

The Limits of Activation in Active Labour Market Policies

by

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Let me first thank for the invitation to give this speech. The title is: *The Limits of Activation in Active Labour Market Policies*. I shall indeed focus on what can be achieved through active labour market policies, but I shall also try to place them into a broader perspective and discuss their appropriate use in the German context. I will also make some comments on suitable employment policies in general for Germany as seen from my perspective as an outsider with only limited knowledge of your debate.

When analysing unemployment, economists like to distinguish between *cyclical unemployment*, that is unemployment due to a temporary shortfall of aggregate demand, and *structural unemployment*, that is unemployment caused by a badly functioning labour market. To make this decomposition in a proper way is quite a challenging task. But taking the case of Germany, most sensible economists seem to agree that there are both types of unemployment. Some of the unemployment is due to the cyclical downturn, but this can only be part of the story. Since unemployment has been persistently high over a number of years, there must also be a very large structural component.

In Germany, as elsewhere, high unemployment falls to a disproportionate degree on the low-skilled. So any policy to reduce unemployment must by definition be a policy that reduces unemployment very significantly among the low-skilled.

With high structural unemployment, a successful strategy to reduce unemployment must encompass substantial *labour market reforms* Germany has just embarked on such a path. One ingredient in these reforms is *activation* of the unemployed through *active labour market* policies. Indeed, the reform process in Germany started with such reforms along the lines of the Hartz Commission.

It is a standard recommendation from international organisations that there are large gains from re-allocating resources from passive unemployment benefits to active labour market policies. This recommendation has to some extent been followed in many countries. The average EU country today spends nearly 1 percent of GDP on active programmes. Germany spends even more, around 1.2 percent, although this is a

smaller fraction of total expenditures on the unemployed (39 percent) than the average EU country (42 percent).

The recommendation to channel more resources to active labour market policies is underpinned by a large empirical research literature, where one has tried to explain differences among countries and over time in unemployment with differences in *labour market institutions*: a standard result in these studies is that more expenditures on active labour market policies tend to reduce unemployment.

However, there are reasons to be sceptical about these results, since they only measure the effects on *open unemployment*: it is not surprising that measured unemployment falls if openly unemployed persons are enrolled in various labour market programmes of long duration (training programmes, public-sector job-creation programmes, and subsidised employment in the private sector) and then are no longer counted as unemployed.

It also turns out that if one recalculates the results in the studies, it is very uncertain whether or not active labour market programmes reduce unemployment in total (that is if we add up *open unemployment* and *programme participation*), as one can see from my table, or, which is the flip side of the coin, whether or not programmes increase *regular employment*.

In my view one can learn more about the effects of active labour market policies from the experiences of individual countries than from the aggregate studies I mentioned. Indeed, from a German perspective the experiences from my own country, Sweden, are particularly illuminating.

Sweden has a long tradition of active labour market policy with large placements of unemployed in various training, practice or subsidised employment programmes (usually of about half-a-year length). One can see this from my diagram, which I hope you can follow, even though it is in Swedish. In it open unemployment is given by the blue curve, whereas the red curve gives “total unemployment”, that is the sum of open unemployment and programme participation. This means that programme participation is given by the distance between the two curves. As you can see, labour

market programmes were gradually expanded in the post-war period. They reached a peak during the unemployment crisis in the first half of the 1990s. In that period Sweden spent more on active labour market policies than any other OECD country, almost 2 percent of GDP. At a time nearly 5.5 percent of the labour force participated in various training or subsidised employment programmes.

The Swedish policies in the 1990s can be seen as a giant natural experiment. Afterwards the policies have been subjected to a large number of rigorous evaluation studies.

What do these evaluation studies say? One can summarise the results as follows:

- Looking at the outcomes for individuals participating in various training programmes, results are very disappointing: training programmes appear either to have had *no effect* at all on future employment opportunities or a *negative effect*.
- In contrast, some types of subsidised employment seem to have increased employment probabilities of participants substantially also after programme completion: not very surprisingly the results are better, the closer such a programme has been to regular employment.
- But, unfortunately, subsidised employment seems also to cause large displacement of ordinary jobs: crowding-out effects on regular employment are usually of the order of magnitude of 60-70 percent.
- As expected, training programmes do not seem to be associated with displacement of ordinary jobs.
- The results are particularly bad for youth programmes. It is unclear if programmes increased the employment prospects of participants. At the same time, the youth programmes seem to have caused particularly large crowding-out effects.
- Both training and subsidised employment programmes seem to have reduced rather than increased labour mobility.

These results are indeed very dismal. Some types of subsidised employment have been good for the individual, but have had a high price in terms of reducing regular

employment. Training programmes did not suffer from this crowding-out problem, but were inefficient or even damaging for the individual participant.

Is there nothing good to say about Swedish active labour market policies in the 1990s? I am inclined to say no, but to be fair, it is possible that – by keeping the long-term unemployed attached to the labour market – policies helped to keep up labour force participation. There are studies indicating this, but we do not know to what extent it was *effective labour supply* that was maintained and to what extent it was just the *measured* labour supply that was maintained because programme placements were to a large extent used to requalify the unemployed for unemployment benefits. Programmes may also kept the unemployed “happier” than would otherwise have been the case: there are results from surveys indicating that the experienced welfare of programme participants were significantly higher than the experienced welfare of openly unemployed.

Which lessons are there to learn from the Swedish experiences and from the experiences of other countries of active labour market policies?

A first lesson has to do with the scale of programmes. With such large programme volumes as we had in Sweden, huge inefficiencies are bound to arise. Especially training and practice schemes become of low quality. The same happens with various job-creation schemes if one tries to regulate them in such a way that they should only encompass “tasks that would not otherwise have been carried out”, which one is in effect forced to do with large volumes in order to reduce crowding-out effects.

Equally serious – but often not realised – is that large programme placements of the Swedish type have negative effects on the ordinary matching activities of the public employment services. The core activities of matching unemployed and vacancies in as efficient a way as possible are to a large extent crowded out by the administration of large placements in programmes of long duration.

The obvious conclusion is that programme placements should be carefully targeted. This will automatically reduce programme volumes and increase efficiency. If one can target subsidised employment programmes on those who run the largest risks of

becoming long-term unemployed, displacement of ordinary jobs is much less of a problem: such displacement may even be desired: to the extent that it is the result of increased competition about jobs for “insiders” in the labour market from “outsiders” supported by labour market policies, there will be downward pressure on wages that generates a net employment creation effect.

At the same time there are limits to how much programmes should be targeted. The reason is the risk of “stigmatisation”: if programme participation is reserved only for those with the largest difficulties in the labour market, programme participation may come to serve as a negative screening device for employers. So there is a delicate balance between targeting too little and targeting too much.

One conclusion that has been drawn in Sweden, as in many other countries, is that the focus of active labour market policy should shift from placement in various training and subsidised employment programmes of long duration to activation measures designed more directly to improve the matching process. Such measures include intensified counselling, more frequent contacts between employment offices and job seekers, higher demands on job-search activity, individual action plans for the unemployed, tougher requirements on which jobs to accept, more of benefit sanctions when job offers are not accepted, “workfare” requirements to receive long-term income support instead of passive benefits etc.

Many countries have moved in this direction: for example, Australia, Denmark, Ireland, the UK, the Netherlands, and Sweden. This is also part of the German reforms. According to studies such measures can increase outflow rates from unemployment quite substantially (say in the range of 15-50 percent). This has led to quite some optimism on what can be achieved through activation policies.

To some extent I share this optimistic judgement. But one should also be aware of the risks that the positive effects may be overrated, which seems to be a risk that active labour market policy is constantly exposed to. Improved matching can increase unemployment in two ways. First, labour demand will increase to the extent that hiring costs of employers fall. Second, there is less wage pressure to the extent that employers can fill their vacancies more quickly. But it is difficult to believe that any

of these effects are very large in a situation with very high unemployment. As vacancies then tend to be filled quickly anyway, both employers' hiring costs and wage pressure are already low.

To the extent that activation has been limited to particular groups, better labour market outcomes for these groups have probably come at the expense of other groups, so that one cannot generalise the results to the whole labour market. And where activation measures seem to have led to very positive aggregate effects – such as in Denmark, Ireland, the Netherlands, and the UK – it has often been difficult to disentangle the effects of activation from other institutional changes in the labour market that occurred at the same time. To exaggerate a bit: a prerequisite for successful activation measures seems to be that unemployment is going down anyway.

The overall conclusion must be that we cannot expect too much from active labour market policy. This does not contradict, of course, that it can make an important contribution and that we should try to make it as efficient as possible. It is easy to see several ways of doing this.

- Proper evaluations of various types of active labour market policies are crucial. This is so not least because active labour market policy is one of the areas with the highest turnover of policies: new programmes are invented all the time and old ones are constantly being disguised under new names. This process usually takes place on the basis of far too little evaluation. So, it may be a good idea to institutionalise evaluation procedures, for example, by setting up an independent national evaluation body, which can accumulate both institutional knowledge about policies and apply academic evaluation techniques, as was done in Sweden in the late 1990s with quite some success.
- Statistical methods for evaluation of programmes can also be used to get better criteria for programme selection for individuals. These methods can be used either for predicting at an early stage which individuals run the greatest risk of becoming long-term unemployed or for estimating which programmes are likely to give the largest improvement in future labour market outcomes per resources invested for a given individual.

- There may also be a lot to be gained from introducing more of incentive schemes (incentive pay linked to performance) in the public employment service and to open it up for competition, or at least “quasi-competition, between different providers of employment services (job brokering, activation measures, training etc.) that either the unemployed or local employment offices can choose between. Australia provides an interesting example of how this can be done, but overall it is very hard to assess the potential gains from such a policy without much more experimenting. It is clear though that any such system must be backed up by solid evaluations, so as to counter incentives to select programme participants from groups with very favourable employment prospects already from the start in order to show good results.

But even if there are important efficiency gains to be made, active labour market policy can in my view never be more than one ingredient of many in a successful employment policy. It may even be very harmful to expect too much of it, because it reduces the incentives to pursue other policies. There is always a risk that active labour market policies are used as an excuse for not taking other more efficient – but politically also more controversial – policy action.

As I said before, there exist a large literature trying to explain the differences in both unemployment levels and unemployment developments among countries. The consistent lesson from this literature is that there are a number of important determinants of unemployment: these also include unemployment benefit levels, the duration of benefits, the requirements for obtaining benefits, the way wage setting occurs (which is influenced by such factors as the degree of unionisation, the coverage of collective bargaining, and the extent of co-ordination in collective bargaining), and possibly also tax levels and the degree of employment protection.

We seem to have rather good knowledge of which factors work in which direction, but quite insufficient knowledge about the magnitude of the exact effects of individual factors. The general presumption is then, of course, that in the more areas that we change things in an employment-friendly way, the greater is the chance that unemployment can be reduced.

A roundabout way of illustrating this is to compare the number of areas where changes have been in an employment-friendly direction and the number of areas where they have been in an employment-hostile direction in different countries. This was done in a rather courageous way by an English colleague, Steve Nickell, who did find quite some correlation between changes in an employment-friendly direction and reductions in unemployment between the 1980s and the late 1990s: with an excess of employment-friendly movements in countries that succeeded in reducing their unemployment rates substantially, such as the Netherlands, Ireland, Denmark, and the UK, but with little change or an excess of employment-hostile movements in less successful countries like France, Italy, and Germany. Overall, as you can see from the simple regression equation at the bottom of the table, the difference between the number of areas with employment-friendly changes and the number of areas with employment-hostile changes seem to have some explanatory power for the development of unemployment. Admittedly this is very crude – we would probably not allow our students to make such a simplistic analysis – but still it is very suggestive.

How should one against this background look upon what is being done in Germany? These are my reactions as an outsider.

- As to active labour market policy, I believe one takes a number of steps in the right direction, although I am not too impressed. One seems to be moving towards rather traditional Swedish policies, which have been less lax and better than German policies, but still not particularly good. You may be moving from very bad to bad, which is an improvement, but not a very great one.
- I believe reductions in benefit levels (especially for the long-term unemployed) are a necessary part of any reform programme, and I hope that these changes will survive politically even when the business cycle turns up again. I see a risk that they will not, partly because they have to a large extent been motivated by budgetary concerns rather than by arguments about the need to make the labour market function better. This may make it difficult to resist demands for benefit rises again when the budgetary situation improves, as has indeed happened in many countries, not least in Sweden.

- It is important that benefit reductions give a maximum contribution to wage flexibility. It is a step in the right direction that unemployed may have to accept jobs that pay less than the jobs they had before. But stipulations that unemployed workers are not required to take jobs at wages below the prevailing ones in the local market means in effect a support for collectively bargained wage levels, which reduces pay flexibility. So, I hope that the plans to remove this stipulation for the long-term unemployed are carried through.
- Without reforms of the pay bargaining system other labour market reforms will take a long time to have full effect. Other – smaller – countries, like Ireland, the Netherlands, and Sweden – have succeeded in achieving aggregate wage moderation through co-ordination of bargaining, which is probably not an option for Germany. More decentralisation of pay setting and larger possibilities to adjust wages to the local employment situation (especially in eastern Germany) seems unavoidable to me if a large-scale reduction in unemployment is to be achieved. This would have to mean more liberal opening clauses in collective agreements and possibly, as has occurred in Sweden, collective agreements that leave the determination of the margin for wage increases entirely to the local level.
- One should also contemplate very seriously some kind of employment income tax credit for low-wage earners along the lines of the *Earned Income Tax Credit* in the US or the *Working Family Tax Credit* in the UK. The aim is to increase the attractiveness of work relative to benefit incomes and to facilitate a downward adjustment of wage levels. This can be done through general tax rebates for all low-wage earners as in the US and the UK, which is very expensive, or it can be limited to long-term unemployed or earlier welfare recipients (similar to what was tried in Canada), which is much less expensive. I have a preference for the more limited variant, which one can see as a complement to active labour market policy of the conventional type. An advantage with employment income tax rebates is that the employment support can be given directly to the targeted group without involvement of the employer. As a consequence, the risks of “stigmatisation” are much smaller than when employers are induced to hire long-term unemployed with extra wage subsidies that identify the unemployed as problem cases.

- Finally, one must not forget about macroeconomic policies in general. Any labour market reforms putting downward pressure on real wage levels will produce much faster results in a situation when product demand is increasing. Also, there is a cyclical element in present unemployment in Germany that can only be reduced through an expansion of aggregate demand. I am very certain that without the EMU, such a demand increase would have been achieved through a devaluation of the D-mark relative to the other European currencies. I do believe that the D-mark was locked to the euro at a conversion rate, which is overvalued in a long-term perspective. This was not so serious as long as the euro was weak against the dollar, but with a stronger euro this becomes a very serious problem for Germany.

As far as I can understand, the only fast way of achieving a reduction of real labour costs and a real exchange rate depreciation boosting Germany's international competitiveness is a radical cut in payroll taxes of firms that would have to be matched by an increase in taxes or contributions falling on employees (VAT, social security contributions, or income taxes) to the extent that government expenditures cannot be reduced. Such a tax shift – or *internal devaluation* as it is sometimes labelled – is a policy measure that has been used in the Nordic countries.

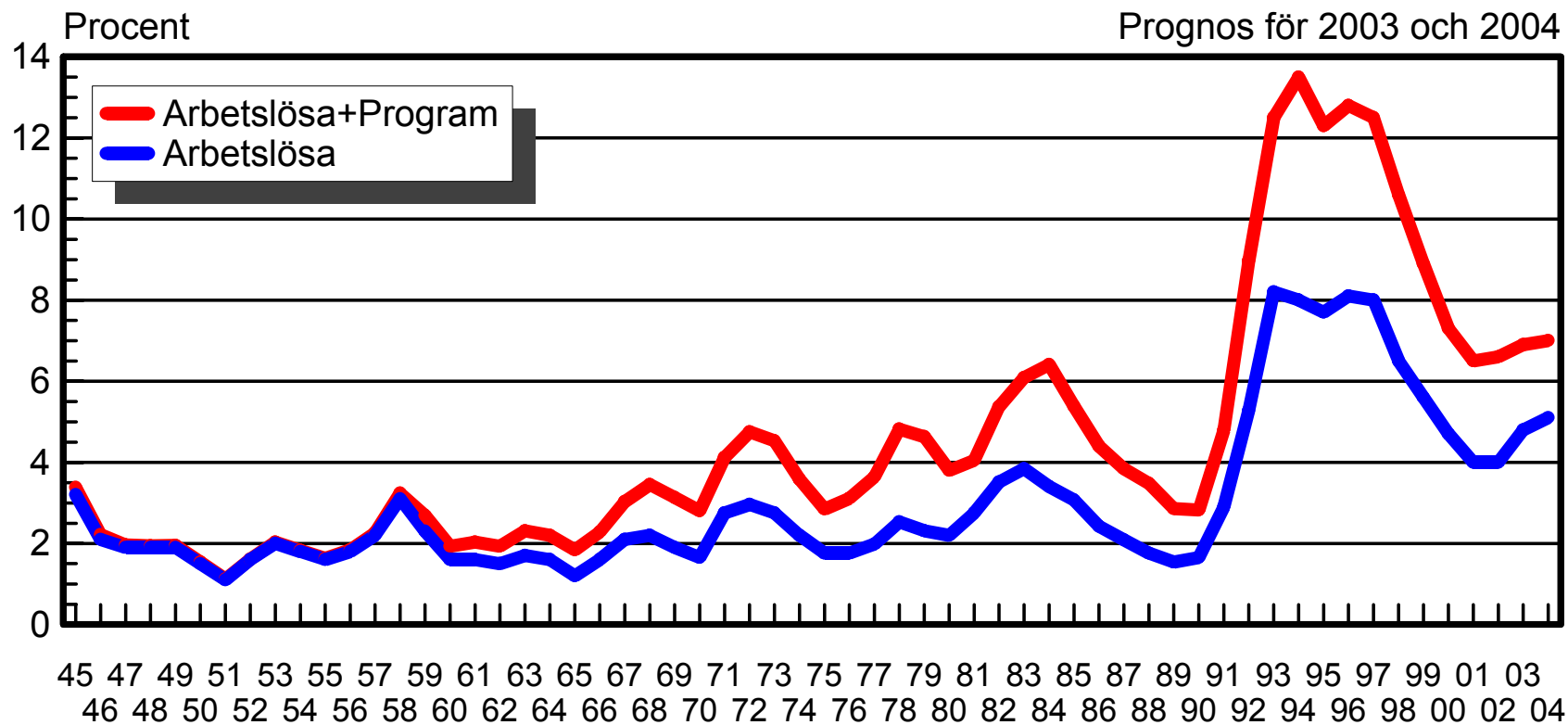
I do not know whether this is a politically realistic policy option for Germany. It obviously requires the development of a consensus on both the causes of the present situation and on the appropriate cure. But to me, a two-handed approach combining demand policy with even more thorough-going labour market reforms seems to be what is required to lift Germany out of its present stagnation. In such a policy package there is a place for active labour market policy, but in my view a rather small one. Well, I am aware that my views on policies for Germany may represent wishful thinking on the part of an outsider on what is politically possible, but I take it that this is the role I was expected to play at this conference.

Calculated effects on unemployment of an increase in programme participation of one percent of the labour force

Study	Open unemployment	Total unemployment
Layard, Nickell & Jackman (1991)	-1.53	-0.53
Zetterberg (1995)	-1.49	-0.49
Jackman, Layard & Nickell (1996)	-0.06	0.94
Scarpetta (1996)	-0.51	0.49
Elmeskov, Martin & Scarpetta (1998)	-1.18	-0.18
Nickell & Layard (1999)	-0.18	0.82
Blanchard & Wolfers (2000)	-1.43	-0.43

Total unemployment is the sum of open unemployment and programme participation

Arbetslösa och konjunkturprogram i förhållande till arbetskraften 1945-2002



Källa: SCB, AMS

	Unemployment change 1980-87 to 2000-01	Employment- friendly changes	Employment- hostile changes	Net of employ- ment-friendly changes
Denmark	-2.6	4	2	2
Ireland	-9.8	4	1	3
Netherlands	-7.4	5	0	5
UK	-5.3	6	2	4
France	0.1	1	4	-3
Italy	1.7	2	2	0
Germany	0.3	2	1	1

**Unemployment change = -0.42 – 1.21 (Employment-friendly changes – employment-hostile changes)
(4.3)**

$R^2 = 0.51$

N = 20