consistent with the results found in related studies based on US data.

WFTC is a version of Earned Income Tax Credits (EITC), a program with a long history in the US. In the US, EITC has been practiced since 1975 and has become the largest federally funded and means-tested cash assistance program in the country. By now, there is a large number of studies evaluating the program; see Hotz and Scholtz (2001) for a recent review. This literature has produced results well in line with what would be expected from a simple labour supply model. First, there is a positive and substantial effect on labour force participation rates among single-parent households, reflecting the fact that only the substitution effect matters for workers contemplating joining the labour force. Second, there is a decline in work hours among workers in the labour force, a result driven by two forces: (i) only the income effect bites in the flat range of the budget constraint and (ii) the effective marginal tax rate increases in the phase-out region. Third, there is a small negative effect on labour force participation among secondary workers in two-earner families. The net effect on total hours worked appears to be positive, however.

3. Policy interdependencies

The paper raises interesting issues about the best design of policies. In broad terms, there are at least three types of interrelated policies to consider: unemployment insurance (UI), taxes, and active labour market policies (ALMP).² UI is an important ingredient in an overall welfare approach to employment policies. Risk aversion, imperfect capital markets etc call for UI; adverse selection may give a rationale for *publicly* provided UI. But UI has adverse incentive effects, which may in itself motivate certain forms of ALMPs so as to mitigate the moral hazard problem.

The interdependency among the policies is obvious. The optimal design of ALMP, such as job search assistance, is bound to be dependent on the rules pertaining to UI, and vice versa. The effects of in-work benefits are likewise bound to depend on the prevailing benefit levels. In principle, these interdependencies call for a unified approach, where policy instruments are chosen simultaneously.

Several recent theoretical papers have taken some steps towards a unified analysis of taxes, UI and ALMP. For example, Boone and Bovenberg (2001) analyse the optimal interaction between the tax sys-

² One could add educational policies since the borderline between regular education and labour market training measures is often somewhat fuzzy.

tem (in-work benefits) and unemployment compensation. Boone et al. (2001) explore the case for introducing monitoring and sanctions in a model of optimal UI. Hopenhayn and Nicoloni (1997) show that the optimal UI system involves a declining time profile of benefit payments combined with a reemployment tax (or subsidy) that depends on elapsed duration.

Characterising the optimal design of UI, taxes and ALMP in all its fine details would be a formidable problem; indeed, there are plenty of policy parameters. We will certainly have to wait quite some time, probably forever, before this problem has been satisfactorily solved. In the meantime, we can learn from partial empirical and theoretical exercises, such as the paper by Blundell and Meghir. In addition to the presentation of interesting empirical results, they have reminded us that ALMP does not operate in isolation from other policies.

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