

Report to Prime Ministers Blair and D'Alema

**WELFARE-TO-WORK AND THE FIGHT
AGAINST LONG-TERM UNEMPLOYMENT**

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EXECUTIVE SUMMARY

Diagnosis

European unemployment is mainly a problem of long-term unemployment. Short-term unemployment is roughly the same as in the U.S. but in addition 5% of our workforce have been out of work for over a year, compared with almost none in the U.S. This long-term unemployment is deeply damaging, because it makes individuals increasingly unattractive to employers, so that even in a recovery, when labour becomes scarce and inflation starts rising, mass unemployment continues.

On top of this, millions of people of working age are not even looking for work, so that in Europe only 61 per cent of people aged 15-64 are in work, compared with 74 per cent in the U.S. Thus, compared with the U.S., Europe has massive resources of people without work who, if mobilised, could contribute to future growth and rising standards of living, offsetting the effects of ageing on the size of the European workforce.

Thus the challenge is to restore full employment, and to raise participation in the world of work.

Long-term unemployment and non-participation have very different causes in different parts of Europe. In Northern Europe, including the U.K., they result mainly from the dysfunctional structuring of the welfare system. Huge sums are spent on long-term benefits which encourage inactivity and exclusion. Unemployment and poverty traps are common, discouraging work. At the same time too little is done to promote activity and to help people back into active work.

In Southern Europe, including Italy, long-term unemployment is mainly regional. A vicious circle is at work in high unemployment regions. On the one hand, centralised collective bargaining institutions do not allow wages to compensate for lower productivity levels vis-à-vis other regions, discouraging job creation outside the state sector and inflating the ranks of the underground economy. On the other hand, the external diseconomies related to the poor enforcement of the rule of law (the informal sector may involve up to 1/3 of the entire workforce in these regions), to an inefficient state machinery and to a lack of public infrastructure hamper convergence to the productivity levels prevailing elsewhere.

In Southern Europe, the dominant form of transfers provided to non-employed individuals of working age is represented by pensions or bridging schemes to retirement. Non-employment benefits are targeted at those adult workers with relatively long work records, while youngsters receive state support only indirectly via their families. This helps to explain why large regional labour market imbalances do not induce migration of young people: the (largely in-kind) income support provided by the family is conditional on the sharing of the same dwelling.

One feature that both Southern and Northern Europe have in common is pension systems encouraging workers to retire early, and a long standing tradition of early retirement (and other “soft landing”) schemes used to deal with redundancies.

The way forward

In devising a strategy for reform, Europe has to find its own new model. The U.S. model provides no safety net, so that there is unacceptable inequality and levels of crime unknown in continental Europe. We need a model which supports a more equal society but one where people are helped to sustain their own incomes rather than depending on long-term transfers.

The goal in Europe **must be** full employment. Under full employment, anyone can find work within a reasonable period of time. So restoring full employment is synonymous with preventing long-term unemployment. If that is done, participation will also increase, since more people will participate if work can be found more quickly.

This report advocates four strategic elements which could be implemented - with suitable national variation - by E.U. governments.

1. To prevent people drifting into long-term unemployment, there should be active policies to ensure that eventually everyone gets offers of work or training within a year of becoming unemployed. The work should, where possible, be with regular employers, and secured if necessary by a recruitment subsidy. A modernised Public Employment Service is a key instrument in the business of channelling job offers to workers. It should be properly staffed and funded, with private agencies free to compete with it.
2. The Welfare-to-Work approach will not prevent long-term unemployment if individuals who receive offers from employers can instead choose to continue living on benefit. A system of complementary rights and responsibilities is needed, where the citizen can expect high-quality help in finding work, but in return must take advantage of it or cease to draw benefits. Once the state is channelling offers of work to everyone within the first year of unemployment, that would become in effect the maximum period for which benefits are available.
3. Further policies are needed to deal with regional unemployment. In particular, the decentralisation of wage setting (e.g. to territorial level, as currently done on an experimental basis in Italy) and measures aimed at improving the external environment in which firms operate (the efficiency of public administration, the enforcement of the rule of law, etc.) are essential to break the vicious circle described above. The decentralisation of collective bargaining can be accompanied with measures encouraging regional labour mobility and encouraging take-up of relatively low-paid jobs, e.g., by providing in-work benefits to low-wage earners.
4. Labour-supply-reducing policies such as early retirement, as well as uncontrolled access to invalidity pensions, should be phased out, as the welfare-to-work

approach makes it possible to deal with redundancies without having to implement (high cost) early retirement for older workers. Ongoing or planned reforms of pension systems should also remove those features which discourage the participation of older workers.

The welfare-to-work approach outlined above is incompatible with the view that full employment can be achieved only by reducing the number of persons in the labour market. Yet many people doubt whether society can actually provide jobs for more people. According to this popular wisdom (the so-called “lump-of-labour” fallacy), the number of jobs is fixed. Hence unemployment can only be reduced by redistributing the stock of jobs available across individuals and pushing people out of the labour force. This widespread belief lies at the root of the campaign for earlier retirement, and explains much of the pessimism about welfare-to-work policies for the unemployed.

We discuss these issues at some length in our report. In the very short-run there is of course a limit to the number of jobs, which is set by the level of aggregate demand. But aggregate demand in Europe is rising and will continue to do so until it hits its long-run upper limit. This limit is set not by demand but by the effective supply of employable labour. And if the supply of labour rises the number of jobs responds. If history tells any lesson, it is that.

So now is the time for an optimistic approach to Europe’s employment problem. Twenty years ago inflation still looked like a chronic disease of the European economy. It has been conquered by the adoption of good policies. There is no reason why, with good policies, we should not also deal with long-term unemployment and low participation.

1. INTRODUCTION

The present level of unemployment in Europe is intolerable. Nearly 10% of European workers are unemployed – with 12% out of work in Italy and 6% in the U.K. In addition millions of people of working age are not even looking for work. Something is terribly wrong.

There is a short-term problem and a long-term problem. The short-term problem is in that many countries there is still inadequate aggregate demand. The process of convergence to EMU has involved a painful period of fiscal consolidation, following on a period of high interest rates caused by German reunification. Europe is only now emerging from this recession, and most countries have some way to go before bottlenecks of labour shortage become a serious barrier to non-inflationary growth.

But unfortunately bottlenecks will eventually appear and, with existing labour market policies, they will appear even when unemployment remains unacceptably high and when millions who could work are not doing so. This is a problem in almost every European country, though more in some than in others. It is a problem of the underlying structure of the labour market. Even when there are large numbers of vacancies, many people remain unemployed **either** because they do not find work sufficiently attractive **or** because they are not offering employers what they want **or** because the system of matching workers with jobs is inadequate. In addition there are regions in many countries where the demand for labour is lower than it should be because of lack of wage flexibility and incentives to invest.

If Europe is to return to full employment, all these issues must be addressed. They **can** be successfully tackled, and Europe should therefore set itself the goal of full employment – with all the consequences that flow from it.

In many of the countries of Northern Europe the biggest problem is of benefit dependency – of people who have become effectively excluded from the labour market by long-term unemployment or prolonged inactivity. The task is to help these people back into the labour market, replacing “passive” benefits by “active” help so that they find work. In much of Southern Europe there are regions where mass unemployment can only be cured by a mixture of job promotion through managed programmes, wage flexibility and outward migration. All of these reforms are part of a strategy to raise the number of “employable” people – people who are actively looking for work and have the skills, attitudes and location that employers want.

Some people doubt whether such an increase in labour supply will lead to a response in the number of jobs. Yet all experience shows that that is exactly what happens. As Figure 1 illustrates, the countries which allow their labour force to grow have the fastest growth in the number of jobs.

Those countries which have high labour force participation have no more unemployment than countries like Italy where participation is low (see Figure 2). If

anything, the reverse is true. Similarly those countries which have reduced their labour supply have had no greater success in avoiding unemployment. This is shown in Figure 3 which, in order to control for the business cycle, compares the 1990s as a whole with the 1980s. If anything, unemployment has fallen most where labour supply has most increased.

Thus retirement from the labour force is emphatically not a solution for unemployment. If there are fewer people in the labour force, the European recovery will be more short-lived because employers will more quickly run into shortages of labour. Early retirement thus fails to reduce unemployment. And it reduces national income. We want to do the opposite – to expand the effective supply of labour, giving people richer lives and ending the exclusion that comes from being cut off from the labour market and the world of work.

In this report we begin with a presentation of the principles of welfare-to-work. We then review the situation in the U.K. and Italy and show how the overall principles apply in each case. We end with recommendations for E.U. governments.

Figure 1
Percentage growth in the labour force and employment 1960 – 1997

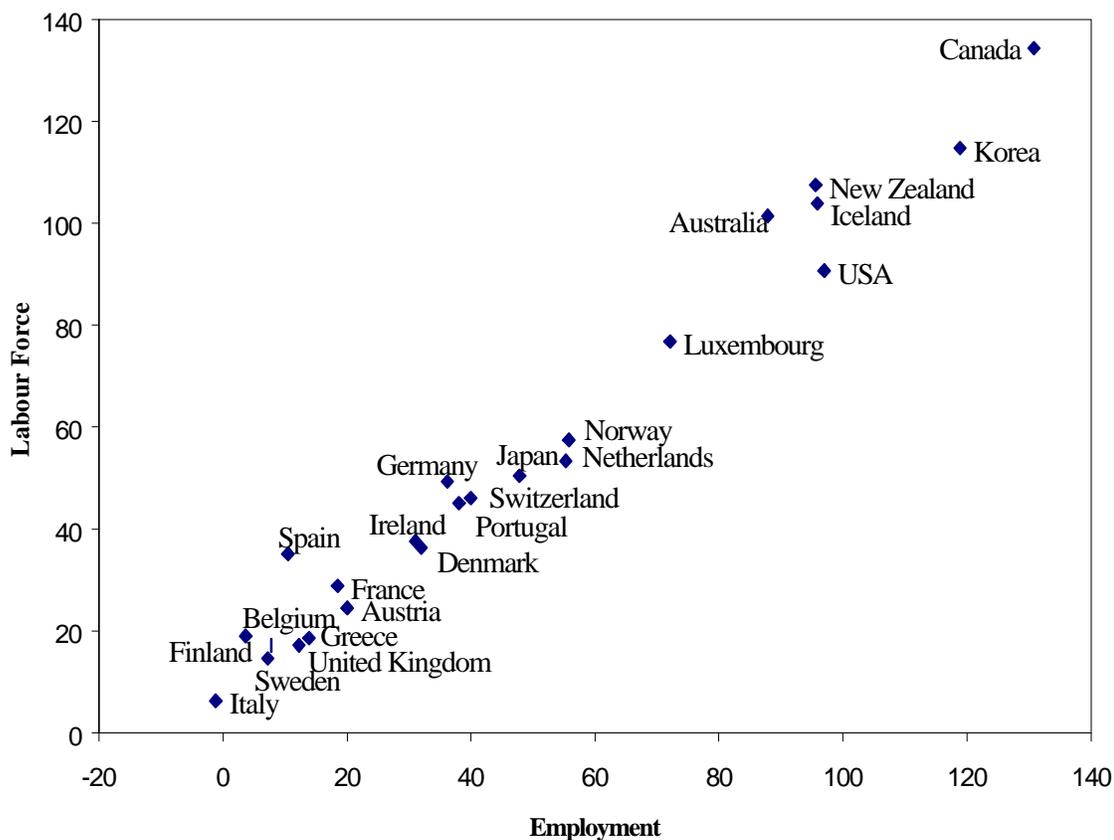


Figure 2
Labour-force participation rate (15-64) and unemployment rate, 1998 (%)

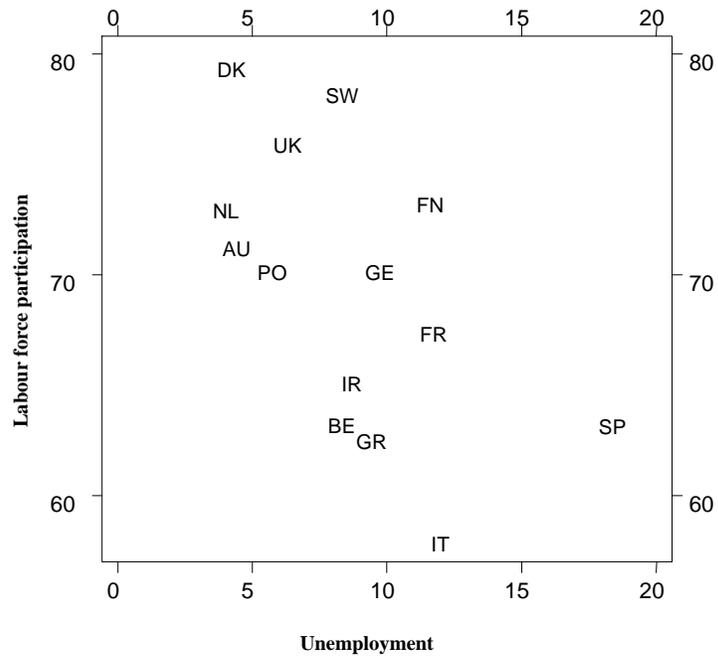
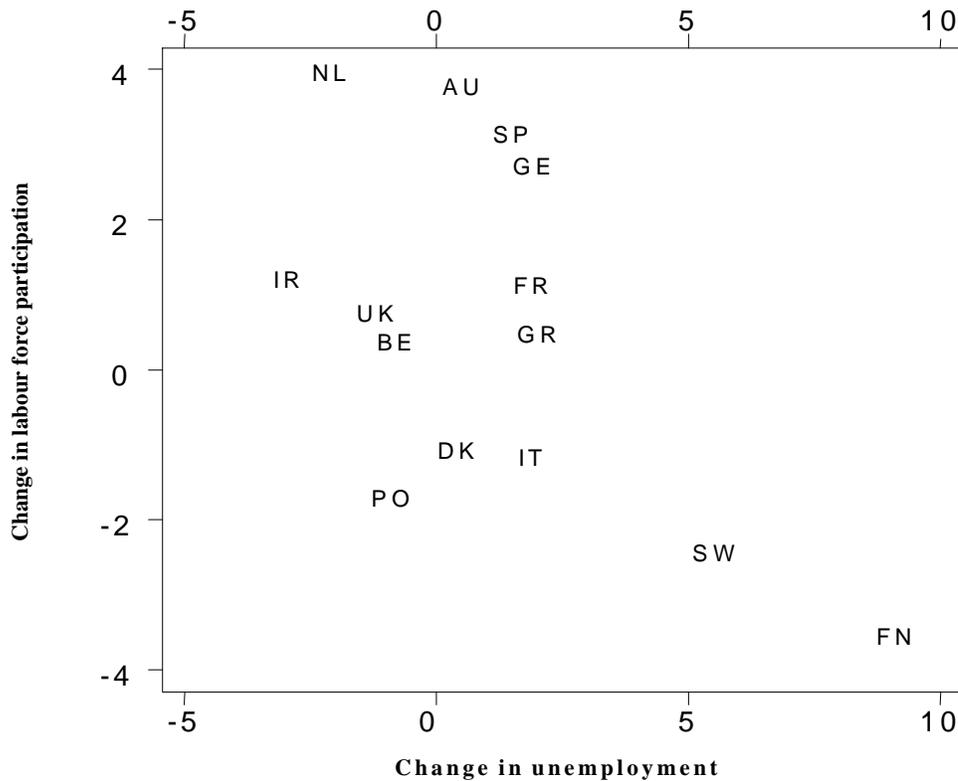


Figure 3
Change in labour force participation rate (15-64) and change in unemployment rate, 1990s compared with 1980s (% points)



2. PRINCIPLES OF WELFARE-TO-WORK

In a particular year the level of unemployment is determined by the level of aggregate demand for the goods and services which a country produces. If demand is higher, this reduces unemployment. So the demand-side approach to unemployment is to expand demand through higher budget deficits and lower interest rates.

But unfortunately unemployment cannot be reduced indefinitely by expanding demand. For eventually the economy will run into bottlenecks and labour shortage. At that point employers will increasingly raise wages to attract labour, and there will also be increased union demands for higher wages. So demand will have to stop rising – either of its own or through policy action.

Thus our ability to reduce unemployment is limited by the labour shortages which begin to appear as unemployment falls. These are features of the “supply-side” of the economy, and it is they which determine how low unemployment can fall without creating inflationary pressures. While demand management is important, the key issue for employment policy is how reduce the level of unemployment at which inflationary pressures appear.

Clearly, this level has been much lower in some European countries than others. There has been a mass of research into what actually determines this level. We shall concentrate mainly on two factors which are of critical importance.² The first is how unemployed people are treated, and the second is why they are concentrated in some regions with persistently larger labour slack.

HOW UNEMPLOYED PEOPLE ARE TREATED

If inflation is to remain under control, employers must find it reasonably easy to fill their vacancies. This means that **either** unemployment must be high **or** (far better) that employers’ needs can be met from a smaller pool of unemployment because the unemployed are highly employable – actively looking for work, appropriately skilled and properly presented to employers. In the latter case unemployment can be quite low without inflation increasing.

“Active” labour market policy is one way to bring this about. It helps unemployed people become more desirable to potential employers – through active placement services, through training and, where appropriate, through job subsidies. Effective job-broking is the best way of making labour markets more flexible, because they reduce turnover costs for both firms and workers. The evidence confirms that, if properly structured, this approach does increase economic activity and reduce unemployment.

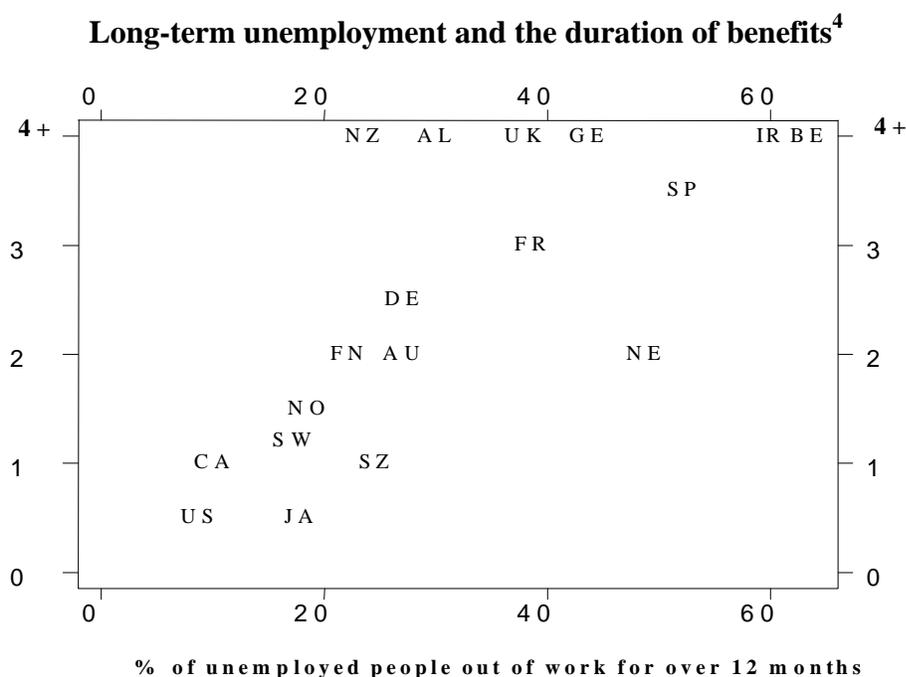
On the other hand unemployment benefits, if not properly managed, have the opposite effect of encouraging “passive” inactivity. This is particularly so if, as in

much of Europe, unemployment benefits can be drawn for a number of years. It is a remarkable fact that at present the amount of short-term unemployment in Europe is little higher than in the United States – about 4½% of the workforce have been unemployed for under a year, compared with just below 4% in the U.S. But in Europe another 4½% have been unemployed for over a year, compared with virtually none in the United States. The most natural explanation for this is that unemployment benefits run out after six months in the U.S., whereas they last for many years in most European countries.

The position is illustrated in Figure 4 for most of the OECD countries. (Italy does not appear because Italy has no comprehensive system of benefits). In the Figure 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 the other possible factors affecting the duration of unemployment.³ Long-term unemployment in Italy has other origins (discussed below), but it is crucial that Italy's new benefit system does not develop the dysfunctional characteristics of many of the other systems in Europe.

For long-term unemployment is the worst form of unemployment for those who experience it, and it is also the most inefficient. 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 long-term unemployed, with the result that inflation rises even in the presence of mass unemployment.

Figure 4



One way to reduce long-term dependence on benefits is to make sure that benefits are used for their intended purpose – to support people who are not working and who really cannot find work. In other words the right to benefits must be matched by an obligation to find a job, if jobs exist. There must be a “test of willingness to work”. Countries differ widely in the strictness with which they apply a test.⁵ Experience shows that unemployed people are more available to fill employers vacancies if

- (i) benefits are paid through the same office as that where people are placed in work,
- (ii) unemployed people have to attend regularly in person, and
- (iii) unemployed people are expected after a period to be available for most types of work, even if this involves substantial journey times or even (as in a few countries) moving home, with the help of a subsidy.

The problem however with imposing strict availability conditions is that these are difficult to apply unless the Employment Service is extremely active in helping people to get offers of work. So a “stricter benefit regime” to reduce “passive” dependence on benefits only makes sense if linked to an “active” labour market policy to help people back into work. The two should be complementary.

This is the policy known as “welfare-to-work”. The phrase comes from America, where it mainly applies to lone mothers. But the practice as applied to unemployed people has been mainly developed in Europe, where countries like Denmark, the Netherlands, Sweden and Britain all now have major welfare-to-work policies.

Because long-term unemployment is so destructive, we should prevent it happening. This means ultimately ensuring that everyone gets offers of work or training within a year or so of becoming unemployed. The aim must be to channel offers of work from regular employers, mainly in the private sector. But, to prevent long-term dependence on benefits, we need to ensure worthwhile activity for everyone. It must be actively aimed at employability, so that, when we cannot secure a regular job, we should offer meaningful work with NGOs or socially-useful projects. But the measure of success is the number who get regular work and keep it.

By preventing long-term unemployment we can expand the effective supply of labour and thus the number of jobs. But will it really work? The record of active labour market policies is examined in a number of surveys.⁶ Some policies have succeeded but some have failed. The task is to draw the right lessons and copy the best examples, some of which have been impressive. There remains the need for further systematic experimentation and evaluation. Welfare-to-work policies need to be systematically monitored and assessed in order to be improved. Welfare-to-work has costs – not only subsidies provided to employers or workers, but also staff running the programmes and enforcing the work-test. Hence systematic evaluation of costs and benefits is vital.

Additionality

A key issue is the extent to which the policy creates net additional jobs. Many people doubt whether active labour market measures can work owing to “displacement” and “substitution”. In 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? (“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,⁷ and often implies that net job creation is only 20% of the total number of jobs subsidised. Yet these estimates 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. The procedure is especially extraordinary when one considers that typically half the people supposedly sent into unemployment by the process of substitution are people who already have a job and would have simply been changing jobs.

Only recently have economists began to realise that the old assumptions about substitution are invalid. Lawrence Katz of Harvard University for example, has

insisted on a more rational analysis of the main U.S. wage subsidy programme for youth, the Targeted Jobs Tax Credit . Until 1988 it covered disadvantaged young people aged 18-24, but from then onwards it ceased to apply to people aged 23-24. This change provided a good controlled experiment, enabling one to isolate the effects which the subsidy had previously had on the employment of 23-24 year-olds. The conclusion was that 40-52% of the subsidised jobs had represented net additions to employment.⁸

Welfare-to-work must involve the principle of mutual obligation. The state has an obligation to ensure that offers of work are channelled to every unemployed person within a reasonable time after becoming unemployed. But in return the citizen should take advantage of those offers or lose the opportunity of continuing to live on benefit while rejecting them.

The causes of high regional unemployment

This system of mutual rights and responsibilities works better in labour markets where a sufficiently large number of vacancies is generated each year. European long-term unemployment is, however, largely concentrated in some depressed areas characterised by persistently low labour demand. In order to apply welfare-to-work principles to Europe, it is therefore necessary to cope with this regional dimension of unemployment, understanding first of all how large regional labour market imbalances can be so marked and persistent.

US and the UK experience suggests that marked differences in unemployment rates across regions can be reduced whenever two re-equilibrating factors are at work. The first is wage adjustment. If unemployment is higher in one region than another, wages in the high-unemployment region decline vis-à-vis wages in the low-unemployment region. This attracts investment, which leads to more jobs in areas of high unemployment. The second re-equilibrating factor is regional labour mobility. As the promotion of local development is relatively slow, the reduction of differentials in unemployment rates typically involves also some outward migration, which may well be just temporary. As soon as unemployment differentials disappear, migrants tend to go back to the original area of residence. This happened, for instance, in the case of Irish migrants to the UK who went back to Ireland in the second-half of the 1990s when labour market conditions improved significantly in their home country. The British and the Irish labour markets are very closely interconnected, not least because there are no language barriers between the two islands.

In Continental Europe, these two re-equilibrating factors are often not allowed to operate at the regional level. Centralised wage setting institutions prevent the emergence of significant regional wage differentials. At the same time, a number of factors – including state transfers to the high-unemployment areas – reduce the pressure to migrate. Thus, large regional labour market imbalances – the North-South divide in Italy and Spain or the West-East divide in Germany - are a prominent feature of the European landscape. Persistently high unemployment in some regions is also associated with low participation rates⁹ and a deterioration of the environment in which firms have to operate. The rule of law is poorly enforced due also to the development of a sizeable informal sector. Moreover, the state administration – whose ranks are often artificially inflated as state sector jobs are typically a hidden transfer to

high unemployment regions – is highly inefficient. Frequently the public sector pays more than the private sector (at least in terms of entry wages) and provides job security, while tolerating shirking, moonlighting and low productivity. If it is difficult to get a public sector job when already employed in the private sector, this encourages “wait-unemployment” while people (sometimes the most educated people) queue for public sector jobs to become vacant. Thus individuals’ wage aspirations are relatively high¹⁰ in spite of high unemployment. Hence improvements in labour demand conditions, e.g. through a widening of interregional wage differentials, may by themselves not be sufficient to absorb long-term unemployment and to increase participation significantly in these regions.

In order to move these regions away from the high-unemployment low-participation equilibria in which they are trapped, it is therefore necessary to act on both the demand and the supply side. On the demand side, it is necessary to pursue greater decentralisation in collective bargaining, as wages should be allowed to vary across regions so as to reflect more closely the differences in labour productivity. Decentralisation in pay determination should extend to the public administration, and be accompanied by the introduction of incentives for higher productivity and hiring procedures which discourage queuing. On the supply side, the task is to transform along welfare-to-work principles the cash transfers provided to non-employed individuals in these regions. A key requirement for this is to have unemployment benefits, rather than other instruments (e.g., early retirement and invalidity pensions) which merely encourage non-participation in the labour market rather than supporting job search. Welfare-to-work should encourage regional labour mobility, but should circulate information on jobs available in more buoyant labour markets and sometimes also subsidise moving costs. Regional mobility should not necessarily involve long-range migration as there are often areas within the high-unemployment regions that are more dynamic.

Our analysis so far is based on evidence from a range of OECD countries. We turn now to the specific cases of the U.K. and Italy, which provide an application of the welfare-to-work principles to conditions where either one or the other factor discussed above – benefit dependency and regional unemployment – is particularly marked. As background, the Annex offers some key comparative statistics on the two countries.

3. BRITISH EXPERIENCE

We begin with some history. Britain went into sharp recession in the early 1980s and again in the early 1990s. But from comparing the two cycles we can see that the sustainable level of unemployment is at least two points lower now than it was ten years ago. This is illustrated in Table 1.

The question is: What has changed to bring sustainable unemployment down in the UK, when it has been increasing in so many other European countries? There are two main factors. First, how unemployed people are treated. The unemployment benefit regime has become substantially stricter, through a series of changes from 1986 onwards. There has also been a growth in welfare-to-work support, especially since the new government came to power in May 1997. The second factor is wage flexibility, linked to labour mobility. Regional wage differentials have become more flexible and some of the barriers to inter-regional labour mobility have been reduced. So regional inequalities in unemployment rates have become very much less.

We shall review these different factors, looking at their past history, their likely future, and what further steps are needed.

HOW UNEMPLOYED PEOPLE ARE TREATED

Unemployment Benefit System

Most unemployed people in Britain receive Job Seeker's Allowance. The level of benefit is unrelated to previous earnings, but it is higher if the person has a dependent spouse or children. It is means-tested, so that an unemployed person can gain very little from part-time work. The level of cash benefit is quite low, but nearly all unemployed people also get their housing costs paid for in full. For some people the replacement ratio is quite high – 5% of people in work would keep 70% of their income if they became unemployed.¹¹ The government is making work pay better, by increasing the benefits paid to people who are in work but on low incomes, through a revamped and more generous Working Families Tax Credit.

Table 1
Britain : a comparison of two boom years

	Unemployment rate (%)	Labour shortage index	Change in wage inflation
1989	7.3	Highest ever	+1%
1999	5.9	Below average of 1980-99	-1%

Source: OECD Economic Outlook; Goldman-Sachs, UK Economics Analyst September/October '99; Wages: average earnings index.

Unemployment benefits can be drawn without any time limit, but there are clear conditions:

- (i) The person must sign on at the job centre once a fortnight (on a specific day and time). He will have conversations of around 5 minutes with an adviser, who is meant to draw his attention to suitable vacancies.
- (ii) Longer interviews lasting around an hour are held every six months. The person must have an “action plan” and can be subject to specific direction by the adviser – for example to attend a course.
- (iii) For up to 13 weeks a person need look only for jobs like the one he lost. But after that he is in principle expected to consider any job in any occupation, provided it involves less than 1 hour’s travel each way. In practice these obligations are not fully applied.
- (iv) If individuals do not satisfy the above requirements, or become unemployed by quitting their previous job without just cause or being sacked for misconduct, they get no Job Seeker’s Allowance for up to 6 months, unless they qualify for hardship payments.

It is the job of the Employment Service to monitor whether people satisfy the criteria for receiving benefit.¹² If there is evidence to the contrary, the matter goes to an adjudicator. Table 2 shows how many people have their benefit cut. Sanctions may last for between a few days and six months.¹³ In addition those in the middle three rows of the table lose their Housing Benefit, but not the others. (The numbers in Table 3 can be compared with some 3 million people who enter unemployment during the year and with some 1.3 million unemployed benefit recipients at a point in time).

Table 2
Number whose benefits were cut during the year: by cause (1998/9 year)

Lost job through quitting without good cause	103,000
Lost job through misconduct	23,000
Not available for work	15,000
Not actively seeking work	17,000
Failed to attend interview	94,000
Refused work	11,000
Refused to attend course/programme	14,000

This is the system as it exists at present. It has varied substantially over time, becoming slacker up till the mid-1980s and stricter since then. Up to the early 1980s the work test was progressively relaxed. In the mid 1970s the payment of benefit and the placing of unemployed people, which had previously been done in one office, was split into two separate offices, and from 1982-86 benefit recipients did not even have to register for work. Signing on, which had been weekly, became fortnightly. It is not surprising that the sustainable rate of unemployment rose.

But from 1986 onwards the work test began to be used again and the system tightened. The benefit offices and job centres have been reunited. In 1986 six-monthly

interviews began, and since 1990 benefit recipients have been formally expected to be “actively seeking work”. The full current system was introduced in 1996.

Public employment service

The main job of the Employment Service is to help people find work. There are 30,000 staff working in 1,000 job centres, servicing 1,300,000 unemployed benefit recipients – a staffing ratio of about 1:45.

The Employment Service has about 2.5 million vacancies referred to it each year – about 1/3 of the total vacancies created in the country. It fills about 1.3 million of these, thus itself placing about 40% of all the people who become unemployed each year. Clearly with more resources it could place more unemployed people more rapidly. It has a computerised system of vacancies, but with the existing IT facilities it is not yet possible to print off a list of suitable vacancies for every unemployed person each time they sign on. This would be highly desirable.

There are no limits on the rights of private sector companies to set up as job-brokers in competition with the Employment Service. For, though the market for job-matching is imperfect and therefore needs public intervention, this is not an argument for limiting it in any way.

To do its work most effectively, the Employment Service must be able to help people become more employable. Many people are so disadvantaged that they need to be referred to courses in job-search methods, or to job clubs which assist job-search, or to vocational training. It has long been the job of the Employment Service to do this and it has had some funds to buy these services.

New Deal

But since Labour came to power a quite new line of thought has come to the fore – that people ought not to remain unemployed beyond a certain time limit. It is very bad for anyone to continue unemployed for a long time. If they are desperate to work, it is deeply depressing. Or, if they are working the system (for example “working while drawing benefit”, as a number do), it is an abuse of tax-payers’ money. On top of this, long-term unemployment stigmatises a worker and makes it increasingly difficult for him to find work.

So there should be a point at which it becomes impossible for a person to remain inactive and draw benefit. **Instead people ought after a period to be guaranteed activity and to receive their income through activity rather than inactivity.** Activity should be a mandatory condition for income.

This is the idea behind the New Deal. Since 1998 there has been a New Deal for Young People under 25, costing the Government about £½ billion a year. After young people have been unemployed for 6 months, they 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 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 New Deal is well funded and has received general acclaim from young people, employers and the general public. Since April 1998 170,000 young people have been placed in work, and long-term unemployment among young people has already fallen by two-thirds.

But 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.

For adults reform has only just begun and there is a long way to go. Over the next few years a comparable New Deal will be created for unemployed people over 25+. (Up to now we have only a set of controlled experiments on this group). The basic principle will be (as before) a gateway, followed by a mandatory period. But it remains to determine

- (i) when the gateway begins,
- (ii) the length of the mandatory period, and
- (iii) the nature of the guarantee offered.

We can only at this stage offer our own suggestions on each point.

- (i) As the European Employment Guidelines imply, it should eventually become impossible for anyone to be unemployed beyond a year. This is when the gateway for adults could begin, with an offer of a job, training or some similar opportunity coming within the following three months.
- (ii) The mandatory period needs to break the habit of benefit dependence. At present most unemployed people in Britain feel that unemployment benefits are an entitlement with few obligations. Thus if a person's benefit is £200 and he is offered a job paying £240, he will often say 'I will be working for £40.' To break this psychology may often require a period of as long as 6 months off benefit, plus the clear prospect of a fall in income if the person returns to benefit.
- (iii) Thus any work that is offered should be paid at the normal rate. To deliver such an offer would be a major challenge, even allowing for the fact that the

fall-back would have to be a 6-month job on a public project. But something as dramatic as that may be needed to break with a past, where on many housing estates in Britain half the people are unemployed and have remained so year after year.

Many of Britain's unemployed are virtually illiterate and innumerate. Some 20 per cent cannot read the instructions on a medicine bottle or calculate the change they should receive after a simple purchase at a shop. (The comparable proportion for Sweden's unemployed is around 10 per cent). Plans are under consideration for a major operation to screen the unemployed for basic skills problems and to refer those with problems to suitable courses. It is important that this screening happens as soon as people register as unemployed, so that no unnecessary time is wasted.

Inactivity

Unemployment is not the only labour market problem in Britain. In addition to the unemployed, there are 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 with long-term health problem. Many people 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. There are currently no plans for compulsion in this area other than to require participation in a work-focussed interview.

The drive against unemployment and inactivity is central to the drive against child poverty in Britain. In Britain, unlike Italy, 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.

WAGE DETERMINATION AND LABOUR MOBILITY

One of the most persistent problems in Britain has been regional employment. In the 1989 boom the level of unemployment in the North remained high, while that in the South fell sharply (see last two rows of Table 3). However, during the 1990s most of the gross regional inequalities have disappeared, leaving high unemployment blackspots within every region but low-unemployment areas in every region also.

What has changed? As Table 3 shows, there has been a dramatic reversal in the drain of jobs out of the North. This change in employers' behaviour results in part from the lowering of wages in the North relative to those in the South. As Figure 5 shows, relative wages have responded to differences in unemployment rates. Moreover, this responsiveness has risen over time,¹⁴ reflecting the diminished power

of national unions caused by a series of legal changes in the 1980s and by a smaller membership.

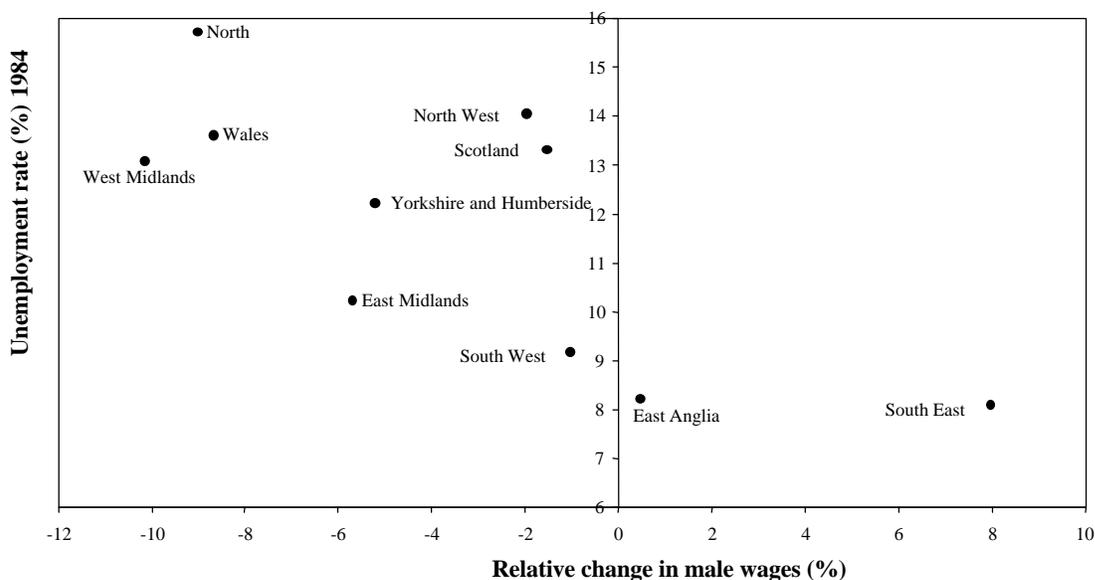
As the drain of jobs ceased, migration from North to South fell. But some migration continued in response to differences in wages and job opportunities. It was the combination of more jobs and fewer people that cut the relative unemployment rate in the North.

Table 3
The UK's North-South divide, and how it was reduced

	1979	1989	1997
Unemployment rate			
North	5.1	8.1	6.3
South	3.1	4.0	4.9
Employment			
North as % of South	129.1	113.7	114.3
Labour force			
North as % of South	131.8	118.7	116.0
Wages			
North as % of South	91.3	80.2	80.0

Note: In this analysis, South = South-East, South-West and East Anglia; North = rest.

Figure 5
Unemployment rates and the change in male wages : (1974-1997)



SUMMARY OF PROPOSALS

To conclude this section, it may be helpful to list our main conclusions about the further developments which could occur in the U.K.

1. The Employment Service needs to improve its IT system if it is to become a first-class matching service. Under such a system claimants could receive a list of suitable vacancies each fortnight, and report on the upshot of their applications next time they visit the job centre.
2. Unemployed people should be willing to take jobs even where this requires travelling up to one hour each way. But they may need discretionary help with fares when they travel far for interview and when they first start work.
3. There should be a New Deal for adults along the lines of the Youth New Deal – but cutting in later. Eventually the aim could be to offer a job or training or some similar opportunity within 15 months of becoming unemployed. The priority would be jobs with regular private employers, with waged work on publicly-supported projects providing no more than a fallback position.
4. All workers without a good Maths/English performance by 18 should be screened for problems of basic skills when they start claiming a benefit.
5. There should be more help for single parents and for people on health-related benefits to find work.
6. Housing Benefit should be reformed to prevent people becoming and remaining unemployed in order to get their rent paid.

4. ITALIAN EXPERIENCE

In spite of the improvements registered in the course of the last year in aggregate labour market indicators, Italy still appear to be caught in a high unemployment - low participation trap. Labour supply is increasing very slowly, perhaps too slowly to prevent employment growth from exerting inflationary pressures. The rise in the labour force participation of women is negligible, in spite of declining fertility rates, elsewhere typically associated with increased labour supply of women. The incidence of long-term unemployment has not declined in spite of rising unemployment outflows as the latter have involved mainly individuals with low unemployment durations. More and more of the over 55s are not working.

Regional unemployment differentials have increased since employment continues to grow mainly in the North. Inflation is still low, by Italian standards, but it is significantly higher than in the rest of Europe. While other factors (mainly lack of competition in sheltered services) account for these inflationary pressures, in some areas in the North-East there are indications of labour shortage and over-heated local labour markets.

The responsiveness of employment to output changes has increased, mainly as a result of the spread of new contractual types, allowing employers to have more degrees of freedom in adjusting their workforce. Thus, in the last two years a one per cent increase in GDP has been associated with an 0.8 per cent increase in employment; while until 1995 growth rates of GDP lower than 1.5 per cent were not sufficient to generate *net* job creation. Evidence from countries that embarked earlier on this partial labour market liberalisation route suggests that the other side of the coin of these developments is more job destruction when things go wrong (during cyclical downturns) and more dualism in the labour market, that is, a sheltered group of “insiders” with high employment security coexisting with an increasing pool of workers whose job is explicitly defined as temporary. In a nutshell, employment is getting more and more volatile as employment protection, a cyclical stabiliser after all, has been reduced by the spread of so-called “atypical work”. There are no signs as yet that the structural component of unemployment has declined.

Future developments will depend on the capacity of economic policies accompanying the recovery to mobilise labour supply. The lessons that can be learned from the Italian experience are potentially useful also for Southern European countries with similar clusters of labour market and social policy institutions (e.g., Spain, Portugal and Greece) as well as for Continental European countries with two-digit or close two-digit structural unemployment rates (France, Germany, Belgium). It is to just this structural component of unemployment that we now turn our attention.

WHO ARE THE UNEMPLOYED?

Five unemployed out of seven live in Southern Italy, two out of three are aged 35 and less. Unlike in the UK and in many EU countries, in Italy youth and long-term unemployment are synonymous: about 60 per cent of youth unemployment lasts more

than twelve months. The divide between unemployment and inactivity is rather tenuous. About one person out of four in the ranks of the unemployed population is inactive one year later. In other countries, this proportion hardly exceeds 10-15 per cent.

Youngsters stay for long in their families (the average age of entry in the labour market is 25) who provide their income (the family is the most effective unemployment benefit in Italy) while they search for a job corresponding to their aspirations. Until recently, the profile of the desired jobs was fairly standard: a full-time post, in the area of residence and often in the public sector¹⁵.

There are more women than men unemployed. Female participation is increasing, while the male rate is declining owing to early retirement.

There are signs that these traditional characteristics of Italian unemployment are changing.

First, the proportion of the young jobseekers willing to commute to work outside their area of residence has increased since 1993 by almost ten percentage points and (administrative) data point to a rise in interregional migration flows.

Second, hirings on fixed-term contracts, and other temporary work schemes have also significantly picked up: 85 out of 100 new posts created in the third quarter of 1999 were in so-called atypical forms of employment. These developments are also partly associated with changes in the characteristics of labour supply. Part-time, in particular, is a preferred (or at least accepted) working time arrangement for an increasing proportion of unemployed and it is indeed picking-up significantly. Until recently, part-time was synonymous with under-employment: part-timers were, for the most, just seeking full-time jobs.

Third, adult unemployment rates are increasing. The unemployment rate of those aged more than 35 has increased from less than 4 to more than 6 per cent in the course of the last decade. Currently one in three unemployed is aged more than 35, compared with one in five at the beginning of the 1990s. Moreover, adult unemployment is predominantly long-term: between 7 and 8 out of 10 jobseekers in this age class have been unemployed for more than a year (compared to about 6 in 10 for the unemployed population as a whole).

Fourth, the percentage of jobseekers using the “concorsi pubblici” (competitions for posts in the public sector) as their main search strategy has declined in parallel to the decline in the number of posts offered by the public administration in the South.

Fifth, the South of Italy is no longer a uniform area of backwardness; there are regions where the industrialisation has started, even if at a pace which is still too slow.

These developments are, on the one hand, encouraging as they point to a reduction in labour supply bottlenecks, but, on the other hand, signal also potential social problems related to the changing profile of unemployment. While the social costs of high unemployment of the 1980s were significantly reduced by the presence

in the same household of employed individuals, the increase of adult unemployment has been associated with a rise in the proportion of no-job households. The role of the family in providing a safety net to the unemployed is declining, and temporary workers often do not have access to social insurance against the risk of job loss, as further discussed below.

HOW UNEMPLOYED PEOPLE ARE TREATED

Unemployment Benefit System

The Italian social welfare system was designed to protect the heads of the households - the breadwinners. Only employees in mainly large manufacturing firms were protected against the risk of job loss and were offered strong protection. First, employment protection legislation and legal decisions traditionally unfavourable to employers created almost insurmountable barriers to dismissals. Second, those involved in redundancies were offered very generous treatment ending, almost by definition, in an early retirement scheme. Third, a “seniority” pension was provided, especially to civil servants, allowing them to stop working and draw a full pension after just 20 years of service (15 for married women).

Changes in the structure of employment (mainly the shift from manufacturing to services), the response of the system to labour market rigidities -- resulting in the steady increase in the share of employment in small firms (almost 50 per cent is in firms with less than 15 employees, where the strictest employment protection norms do not apply) -- have put such a system repeatedly under strain because new categories of workers were pushing to get more protection against the risk of job loss. The policy response has not been a change in the overall design of benefits, but simply a selective extension of the policy instruments used in the past to deal with redundancies, and the creation of new unemployment benefits schemes accessible to other workers-lobbies.

The current (rather messy) design of unemployment benefits is summarised in Table 4. As shown by the table, those outside manufacturing (and large units in trade and tourism), can, at best, have access only to the “ordinary unemployment benefits”, offering a very low replacement rate (30 per cent compared with an average of 50-60 in the European Union) for 6 months (6 unemployed out of 10 have been searching for more than a year).

Table 4. The Italian Unemployment Benefits System

	Ordinary Unemployment Benefit	Ordinary “Cassa integrazione guadagni” (CIGo)	Special “Cassa integrazione guadagni” (CIGs)	“Mobility List”
Workers involved	All the permanent lay-offs (excluding “apprendisti” ¹) in the private sector. ²	All the temporary lay- offs (excluding “apprendisti” ¹ and managers) in manufacturing. ³	All the temporary lay-offs (excluding “apprendisti”, ¹ temporary employees and managers) working in firms in structural crisis, with more than 15 employees in manufacturing and construction and more than 200 employees in trade and tourism.	“Collective” lay-offs in firms eligible for CIG and individual lay-offs in case of workers already in CIGs.
Replacement ratio⁴	30%	80% (there is a partially price indexed maximum level of benefit which was in 1999 about 60% of the average wage in the sector).	80% (same maximum level as CIGo).	80% in the first year, 64% in the following years (same maximum level as CIGo).
Eligibility	Full benefit: 52 weeks of contribution to the social security system in the previous 2 years. Reduced benefit: 78 days of contribution in the previous year.	No particular qualifying conditions.	3 months of seniority.	1 year of seniority.
Maximum duration	Full benefit: 6 months. Reduced benefit: number of days worked.	12 months (not necessarily continuous) in two years.	Up to 4 years.	From 1 year (for young workers in the North) to 4 years (for old workers in the Mezzogiorno) In some special cases (“long mobility”) the duration is extended up to retirement.

¹ The “apprendisti” are young workers (16-24 years old in the North 16-26 in the Mezzogiorno) in vocational training.

² Workers employed in agriculture and construction have more favourable treatment.

³ There is a similar arrangement in agriculture and construction: the main differences are in the duration of the benefit (maximum three months in both sectors) and in the presence of qualifying conditions in agriculture (6 months of seniority).

⁴ Benefit as a percentage of previous wage

Public employment service

It is fair to say that unemployed people in Italy are not assisted in their search efforts. While some progress has been made in the direction of improving the information system of the Public Employment Service (PES), there are, as yet, no nation-wide vacancy registers. Job counselling services are offered only in the public employment agencies of the North, where they are actually more valuable for the employers than for the jobseekers. No pressure is put on those registered, not even on those claiming benefits, to seek a job. There are no standardised procedures to clean-up the unemployment registers.

The number of unemployed per PES official working in close contact with the jobseeker clientele (rather than involved in administrative duties) is still very high (about 500). The PES model inherited from the past is one of services mainly carrying out certification activities. Although efforts have been made recently (thanks also to funding from the European Commission) towards retraining the PES personnel, most of the PES staff still lack the skills and qualifications to assist the unemployed.

Private placement agencies are tolerated, but are still marginal (mainly confined to Temporary Agency Work) and hence do not yet exert competitive pressures on the PES.

Active labour market policies

Employment subsidies are the dominant form of active policy in Italy. In 1998 about 0,35 of GDP was spent in various kind of incentives to job creation, mainly consisting of tax rebates, involving about 1,800,000 individuals. Evidence on their effects is not always encouraging. Subsidies provided to employers hiring from the so-called “mobility-lists” (the most generous unemployment benefit being provided in Italy) did not seem to stimulate additional outflows from unemployment, both in Northern and in the Southern regions¹⁶. There are simply too many employment subsidies and they frequently end-up crowding-out one another. Alternatively, they simply compensate for differences in unit labour costs related to the very limited wage differentials allowed by collective bargaining institutions across regions displaying much different labour productivity levels. In this case, employment subsidies can, at best, prevent further employment reductions rather than contributing to employment expansion.

The only active programme which has been so far been considered as successful (to the extent that it was included in the 1997 European Best Practices Examples) is represented by the rather generous (in the 1986-93 period they offered, on average, 150,000 Euros per entrepreneurial project) start-up loans offered to young unemployed individuals in Southern regions. However, microeconomic evidence does not indicate that subsidised firms, other things being equal, tend to live longer than unsubsidised firms. This suggests that the selection of projects is inefficient, as such a programme should clearly try to select worthwhile projects that, due to imperfections of capital markets in the South, would otherwise not be financed.

The share of unemployed involved in training and retraining courses is negligible (about 0.1 per cent). Direct job creation schemes (the so-called *Lavori Socialmente Utili*, LSU) were poorly targeted, due also to the administrative weaknesses of the PES, and ended-up creating a pressure group pushing for preferential treatment in terms of placement. Indeed ad-hoc tax rebates have been granted to employers hiring from the LSU list. The stated objective of the Government is to gradually absorb the LSU stock into jobs.

Levelling the playing field

A streamlining of both unemployment benefits and active labour market programmes is required to increase both the cost-effectiveness and the equity of labour market policies. Active and passive policies work best when they are used in combination: unemployment benefits having a fixed duration induce individuals to take up slots in active programmes when they are close to the exhaustion of benefits, while active policies can also be used as a work test for the long-term unemployed. Those refusing to be involved in active programmes should be struck off the register.

The Government was given by Parliament a broad mandate to rationalise the unemployment benefit system. This opportunity could be used to introduce a uniform unemployment benefit system replacing the very many different schemes currently in place (ordinary unemployment benefits, *Cassa Integrazione Guadagni*, mobility lists). Unemployment benefits ought to be offered only to individuals with work experience who have been laid-off or whose contract has expired, in order to cover temporary workers. Replacement rates should initially replace about 50-60 per cent of the previous wage, in order to allow beneficiaries to devote all their energies to job search, and decreasing over time. Benefits should be of fixed duration (at most one year) but should decrease over time in order to avoid people getting caught in long-term unemployment traps. Such a benefit system could also have labour supply enhancing effects: according to a survey carried out in 1998¹⁷, a large majority of young unemployed individuals would be willing to accept reductions of 2 per cent or more of their entry wage in order to be eligible for (albeit short duration) unemployment benefits.

Unemployment insurance on the top of this basic allowance -- e.g., offering replacement rates matching those currently provided by the sequence *Cassa Integrazione Guadagni*-mobility lists - could be provided only in the context of voluntary, self-financed schemes (e.g. run at the industry level). As in the case of Finland or even of the artisans in the central regions of Italy, such schemes can be managed by social partners.

A third tier of social protection, like the RMI (*Reddito Minimo di Inserimento*), currently under trial, could complete the reform design. Such a third tier was recommended by a commission of experts, appointed by the Government in 1997 to evaluate social expenditure and to suggest possible reforms, (*Commissione Onofri*, 1997). Since 1999, a two-year experiment with the *Reddito Minimo di Inserimento* has been enacted in 39 municipalities.¹⁸

The extension of this program to the whole country will achieve a needed goal of levelling the playing field of social assistance, as well as completing the design of the unemployment benefit system. The creation of a third means-tested tier could also permit a drastic simplification of the complex jungle of provisions currently in place. The reform must pay attention to the promotion of self-help and to incentive aspects, preventing the risk of unemployment and/or poverty traps, not adequately covered by the current disregard system. This could be strengthened by introducing disregards which rise with unemployment duration and/or the continuation of poverty.¹⁹

The main obstacle to the completion of the reform of unemployment benefits and employment subsidies has been a lack of funds. Indeed, the reform has been postponed until after the approval of the 2001 budget law. However, a reform of unemployment benefits along the lines discussed above can be accommodated with a very minor increase in public expenditure outlays for unemployment benefits, which is among the lowest in the OECD arena in spite of the relatively high unemployment rate of Italy. Moreover, savings in social expenditure can be achieved by accompanying the reform of unemployment benefits with the phasing out of early retirements and the acceleration of the pension reform, which improves incentives to continue working at least until the age of 65.

Strengthening the effectiveness of the PES is essential to make better use of the basic public unemployment insurance scheme and to better diversify the mix of active labour market policy programmes. All individuals receiving benefits should be offered job counselling services and, in due course, involvement in retraining, public work schemes or subsidised jobs, which should be used as a tool to place those who are less "marketable" and as a device to test their willingness to work. Experience with the reform of the "Collocamento" suggests that such an overhaul requires more a coherent set of administrative guidelines than regulations to be approved by Parliament. The effectiveness of the PES can also be enhanced by introducing performance indicators and rewarding the most successful offices. This is being done in the allocation of the EU structural funds.

All this requires having more and better-trained PES staff involved in field work. The cleaning-up of the unemployment registers is essential to define realistic workloads and targets for active programmes. Competition with private placement agencies may contribute to enhancing the effectiveness of the PES. In order to avoid cream-skimming effects, where private placement agencies do not take-up hard-to-place individuals, scores rewarding the placements of hard-core long-term unemployed by private agencies may be defined.

The government has also been given by Parliament the mandate to streamline the vast array of employment subsidies. International experience suggests that selectivity is essential for the success of such schemes. Better targeting can be achieved by decentralising the use of such instruments and rewarding with larger allocations the PES centres displaying a better performance (according to a variety of indicators) in the use of such instruments. Incentives to regional mobility of young people resident in the high-unemployment regions should also be envisaged to simultaneously reduce unemployment in Southern regions and inflationary pressures in the North. Regions with overheated labour markets could be involved in the financing of such mobility loans, in order also to strengthen incentives to make a

better use of these instruments. In the near future, the most important policy actions addressing regional labour market imbalances have to do with wage setting, an issue which is taken up below. A reduction of social security contributions for low-paid, younger workers could also be devised in order to cope with the concentration of unemployment among young and relatively low-skilled people.

The spread of part-time work is being encouraged by allowing for more flexibility in working time and via fiscal incentives. Remaining procedural obstacles to the expansion of part-time work should be removed. This, together with improvements in the supply of child and disabled care programs, alleviating the care duties actually supported by women within the household, could contribute to increasing the labour supply of women.

WAGE DETERMINATION AND LABOUR MOBILITY

Since the agreement of July 1993, wage bargaining institutions allow for some decentralisation of wage setting in the private sector, with performance-related plant-level bargaining (affecting however about 3 per cent of remuneration). Local wage setting was encouraged in the context of the so-called Patti Territoriali and Contratti d'Area²⁰ allowing for a combination of infrastructural projects, incentives and exemptions from the application of contractual wage minima in order to attract capital. Yet, in spite of all these attempts, North-South wage differentials are not widening and are significantly lower than labour productivity differentials. This was in the past compensated by reduced social security contributions (*fiscalizzazione degli oneri sociali*) for firms operating in the South, but such transfers are now being gradually phased out as the European Commission deems that they are contrary to Single Market principles.

More than 1 out of 5 workers in the South are in the public sector, compared to 1 in 10 in the Northern regions. Public sector entry wages are typically above private wages in the South. The public sector does not allow for any interregional pay variation and the cost-of-living is significantly lower in the South than in Northern regions. Thus, posts in the public administration -- which also offer the strongest employment security -- still attract a large fraction of the jobseekers in Southern regions. Significant efforts are being made towards enhancing the effectiveness of the state machinery in Southern Regions. The contractual status of civil servants has been transformed, modeling it along the lines of private sector employees. Tighter procedures have also been adopted in the use of the EU structural funds, rewarding the best performance across the various local administrations. Such reforms would seem to have significantly speeded up the allocation of structural funds and rationalized its use. Yet much remains to be done in this area.

As administrative extension is provided to collective wage agreements, the only way to avoid applying contractual minima -- determined by labour market conditions in the North²¹ - is to go underground. Thus, the other side of the coin of wage compression in spite of large productivity differentials is the spread of the informal sector. According to some recent estimates, the latter accounts for as much as 30 per cent of employment in the South²². Clearly workers in the informal sector are not protected by any form of social insurance. The "New Social Pact" agreed upon

by the government, unions, and employers' associations in December 1998 involves temporary tax relief for firms exiting the hidden sector. Unfortunately, there is no evidence yet on the effects of such policies.

SUMMARY OF PROPOSALS

Broad reforms of unemployment benefits and of the system of employment subsidies are badly needed to level the playing field, that is, no longer to discriminate between different categories of unemployed people. The necessary resources for these reforms can be obtained by accelerating the phasing out of seniority pensions. The reform of unemployment benefits could also be accompanied with changes in employment protection legislation. The principle should be to phase out absolute and procedural obstacles to dismissals and replace them with severance pay, advance notice and a broader coverage of unemployment benefits, that is, a larger share of workers potentially eligible for unemployment benefits.

Incentives to take up jobs in the private sector would be enhanced by allowing wages in the public administration to reward productivity. Reducing employment security for civil servants would also make private jobs more palatable to jobseekers and, at the same time, contribute to improve the efficiency of the public administration, including the PES itself.

Decentralised wage bargaining ought to be encouraged and its scope expanded to cover a larger component of the pay structures (currently it is only of the order of 3 per cent). Decentralisation of wage setting can be accompanied by the introduction of a nation-wide statutory minimum wage, set at levels which are compatible with Southern labour productivity levels.

The larger wage differentials induced by decentralised wage bargaining could be combined with the introduction of in-work income support (supplementing low wages with subsidies or tax credits) encouraging the transition from welfare to work for unskilled individuals and those with short work experience. In the absence of a larger dispersion in wage structures, the risk in such an approach is that it would have too many potential beneficiaries, in which case the disincentives associated with the financing of these schemes could outweigh their incentives to make welfare-to-work transitions. International evidence suggests that such in-work income support schemes work best when they are rather narrowly targeted²³.

In-work income support schemes may be difficult to administer as they require means-testing and ought to be linked to social assistance of last resort schemes which are not yet in place. An alternative is to introduce social security reductions for low wage earners. If wages in the South are actually allowed by collective bargaining to decline below those paid in Northern regions, such a measure would target mainly jobs in the Mezzogiorno, reducing the adverse effects on Southern employment of the phasing out of the "fiscalizzazione degli oneri sociali".

5. RECOMMENDATIONS TO E.U. HEADS OF GOVERNMENT

The goal in Europe **must be** full employment. Under full employment, anyone can find work within a reasonable period of time. So restoring full employment is synonymous with preventing long-term unemployment. Four strategies to prevent long-term unemployment are advocated in this report:

1. To prevent people drifting into long-term unemployment, there should be active policies to ensure that everyone gets offers of work or training within a year of becoming unemployed. The work should where possible be with regular employers, and secured if necessary by a recruitment subsidy. A modernised Public Employment Service is a key instrument in the business of channelling job offers to workers. It should be properly staffed and funded, with private agencies free to compete with it.
2. The Welfare-to-work approach will not prevent long-term unemployment if individuals who receive offers from employers can instead choose to continue living on benefit. A system of complementary rights and responsibilities is needed where the citizen can expect high-quality help in finding work, but in return must take advantage of it or cease to draw benefits. Once the state is channelling offers of work to everyone within the first year of unemployment, that should be the maximum period for which benefits are available.
3. Further policies are needed to deal with regional unemployment. In particular, the decentralisation of wage setting (e.g. at the territorial level as currently done on an experimental basis in Italy) and measures aimed at improving the external environment where firms operate (e.g. the efficiency of public administration, the enforcement of the rule of law, etc.) are also essential. The decentralisation of collective bargaining can be accompanied with measures encouraging regional labour mobility and encouraging take-up of relatively low-paid jobs, e.g., by providing in-work benefits to low-wage earners.
4. Labour supply reducing policies such as early retirement, as well as uncontrolled access to invalidity pensions, should be phased out as the welfare-to-work approach makes it possible to deal with redundancies without having to implement (high cost) early retirement for older workers. Ongoing or planned reforms of pension systems should also remove from public pension arrangements those features which discourage the participation of older workers.

These four strategies have to be adapted to the institutional features of each country. In this report we discuss in some detail the way in which welfare-to-work principles can be applied to the UK and the Italian labour markets. The proposals and policy recommendations that we developed in this context may extend to other countries with similar institutions in place.

Welfare-to-work requires, in any event, constant monitoring and evaluation. The EU supra-national authorities have a key role in this context. While the European Community cannot substitute for national governments in the decision as to which set of measures is most appropriate to deal with long-term unemployment and low participation traps, it can nevertheless make sure that resources allocated to welfare-to-work policies – including the whole set of unemployment benefits and active policies – are spent efficiently and that appropriate evaluations of the effects of policies are carried out, which ought to be based on stated goals of policies and on methodologies agreed upon at the European level.

So now is the time for an optimistic approach to Europe's employment problem. Twenty years ago inflation was still a chronic disease of the European economy. It has been conquered by the adoption of good policies. There is no reason why, with good policies, we should not also deal with long-term unemployment and low participation.

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ANNEX

LABOUR MARKET STATISTICS, 1998

		Italy	UK
ILO unemployment rates (%)			
Total			
	15-24	33.8	13.7
	25-54	9.4	5.3
	55-64	4.6	5.2
	Total	12.0	6.7
Men			
	15-24	29.8	15.5
	25-54	7.0	5.8
	55-64	4.7	6.5
	Total	9.3	7.4
Women			
	15-24	39.0	11.6
	25-54	13.4	4.8
	55-64	4.5	3.1
	Total	16.4	5.8
Heads of household		5.0	6.5
Others		18.7	7.0
North		7.1	8.0
South		22.2	6.3
		Italy	UK
Non-employment rates (%)			
Total			
	15-24	74.8	40.1
	25-54	33.8	21.6
	55-64	72.3	52.1
	Total	48.3	29.6
Men			
	15-24	70.5	37.9
	25-54	16.2	14.3
	55-64	58.6	41.9
	Total	33.8	22.6
Women			
	15-24	79.3	42.3
	25-54	51.5	29.1
	55-64	85.0	62.0
	Total	62.7	36.6
North		42.4	32.8
South		58.9	28.5

	Italy	UK
Analysis of the ILO unemployed (%)		
Never worked	41.2	16.4
Have worked	58.8	83.6
Duration		
All (> 15 years old)		
Under 12 months	39.9	70.0
12 and over	60.1	30.0
Men (> 15)		
Under 12 months	39.7	64.8
12 and over	60.3	35.2
Women (>15)		
Under 12 months	40.1	77.7
12 and over	59.9	22.3
15-24 years old		
Under 12 months	44.0	85.4
12 and over	56.0	14.6
24-49 years old		
Under 12 months	37.7	66.2
12 and over	62.3	33.8
More than 50 years old		
Under 12 months	40.6	49,8
12 and over	59.4	50.2
% on unemployment-related benefits		
15-24	3.0	
25-54	17.8	
55-64	23.0	
Total	12.2	
Men		79.0
Women		43.2
Total		65.0

ENDNOTES

¹ The authors are from Bocconi University (Boeri) and the London School of Economics (Layard and Nickell). They write in their personal capacity. They are grateful for help from R. Tangorra, S Fassina, R. Barwell and N. Ali, and for statistical support from Fondazione Rodolfo Debenedetti.

² Changes in these areas could produce large changes in the unemployment rate which is not true of employment protection, early retirement or reduced hours, for reasons explained in Layard et al (1991). See also Nickell and Layard (1999).

³ See Nickell and Layard (1999).

⁴ Benefit duration is from Nickell and Layard in O. Ashenfelter and D. Card, Handbook of Labor Economics Vol.3C, 1999 and it relates to 1992. LTU data relate to 1989-98 and are based on tables at the end of OECD Employment Trends.

⁵ For example Martin (1998), Grubb (1998) and the various OECD national reviews of the Public Employment Service.

⁶ Martin (1998), U.S. Dept of Labor (1995).

⁷ NERA (1995).

⁸ Katz (1996).

⁹ Blanchard and Katz (1992) and Decressin and Fata (1995) nicely characterise differences in the adjustment of regional labour markets in the US and in Europe. While in the US, regional migration plays a crucial role, in Europe migration is negligible and high-unemployment regions experience large flows to inactivity.

¹⁰ Boeri and Pagani (1997) estimated the likelihood of searching for public sector and private sector jobs as well as reservation wage functions for Italian workers. They found that residence in the Southern regions yields a higher probability of searching for public sector jobs only (e.g., applying to “concorsi pubblici”) and wage aspirations not lower, ceteris paribus, than in the Northern regions.

¹¹ In this calculation housing costs are excluded from income in work and from income out of work. Adding in housing costs would raise the replacement ratio.

¹² The calculation of benefit is actually done by the Benefit Agency, who also pay the benefit, usually by giro-cheque sent by post. But claimants rarely meet Benefit Agency staff.

¹³ The average length of sanction was 16.5 weeks, with 29% of sanctions lasting the full 26 weeks. In August 1999, 8000 people were receiving hardship payments. These included 6,000 single persons (including single parents) and 2,000 people aged 18-24.

¹⁴ Bell, Nickell and Quintini (1999) estimate that the long-run value of $\ln w / \ln u$ rose from 0.109 to 0.143 between 1977-87 and 1987-97.

¹⁵ This is suggested by the answers to the Labour Force questionnaire concerning the type of job being searched and the search method being used (e.g., application only to so-called public “concorsi” signal the desire to get a job in the public administration).

¹⁶ See Brunello et al. (1999), Caroleo et al. (1999).

¹⁷ See Boeri and Tabellini (1998).

¹⁸ The program raises the household’s income to a threshold, slightly below the poverty line, but tests for the absence of any asset beside the residential house. An earning disregard of 25% is applied to labour income; for people with working capacity the benefit is conditional, on either availability to accept a labour offer, active labour search, participation to insertion programs, or care activity towards children or disabled people within the family.

¹⁹ See Boeri and Pellizzari (2000).

²⁰ See Cersosimo (1999) for a preliminary assessment of this experience.

²¹ See Brunello (1999) for formal tests of the fact that wage setting reacts to labour market slack in the Northern regions only.

²² Cf. Busetta and Giovannini (1998).

²³ See Bassanini et al. (1999).