Welfare-to-Work: Which Policies Work and Why?

Professor Richard Blundell FBA, *of University College London and the Institute for Fiscal Studies, delivered the Keynes Lecture in Economics on 1 November 2001. The key organizing idea in the lecture was to provide an integrated view of the way 'welfare to work' and 'make work pay' policies affect the earnings, incomes and incentives of working age individuals and their families. Below, Professor Blundell summarises the main strands of his lecture.*

The 2001 Keynes Lecture was concerned with the effectiveness of alternative policies designed to enhance the labour market attachment and earnings of the low skilled. It considered the arguments behind the rapid expansion in 'welfare to work' policies that occurred over the last decade. And it addressed the 'iron triangle' of welfare reform – that is the three, often conflicting, goals: raising the living standards of those on low incomes; encouraging work and economic self-sufficiency; and keeping government costs low. Many different policies can be cast in terms of these three broad aims, albeit with different weights attached to each of them. In the UK there are active labour market programmes like the New Deal and there are also financial incentive programmes like the Working Families Tax Credit (WFTC). Although the latter are often classed as welfare policies and the former as active labour market policies, both are motivated by similar concerns over low incomes and low labour market attachment and they share many similar design features.

Although other countries, most notably the US and Canada, have implemented a similar array of policies, the UK is an ideal test bed in which to evaluate such policy reforms. Over the last decade the WFTC and the New Deal, two prominent examples of these alternative types of policies, were introduced and extended. These policies were targeted at two groups: (1) low income/low educated families with young children; (2) low-skilled workers with long or repeated spells of unemployment. In both cases the diagnosis was similar: relatively low hourly wages with little labour market experience implying little incentive for work. However, the detail is different. In the first case it is the generosity of the benefit system for families relative to potential earnings and child-care costs that are thought to provide the disincentive. For the second group it is the matching with suitable employers and the low initial wages that are perceived as the central issue. Consequently, although the prescription for both is to enhance net earnings in work, the first involves a long-term income-related supplement to earnings, possibly with a child-care component, while the second centres on job-search assistance and short-term employer-based employment subsidies. But to what extent are these differences in the design of welfare to work programmes appropriate and could they be improved?

The recent proposal by the UK government to separate the child component of WFTC from the adult component so as to form an integrated child credit (ICC) and an employment tax credit (ETC), provides a further motivation for investigating the overall design features of in-work benefits and other 'make work pay' policies. This is especially the case once it is recognized that the new ETC will be open to all adults irrespective of whether they have children.

There are no magic solutions but several preferred design features emerge from the analysis presented in the lecture. There is strong evidence from the UK and abroad that financial incentives can be effective in encouraging work, even among the low-skilled, welfare-dependent populations with little labour market experience. Time-limiting the incentive seems to help with human capital incentives and self-sufficiency, but the length needs to be gauged to allow for the relatively slow rates of wage progression that are likely to occur among these target populations. Indeed the evidence is that wage progression for the low-skilled is quite low. Targeting welfare-dependent and unemployed populations is also more cost effective and probably reasonably equitable, provided a longish time limit on receipt is set. That is not to say there should not remain some overall negative income tax or tax credit in place, but the generosity of this can be traded off against the need to target certain low-income populations. Indeed, it may not be beneficial for the mothers of young children to work, at least in comparison to pure income transfers. Here there is little reliable evidence.

Financial incentives appear to work better when they are provided directly to the individual rather than through the employer. This may be because

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job mobility is an important route to wage progression but it also seems to be affected by issues relating to stigma. Moreover, mandatory job-search assistance, together with sanctions, seem to play a useful role. Wage progression can also be enhanced by training. This appears to bring higher returns if it is located in the workplace, at least for lower-skilled individuals with low levels of prior education. There is evidence that this is particularly the case for workplace training that leads to accredited qualifications. Consequently a training subsidy for the employed may be needed in addition to an individual financial incentive.

The analysis of this lecture suggests that an earnings tax credit policy with time limits that are reasonably long and which targets welfare dependency, thereby focusing on low human capital and low labour market attachment, could form the basis for an integrated view of employment tax credits and New Deal-style programmes. It could work as a relatively low cost way of enhancing earnings and self-sufficiency among these target populations. There is still much we need to know but we already know enough to significantly improve the design of policies directed at individuals and families with low incomes and low labour market attachment.