

# **CENTRE FOR ECONOMIC POLICY RESEARCH**

**Australian National University**

**DISCUSSION PAPERS**

## **Can Supply-Side Policies Reduce Unemployment? Lessons from North America**

*Gary Burtless\**

**Discussion Paper No. 440  
November 2001**

**ISSN: 1442-8636**

**ISBN: 0 7315 3510 3**

---

\*Gary Burtless is a senior fellow in the Economic Studies program at The Brookings Institution, Washington, DC, USA. An earlier version of this paper was presented at a conference on “Unemployment: The Role of Government,” sponsored by the Centre for Economic Policy Research, Australian National University, Canberra, September 6-7, 2001. The opinions and conclusions are solely those of the author and should not be attributed to the Centre or to the Brookings Institution.

## **CONTENTS**

	<b>Page</b>
<b>Abstract</b>	<b>iii</b>
<b>Labour market background</b>	<b>3</b>
<b>The population of concern</b>	<b>5</b>
<b>Financial penalties</b>	<b>9</b>
<b>Tough work requirements and human capital enhancement</b>	<b>10</b>
<b>Positive financial incentives</b>	<b>17</b>
<b>Changing employer incentives</b>	<b>23</b>
<b>Political acceptability of supply-side incentives</b>	<b>26</b>
<b>Endnotes</b>	<b>30</b>
<b>References</b>	<b>31</b>
<b>Figures</b>	<b>34</b>

## ABSTRACT

Gary Burtless considered lessons about maintaining a low rate of structural unemployment that can be learned from the North American experience. Cyclical unemployment rises and falls in inverse proportion to the level of aggregate demand in an economy, but cyclical kind of unemployment was not the focus of Burtless's paper. Burtless examined the effects of "supply-side" policies, which he interpreted to include policies aimed at changing the skills of the workforce and the microeconomic incentives facing workers and employers in a labor market. He argued that the low rate of structural unemployment and high rate of adult employment in the United States is partly explained by several supply-side policies.

Two micro-economic supply-side policies were greatly expanded after the mid-1980s. First, the U.S. government established very generous earnings supplements, payable to low-income workers, to encourage low-wage workers to find and keep jobs. Second, American social assistance programs were reformed to limit the duration of income support payments and to link support benefits to workers' active participation in job search, occupational training, and, as a last resort, community work experience jobs. A variety of experimental and nonexperimental studies suggests these measures help explain the increased employment rate of economically disadvantaged U.S. workers during the 1990s. Over the past two decades the United States also maintained strong incentives for employers to create job openings for the hard-to-employ. Payroll tax and regulatory burdens on employers remain low by OECD standards, and the relatively low U.S. legal minimum wage was permitted to fall during the 1980s and 1990s. Burtless concludes that "The U.S. experience suggests ... that strong doses of supply-side medicine can boost the employment rates of the hard-to-employ."

# **Can Supply-Side Policies Reduce Unemployment? Lessons from North America**

*by*

Gary Burtless

OECD COUNTRIES FACE a daunting challenge cutting joblessness and keeping unemployment low. Since the late 1970s most of the leading OECD countries have confronted a common problem of shrinking aggregate demand for workers with below-average skills. The existence of this problem is suggested by high overall joblessness in continental Europe, especially among those with less skill, and rising relative unemployment rates among the least skilled in the United States. Even more strikingly, it is revealed by steep declines in the absolute and relative wages of unskilled U.S. workers. To some extent this pattern is evident in other OECD countries as a decline in the relative earnings of the unskilled. Strong U.S. economic growth between 1995 and 2000 improved the labor market fortunes of the least skilled, but the relative wage of American workers at the bottom of the pay ladder remains well below the level of the late 1970s.

Both low wages and long spells of unemployment can push affected workers and their families into poverty. In the United States and a few other countries, marginalization takes the form of declining real wages and reduced fringe benefits. Disappearing employment opportunities can also depress family incomes. Young and middle-aged workers who are intermittently employed or who are unable to find any jobs at all can slip into poverty unless social assistance payments or family transfers provide an income cushion for workers to fall back on. Joblessness and intermittent employment have become much more common in the OECD since 1980.

This paper examines alternative supply-side policies to reduce unemployment, especially among the least skilled and the long-term unemployed. After briefly describing some background information about labor market trends in leading industrial countries, I evaluate a number of supply-side policies that have been attempted in the past or that are currently under consideration in North America, the OECD region where there has been the smallest increase in long-term joblessness. Some of these policies are designed to encourage work among the unemployed by improving the incomes or circumstances of jobless adults who accept jobs or by improving incentives for employment creation in the business community. Other policies attempt to discourage long-term

unemployment by reducing the attractiveness of public transfers, either by lowering transfer benefits or imposing burdensome requirements on adults who continue to receive government transfers. The first approach is expensive to taxpayers because it increases the cost of the public services or transfer payments provided to unemployed or low-income workers. On the other hand, the approach is likely to yield an improvement in the income and circumstances of the unemployed. The second approach, if successful, is less expensive to taxpayers and, indeed, often reduces taxpayer burdens. However, unemployed workers and social assistance recipients can suffer serious losses in net income and a reduction in living standards.

The contrasting effect of the two kinds of policies raises an important issue about the goal of public policy in this area. If the immediate goal of policy is to reduce joblessness and boost the earnings of formerly unemployed workers, is the ultimate goal to improve the living standards of the currently unemployed? Or is it to improve the performance of the job market and to reduce net burdens on taxpayers? The easy answer is that good public policy should accomplish both goals. Both taxpayers and the unemployed should benefit. The harsh reality is that it is sometimes difficult to accomplish both goals at the same time. Many work-oriented policies that produce increases in employment and gains in the incomes of once unemployed workers can be expensive. They impose extra burdens on taxpayers, because the cost of providing incentives to unemployed workers or employers exceeds the government savings from lower spending on transfers to the unemployed. On the other hand, tough-minded reforms that reduce taxpayer burdens can cut the net incomes of low-wage workers and the unemployed. The policies may boost the earned incomes of the formerly unemployed, but they slash the transfer benefits available to working-age people with limited incomes. Taxpayers end up better off; the current and former unemployed end up worse off.

The following sections of the paper consider several supply-side policies aimed at reducing joblessness. These policies try to accomplish this goal by (1) curbing workers' incentive to remain unemployed by altering the public transfer programs that provide support to jobless workers ; (2) increasing the attractiveness to work by boosting the net income available to unemployed workers who accept jobs; (3) improving the human capital of jobless workers to make them more employable; and (4) increasing the attractiveness to employers of hiring and training the unemployed, especially from among the ranks of the least skilled. I do not consider reforms in the product market or innovations in macro-economic policy that may produce lower

unemployment. I focus instead on policies intended to change the microeconomic incentives facing workers and employers and the human capital characteristics of jobless workers.

## **Labor market background**

Nearly all the industrialized countries have experienced protracted labor market problems since the first oil crisis in 1973-74. Differences in national laws and labor market institutions mean that common problems have been reflected in different ways in different national labor markets. With the notable exception of the United States, most OECD countries, including Australia, experienced a secular increase in involuntary unemployment starting in the mid-1970s. In many countries the increase has brought joblessness to a level several times higher than it was in the 1960s. The lower panel in Figure 1 shows the trend of unemployment in Australia, the United States, and the “Euro-3” – France, Germany, and Italy. Most countries have also suffered a sharp deceleration in real wage growth and slowing improvement in living standards. Since the late 1970s many, though not all, of the major industrialized countries have experienced increased inequality in the distribution of wages and incomes. The sharpest increases in wage inequality have occurred in Canada, the United Kingdom, and the United States, while the biggest increases in income inequality occurred in the United Kingdom and the United States.

It is worth considering the ways in which the job market problems of the major countries differ and the ways in which they are similar. My discussion focuses on Australia, the United States and the largest economies in Western Europe – Germany, France, Italy, and the United Kingdom.

*Employment and unemployment.* Broadly speaking, European countries have suffered more serious and sustained increases in unemployment than either Australia or the United States. The major European economies, except Great Britain, encountered severe difficulties generating enough new jobs to provide employment to their slowly growing working-age populations. As a result, continental Europe has experienced a much steeper fall in the employment-population ratio and a much smaller increase in women's labor force participation than has been the case in Australia or the United States (Figures 3 and 4). In contrast, after suffering serious but temporary problems with high unemployment in the 1974-75 and 1981-82 recessions, the United States saw its jobless rate drop to normal post-war levels in the economic expansions that followed those recessions.

The trend in Australian unemployment has been in between that of continental Europe and the United States. Like Europe, Australia enjoyed much lower unemployment in the 1960s and early 1970s than the United States, and like Europe, Australia has seen a sizable increase in the unemployment rate that is compatible with non-accelerating inflation (the “NAIRU” or “full employment” rate of unemployment). The lowest rate of unemployment seen in the 1980s and 1990s is roughly triple the very low rate Australia enjoyed in the decade ending in 1973. Like the United States, however, Australia experiences large swings in unemployment over the business cycle. This means that unemployment moves down in an economic recovery as well as up in a recession. In continental Europe, unemployment is extremely slow to fall after a recession, even several years into an economic expansion.

Anemic job creation has not been a problem in either the United States or Australia. U.S. employment growth has been robust in each of the major expansions since 1975. The American employment-population ratio has reached a new historical high at the end of each expansion, and an overwhelming share of the new employment growth has been generated by an increase in private sector jobs. The top and bottom panels of Figure 3 show that in terms of the share of the adult population in employment, the Australian experience stands about midway between that of the United States, on the one hand, and the three continental European countries, on the other. Employment growth in Australia and the United States has been robust and stands in marked contrast with anemic job growth in continental Europe (top panel of Figure 4). In most of the European countries, except Great Britain, it is now much harder for the unemployed to find jobs and for young labor force entrants to get established in career jobs than it is for their counterparts in Australia and the United States.

Figure 2 shows statistics that are suggestive of the character of unemployment in the leading industrial countries. The top panel shows the male unemployment rate. For many countries this statistic is more revealing about the level of labor demand than the total unemployment rate, which includes the unemployment experience of women. Adult women in some countries continue to have employment rates far below those of men. A high female unemployment rate reflects the high rates of turnover in the jobs where women have traditionally been segregated. In many economies an adult male continues to be the typical family’s main breadwinner. Joblessness among Australian men is closer to levels observed in low-unemployment economies than in continental Europe. The most painful and socially destructive

type of unemployment is that which lasts a long time. The lower panel in Figure 2 shows that long-spell unemployment in Australia falls in the middle ranks of industrialized countries. Long-term unemployment is well above the level in North America but substantially below levels that prevail in continental Europe.

*Wage developments.* Although the United States has enjoyed stronger employment growth and much lower joblessness than Europe, until recently it has experienced slower growth in real wages. It also experienced faster growth in wage inequality. (Since 1995, however, U.S. wage growth has improved along with U.S. productivity performance, and wage inequality has stabilized, at least among the bottom 95% of wage earners.) Only Britain saw such a steep long-run rise in wage disparities as the United States, and British wages, even among the poorly paid, have generally risen or at least remained constant over the past two decades while wages of many low-skilled workers have actually declined in the United States. OECD statistics suggest that Australia's experience with wage inequality has been about mid-way between that in Canada, Britain, and the United States, on the one hand, and continental Europe, on the other.

## **The population of concern**

When an economy is operating near full employment, unemployed workers who face the most serious job-finding problems fall into two categories. Some do not possess even the rudimentary skills needed for job market success, while others are skilled workers with the misfortune to have been dismissed from a job in a declining company, industry, or occupation. In the United States, the first class of unemployed worker is referred to as "disadvantaged"; the second, as "displaced." Joblessness imposes large welfare losses on both classes of worker. At least in the United States, however, voters have different attitudes toward the two kinds of unemployed. Displaced workers arouse greater sympathy among middle class voters than the disadvantaged, perhaps because displaced workers – aside from bad luck – seem to share so many characteristics of the median voter. U.S. policies toward the two kinds of worker reflect this difference in attitude. Policies toward the disadvantaged are often harsher and more punitive.

*Disadvantaged workers.* Any sensible employment strategy for the economically disadvantaged must confront a basic fact of life: Social assistance recipients and the long-term unemployed typically suffer serious handicaps in the job market. In the United States and Canada, typical long-term social assistance recipients are young parents who have limited schooling and

very low scores on standardized tests of aptitude and achievement. Even if these parents were not responsible for the care of young children, they would face major hurdles in finding and keeping a well-paid job. Since many parents among the long-term unemployed are unmarried and living without an adult partner, they have child care responsibilities that make their employment problems even more formidable.

The weak labor market preparation of most long-term assistance recipients is apparent from simple tabulations of their work experience, educational attainment, and standardized test scores. A 1994 survey conducted by the U.S. Department of Health and Human Services (DHHS) revealed that 40 percent of American mothers receiving cash public assistance had not completed secondary school. In comparison, only about 15 percent of all 25-34 year-old American women has failed to complete high school. Just 1 percent of recipient mothers had graduated from college, whereas roughly a quarter of all 25-34 year-old women have a college degree. Adult assistance recipients also perform poorly on standardized tests of ability and achievement. Among 25-year-old women who received U.S. cash public assistance year-round in the mid-1980s, almost three-quarters obtained an aptitude test score that placed them in the bottom one-quarter of all test takers. Only 12 percent obtained a score in the top half of test takers (Burtless, 1995). Limited education and poor performance on standardized tests restrict the kinds of jobs that most aid recipients can obtain.

People who are sympathetic with the plight of disadvantaged job seekers sometimes view the obstacles to their employment as insurmountable “barriers.” In labor markets operating near full employment, this view is not very realistic. Only a minority – probably a small minority – of disadvantaged workers in long-term unemployment are prevented from working as a result of an insurmountable barrier to employment. It is more sensible to think about the various costs of entering employment. If society as a whole or the unemployed themselves are willing to pay these costs, work should be considered a practical option for the great majority of the long-term unemployed, assuming they are physically and mentally capable of working. The problem, of course, is that many of the long-term jobless are unwilling to bear the costs of finding and keeping a job if the net reward from work is small. Since many of the disadvantaged do not have the skills that equip them to hold highly paid jobs, even a relatively modest cost of employment – such as a small daily bus fare – may seem to represent a formidable bar to employment.

Among the long-term unemployed, the economically disadvantaged face four kinds of obstacles to holding and keeping a job: (a) work-limiting health conditions; (b) deficiencies in education and basic skills; (c) child care responsibilities; and (d) transportation. In the United States, it is estimated that about 10 percent of long-term social assistance recipients have health conditions that prevent them from working, while another 5 percent may have serious psychological problems. It is unrealistic to expect that working-age adults with serious physical or psychological problems will be good candidates for employment, unless the state is willing to pay for a high level of support services. A generous welfare state that places a high premium on employment, such as Sweden, may be willing to bear these costs.

The education and skill deficiencies of economically and socially disadvantaged workers restrict their access to well-paying occupations, but they do not preclude employment altogether. In an economy near full employment, an unskilled social assistance recipient, if he or she is able-bodied and moderately resourceful, can usually find an employer willing to offer a job, even though the job may provide low wages and few benefits beyond those required by law. In many urban labor markets in North America, for example, jobless workers with few qualifications can apply to temporary employment agencies for short-term work. Although the employment is uncertain and irregular, workers who are persistent can usually obtain temporary work assignments, and many eventually find permanent jobs if their work performance impresses a manager who has provided a short-term job assignment. Other job opportunities for less qualified workers can be found in low-wage retailing, cleaning and landscape services, agriculture, manual labor, and informal child care. With relatively little training, less educated job seekers can find work as home health aides for the elderly and disabled.

None of these occupations offers great promise of a comfortable income or long-term career advancement. It is important to recognize, however, that in most industrialized countries job opportunities exist for applicants who are willing to accept them, a fact confirmed by the job-finding success of unskilled immigrants in these labor markets. Many immigrants entering the United States suffer even worse disadvantages than those found among the long-term unemployed in the native-born population. U.S. immigrants often have less schooling and English-language proficiency than long-term assistance recipients. Illegal immigrants into the United States are not eligible to receive public assistance, except emergency medical aid, so they must rely on their own

earnings in order to survive. The great majority finds jobs, and a sizable minority achieves modest prosperity.

The plentiful job opportunities available in the low-wage U.S. labor market are not so common elsewhere in the OECD. In part this is because product and labor market regulation have slowed the development of low-wage service occupations that have become common in the United States. The effects of some of these regulations could be ameliorated with regulatory reform and carefully crafted incentives to encourage the creation of jobs for the less skilled. But more employers would be willing to develop and offer low-wage job opportunities if they believed, as American employers do, that an eager if untrained workforce is available to accept the jobs.

*Displaced workers.* Experienced workers who have been displaced as a result of economic change face substantially different labor market problems than economically disadvantaged workers who suffer long-term unemployment. Advances in technology, changes in consumers' tastes, and shifts in world trade inevitably cause job loss. By definition, improvements in productivity mean that fewer workers are needed to produce the same amount of goods and services. Skilled workers in declining industries and occupations are some of the victims of this process of creative destruction. The ones who remain jobless for a long time, even in a full-employment economy, are typically workers with long job seniority on their previous job. They are understandably reluctant to accept jobs with significantly lower pay or less responsibility than the jobs they lost. Unfortunately, accepting lower pay and less responsibility may be unavoidable if a displaced worker is to become re-employed. For older workers, who must often accept the biggest pay cuts to find another job, the loss of self-respect associated with a cut in pay or responsibility may be too much to bear. They often choose early retirement in preference to a sizable loss in dignity or status.

One reason that long-term unemployment is lower among displaced workers in the United States than it is elsewhere in the OECD is that the U.S. provides far fewer sources of public income support to its economically displaced population (see OECD, 1994, especially Chapter 8). It does not provide generous re-training or relocation benefits to its jobless workers, and in fact most OECD surveys show that the U.S. spends less on active labor market policies for adults than other OECD countries. It is not always clear, however, that training or relocation assistance is needed by displaced workers. Unlike economically disadvantaged unemployed

workers, displaced workers have already demonstrated that they possess the skills to hold a job and earn a decent living. What they need is an employment opportunity; what they hope to obtain is a job with approximately the same wage and status as the position they lost. Because displaced American workers do not have access to the long-term government income protection available to displaced workers elsewhere in the OECD, most eventually reconcile themselves to the reality that the job of their dreams is unlikely to materialize. This process occurs faster in the United States than it does elsewhere in the OECD, especially in Western Europe.

## **Financial penalties**

One approach to encouraging work among the long-term jobless is to impose penalties on people who continue to collect public transfers beyond some limit, say, 12 or 24 months of continuous benefit receipt. This kind of limit is common in unemployment insurance, which is almost always limited to a fixed period (six months in the United States; a year or longer in most of northwestern Europe). Nearly all empirical studies imply that the level and potential duration of benefits have important effects on claimants' job finding.<sup>1</sup> Perhaps equally important, they have an impact on the way jobless workers describe their situation to census interviewers. If jobless workers are not eligible to collect unemployment compensation, many will stop engaging in the kinds of activities that lead to classification as an "unemployed" worker. Under the standard definition of unemployment, a jobless worker must engage in active search to be classified as unemployed. If she does not actively look for a job, she is classified as "out of the labor force" or inactive. Active search is also required of most people who claim unemployment insurance benefits. If they do not actively look for jobs, they may be disqualified from receiving additional benefits. Thus, the typical rules of an unemployment compensation system simultaneously provide incentives to delay accepting a job and to persist in active job search. Both incentives increase the percentage of people who are classified as unemployed.

After Canadian unemployment compensation benefits were liberalized in the 1970s, the Canadian unemployment rate began to climb in comparison with the rate in the United States. The two nations' rates had historically been quite similar, but the gap between the countries rose through the 1980s and reached an all-time peak in the mid-1990s. (The gap subsequently fell after Canadian compensation benefits were trimmed.) As implied by the top panel in Figure 3, the increased generosity of Canadian benefits may have led to reduced employment through delayed re-employment. But several analysts, including me, have concluded that some of the growing gap

between Canadian and U.S. unemployment was caused by the increased persistence of jobless Canadians in seeking work, even after a jobless American would have left the active labor force (Riddell and Sharpe, 1998, and Burtless, 1998).

Although it is common to limit the duration of unemployment insurance payments, it is rare to limit the duration of social assistance benefits (assuming that the assistance recipient continues to meet the income test for eligibility). Starting in 1996, the United States began to limit the duration of social assistance benefits for its working-wage population. In principle, a low-income, non-disabled parent can no longer expect to receive federally subsidized social assistance benefits for longer than five years. At state discretion, the time limit may be even shorter (Burtless et al., 1997). As we shall see below, this reform almost certainly increased job holding and reduced participation in social assistance among the working-age population most likely to collect public aid.

If nations are unwilling to follow the U.S. example and limit the duration of social assistance benefits or shorten the potential duration of unemployment compensation benefits, one option is to reduce the level of benefits after some time interval has passed. Thus, the level of weekly benefits would be more generous for workers when they start collecting benefits than it would be after, say, one year. The disadvantage of this scheme is that it sharply curtails the income protection available to workers who sustain the biggest losses as a result of unemployment. To use an analogy to homeowner insurance, the proposed scheme is equivalent to paying claimants 90% of the loss in the case of minor wind damage but just 10% in the case of a catastrophe that completely destroys a home. Most of us would find this payoff scheme unappealing because it fails to provide insurance for an event – catastrophic loss – for which it is impossible to self-insure, whereas it provides excellent insurance for an eventuality that represents a minor inconvenience.

## **Tough work requirements and human capital enhancement**

Because the consequences of sharp benefit reductions are so unappealing, policymakers in most industrial countries are reluctant to follow the U.S. lead and drastically reduce the unearned incomes available to unemployed family heads. Most lawmakers (and much of the public) agree that work obligations or work incentives facing the long-term unemployed should be strengthened. They are divided on how these objectives ought to be achieved. Here I consider several strategies for encouraging work among the disadvantaged and displaced workers: (1) strict job search obligations supplemented with government assistance and financial penalties for non-compliance; (2) basic education, including classroom training for high school diplomas, improved reading and

math skills, and language proficiency; (3) short-term (and usually inexpensive) occupational training or long-term training; and (4) government-provided jobs, whether paid or unpaid.

*Job search obligations.* The most common (and least expensive) work-oriented strategy is to enroll the unemployed in a job search program. Search programs may combine mandatory instruction in job search techniques with a formal, intensive, and systematic program of job seeking. These programs typically require that participants spend several hours per day or week engaged in search-related activities (preparation of resumes, telephoning prospective employers, and pounding the pavement to find job leads). By assumption, the job seeker is already capable of performing some jobs, though the jobs may be menial and poorly paid. The goal of the job search program is to spur the unemployed to look purposefully for available job openings.

The virtue of job-search programs from an administrator's view is that the obligation to look for work can be enforced easily and inexpensively. A minimal program might require that transfer recipients bring signed statements from five employers each week confirming the recipient has filed formal job applications. More elaborate programs require daily or weekly participation in "job clubs," that is, group job search efforts that involve regular meetings in which participants discuss job search techniques and their recent success or failure in finding and following up job leads.

An example of a typical job search program may be helpful. When Bill Clinton was Arkansas's governor in the early 1980s, the state's Department of Human Services began operating the WORK Program for single parents collecting social assistance payments. Arkansas officials designed a fixed sequence of required activities for indigent parents who were enrolled in the treatment group. Aid recipients were initially assigned to a two-week group job search (job club) program, which was followed by two months of individual job search. Recipients who remained unemployed after the second phase of the treatment could be assigned to an unpaid community work experience position for up to 12 weeks. When this third phase was completed, jobless participants were reassigned to one of the first two activities or occasionally to a new one. The program helped increase the employment rate of enrolled mothers by about 6 percentage points in the third year after the program began. Annual earnings increased by slightly more than \$300, roughly three weeks' earnings for a full-time worker earning the minimum wage. Social assistance benefits were paid to 18 percent fewer mothers during the third year after enrollment in the program, reducing taxpayer outlays on welfare payments by almost one-fifth (Friedlander and Burtless, 1995, pp. 88-89).

North American demonstrations and classical experiments in the 1980s and 1990s showed that mandatory job search programs could be a cost-effective way to raise employment rates and reduce the social assistance rolls (Bloom and Michalopoulos, 2001). The Arkansas WORK program, for example, was very cost-effective from the taxpayers' standpoint. The program cost Arkansas taxpayers only about \$160 per welfare recipient enrolled, but welfare payments and the administrative costs of Aid to Families with Dependent Children (AFDC) dropped by \$800 to \$1,200 per person enrolled, directly saving American taxpayers at least \$640 per assistance recipient served (Friedlander et al., 1985, p. 135).

A series of controlled random experiments was undertaken both before and after the federal social assistance law was changed in 1996 to determine the effects of tough job search, job training, and work requirements in the U.S. social assistance system. Many of these experiments uncovered big effects of job-oriented programs on the employment rates, average earnings, and social assistance benefits of people on the assistance rolls (see Michalopoulos, Schwartz, et al., 2000). Some of the tested programs were unusually well managed and successful, and achieved dramatic effects. Others had more modest effects, often less than one-third of those in very successful programs. Nonetheless, many of the less-expensive programs were found to be cost-effective from the point of view of taxpayers, who spent much less on administering the job search requirement than was saved in social assistance benefits.

Assistance recipients, had they been consulted, would have been less happy with the results. Their net earnings gains often fell short of their loss of government transfer benefits. Well-run programs succeeded in reducing transfer costs and caseloads and in increasing employment rates among the long-term unemployed, but they rarely produced any increase in the net incomes of participating assistance recipients. In the Arkansas WORK program, for example, net earnings gains obtained by assistance recipients were less than the cutbacks of AFDC payments. The net incomes of women enrolled in the program fell by \$360 to \$540 per person enrolled (Friedlander et al., 1985, p. 135). In a small handful of programs with tough work requirements, both taxpayers and welfare recipients benefited financially from the program. Even in these programs, however, many social assistance recipients may have considered themselves worse off after the reformed program was implemented. Assistance recipients may not have believed a small yearly gain in net income was worth the additional hassle involved in collecting social assistance benefits and the extra burden of working in a paid job.

*Basic education.* The educational attainment of many of the long-term unemployed is far below average, as noted earlier. One possible remedy is adult basic education, especially education leading to attainment of a tangible certificate of learning, such as a high school equivalency diploma or a first post-secondary degree. However, this approach has almost never been found to be successful in the case of displaced workers, who lack jobs but not the basic employment skills needed to hold a job. For economically disadvantaged workers the results of this approach are more promising, but they are no better than the results of intensive job search programs, which are significantly less expensive to administer.

During the implementation of early tests of social assistance reform in the United States, basic education was a favored strategy in many states, including California. There little evidence to suggest the approach was any more successful than less expensive strategies, however. California counties that emphasized enrollment in adult basic education programs did not achieve better results than other counties. They almost certainly achieved worse results than those parts of the state which emphasized immediate placement in jobs through intensive job search and short-duration employment training (Ricchio et al., 1994, and Bloom and Michalopoulos, 2001). When Los Angeles re-oriented its welfare-to-work program to emphasize immediate placement in a job rather than investment in basic education, it dramatically increased the percentage of hard-to-employ workers who were successful in finding and keeping jobs (Freedman et al., 2000). However, it is conceivable that the longer-term benefits of adult basic education may not be visible in an experiment that lasts only two or three years. Participants in adult education may sacrifice immediate employment and earnings while they are enrolled in the schooling program for longer-term gains that do not become noticeable until a few years after the schooling ends.

Research on the effects of adult basic education suggests this is unlikely, though. Studies by economist James Heckman imply that attainment of a high school equivalency degree (GED) by a high school dropout has a very small labor market payoff (see, e.g., Cameron and Heckman, 1993). U.S. adults who have received a 10th grade education and a GED earn only slightly more than adults with the same level of schooling who have not received the GED diploma. Investments in basic education should probably be concentrated on youth under age 25 and uneducated new immigrants into a labor market, because these groups can gain the most from such investments. One reason that basic education for older adults yields meager earnings improvements is that

enrollment in a schooling program diverts adults from an activity that offers tangible labor market benefits – actual job experience.

Basic education programs have one important virtue. They are comparatively easy to run. Although they are more expensive than job search programs, they can be less expensive than long-term occupational training, especially if administrators do not provide costly support services, such as child care or transportation subsidies, to people who are required to participate. Unfortunately, there is little evidence that basic education programs in the United States succeed in helping older unemployed workers find better jobs. The programs may affect entry or exit from government transfer rolls in another way, however. If the education program is believed by participants to be time-consuming and burdensome, some potentially eligible people will be deterred from applying for transfer benefits when participation in the program is a condition for receiving transfers. Others who are already receiving social assistance or unemployment compensation may exit the transfer rolls sooner than they otherwise would, even if they do not find a job. When recipients are required to participate in an ineffective or burdensome program as a condition for obtaining government transfers, a small percentage of potential applicants may decline to enroll or may leave the assistance rolls sooner than they would if participation in the job training program were purely voluntary. This is almost certainly a reason that ineffective job search and basic education programs sometimes reduce the number of people collecting public aid.

Some kinds of human capital investment programs offer the long-term unemployed valuable benefits, such as child care subsidies and help with transportation. The long-term unemployed may find these ancillary benefits attractive and apply for assistance benefits in order to obtain them. Other transfer recipients may remain on the assistance and unemployment rolls longer than they otherwise would in order to take full advantage of the special education and ancillary benefits that are offered. Only a few welfare-to-work programs established in North America over the past half decade are likely to achieve these kinds of effect. They are intended to impose extra obligations on the long-term unemployed and hence to make government transfers less attractive. A basic education program that is ineffective in improving job skills may turn out to be effective in pushing unemployed breadwinners off the assistance and unemployment rolls. Because the obligation to participate in adult basic education has made it more difficult and burdensome to remain on the rolls, transfer recipients leave the rolls rather than put up with added hassle. In at least one California county, Los Angeles, there is evidence that an early implementation of California's

welfare reform achieved exactly this kind of effect. Social assistance payments fell more than \$1,500 per recipient enrolled, even though the program had negligible effects in improving the employment rate or earnings of participants (Riccio et al., 1994).

Employment-oriented programs can thus achieve notable results through two routes – by improving the job qualifications of program participants or by discouraging potential assistance and unemployment insurance recipients from entering or remaining on the rolls. Either kind of effect can reduce the cost of government transfer payments and boost employment rates, but only the first one is likely to produce an improvement in the standard of living of unemployed breadwinners. The second effect can yield significant taxpayer savings, but is likely to reduce the net incomes of breadwinners who collect government aid. The success of alternative strategies to reduce unemployment must be judged by which goal is considered more important – improving participants’ living standards or reducing taxpayer burdens.

*Occupational training.* Another strategy to improve the employability of the long-term unemployed is to enroll them in short-term occupational training. This approach has been emphasized in a number of U.S. demonstration programs and continues to be an important strategy in many countries’ active labor market programs. The strategy can be more costly than adult basic education and is nearly always more expensive than simple job search assistance. Careful research studies, including classical experiments in the United States, show that this approach to job preparation for the disadvantaged long-term unemployed can be successful, but the employment and earnings gains enjoyed by participants are often small. Post-program earnings gains in American programs are only rarely as much as \$2,000 per year; gains a third this large are more common. The earnings gains from this strategy seem to be concentrated among a comparatively small percentage of participants. Many participants gain little from their training and do not end up in jobs that use the specialized training that was offered in the program.<sup>2</sup> For experienced displaced workers, this kind of training investment usually yields meager gains in employment and earnings.

We have less evidence about the benefits of costly, long-term occupational training for unemployed adults. The most expensive programs often achieve larger average earnings gains than less costly programs, but the most costly programs are typically offered to volunteers from the social assistance and unemployment rolls rather than imposed on an unwilling population. It is not obvious whether these costly programs would have achieved equally positive results if jobless workers had been required to participate in them as a condition for receiving unemployment

benefits or income assistance. The success of a few comparatively expensive occupational training programs suggests, however, that offering the option of a challenging and costly occupational training program to the long-term unemployed can be beneficial for at least some of them.<sup>3</sup>

*Guaranteed public jobs.* Some people believe the government should guarantee jobs to deserving breadwinners who are unable to find an unsubsidized job in the private market. There are two variants of this idea. In the more generous version, the long-term unemployed who are offered a public job would receive pay and fringe benefits similar to those available in identical jobs elsewhere in the economy. In the less generous variant, the public jobs would offer substantially lower pay or no wages at all.

Unpaid community service employment (called “workfare” in the U.S.) is a costly strategy, but it is one that has long been favored by the American public and some conservative lawmakers. It often surprises voters and legislators to learn that a workfare job is not costless to the government. Administrators must devote time, energy, and resources to make community work experience positions available to the long-term unemployed. The approach requires government officials to find supervisors, safe job sites, and real work opportunities for assistance or unemployment insurance recipients or the long-term unemployed. It also requires elaborate administrative procedures to ensure that participants show up for their jobs, work diligently during assigned hours, and receive penalties if they do not meet their work obligations. A number of American communities have instituted mandatory workfare programs (notably New York City), but participation in the programs usually turns out to be the exception rather than the norm for most transfer recipients. For example, in the Arkansas WORK experiment described earlier, only 3 percent of assistance recipients enrolled in the experimental treatment ever participated in a workfare job. The comparable percentage in an Illinois experiment was 7 percent; in a Virginia experiment, 10 percent; and in a San Diego, California, experiment, 20 percent (see Gueron and Pauly, 1991, and Burtless, 1992).

It might seem odd that so many recipients were in theory required to participate in workfare programs, but so few actually chose (or were forced) to participate. Many people enrolled in the experiments probably had reasonable excuses for their non-participation. Others left the government transfer rolls before a workfare position could be found. Still others participated in some alternative activity, such as education, job training, or a part-time job, that precluded their participation in workfare. But many failed to show up for a workfare job without any good reason.

If a workfare approach is to succeed in putting the long-unemployed into jobs, the government must invest talent and resources to ensure that unemployed workers who are assigned to jobs actually show up and perform the jobs they are assigned.

In an unemployment insurance or social assistance program without any strict duration limits on the length of payments, unpaid community work experience can play a useful role. Long-term assistance recipients can be required to take unpaid work as a condition for continued eligibility for assistance payments. Recipients who decline to comply with this requirement may have more important demands on their time than working, but if so, this would demonstrate they are not willing or available for work, standard requirements for eligibility in most unemployment insurance programs.

In a social assistance program with a strict duration limit on benefit payments, such as the time limits recently implemented in the United States, paid community work experience can play a worthwhile role. If strict duration limits are actually enforced, poor adults and their children would be denied transfer benefits after a fixed cutoff date, such as two years after their entry onto the assistance rolls. Parents who have exhausted their assistance benefits and who cannot find private-sector jobs would be offered community service jobs, presumably at very low wages.

The strategy has two possible advantages. First, it can provide long-term unemployed workers with job experience that may be helpful in finding unsubsidized private-sector jobs. Even more important, it can offer destitute breadwinners a last-resort method for earning enough income to support their dependents. For some current transfer recipients, this may be the only feasible way to enforce a work obligation if we want to see indigent breadwinners kept as the primary caregivers of their children. In the absence of community work experience jobs or continuing social assistance, some parents with no work qualifications may simply be incapable of providing financial support for themselves and their dependents.

## **Positive financial incentives**

Rather than imposing penalties on the long-term unemployed for their failure to become re-employed, a more politically appealing reform is to change other financial terms of public assistance or unemployment insurance in order to encourage faster job finding. The idea is to improve the incomes or services that unemployed workers receive if they enter paid employment sooner rather than later.

*Unemployment insurance.* In the United States, unemployment insurance administrators have experimentally tested re-employment bonuses as an incentive to encourage the unemployed to leave the insurance rolls sooner (Decker and O’Leary, 1995). If a worker finds a job in less than, say, 10 weeks, he is rewarded with a bonus equal to two or three weeks of extra unemployment benefits. This incentive has a modest effect in reducing the average length of short unemployment spells, but for obvious reasons it has little impact on the duration of long spells.

Canada used a random field trial to test a more ambitious scheme called “earnings insurance.” Displaced workers were offered a fixed-duration subsidy payment that began when they became re-employed. The amount of the subsidy was calibrated to replace a fixed percentage of the earnings difference between the wage paid on a new job and the wage earned in the job that was lost. (If the new job paid a wage greater than or equal to the wage on the old job, no subsidy was paid.) A crucial feature of the subsidy was that workers began to receive the subsidy as soon as they became re-employed in a qualifying job, but the duration of their entitlement to benefits was fixed on the date of their layoff. In an 18-month subsidy plan, for example, workers would only be eligible for subsidy payments through the 18<sup>th</sup> month after their layoff. The longer that a worker delays finding a job, the smaller the financial value of the earnings insurance. Workers are thus given a strong incentive to find jobs sooner rather than later in the 18-month eligibility period. Although the tested Canadian subsidy greatly increased the net incomes of re-employed workers, it had little detectable effect on the average duration of their unemployment (Bloom et al., 1999).

In sum, the experimental tests with alternative designs of unemployment insurance suggest it is easier to reduce joblessness by tightening eligibility, reducing average benefits, or restricting benefit duration than by offering financial inducements to leave the unemployment rolls sooner.

*Social assistance.* Reforming the social assistance benefit formula is much more difficult than modifying unemployment insurance, because most assistance recipients are, by definition, closer to the margin of survival. Financial incentives for employment can be achieved through the social assistance system itself – with changes in the program benefit formula – or outside social assistance – through earned-income supplements or special services for assistance recipients who go to work. The United States and Canada have used both these approaches in recent years.

The two crucial features of the benefit formula are the basic grant level (which determines the cash income available to an eligible family with no other income) and the benefit reduction, or tax, rate (which determines how fast benefits are scaled back as recipients increase their earned

incomes). These two features of the payment formula were subject to frequent modification at both the federal and state levels in the U.S. between 1965 and 1990. At the state level, governors and legislators permitted the inflation-adjusted value of the basic assistance grant to fall by about half between 1970 and 1996, when the cash assistance system was dramatically overhauled at both the federal and state levels.

Federal and state officials in the United States repeatedly changed the treatment of earned income, through legislation and through changes in administrative practice. The idea behind these reforms was to encourage recipients to enter work. Cuts in the benefit reduction rate succeeded in increasing the percentage of recipients who reported wage earnings, but they failed to increase the percentage of indigent parents who were employed (Burtless, 1990, and Moffitt, 1992). Despite many changes in the assistance benefit formula and in the treatment of recipients' earned incomes between 1968 and 1994, the work behavior of single mothers remained surprisingly constant until the cash assistance system was drastically reformed in the 1990s. Employment rates among single mothers with children under 18 fluctuated within a few percentage points between 1965 and 1990. In 1968, the percentage employed was 52 percent; in 1985, it was 53 percent. The proportion of working single mothers on full-time schedules also remained fairly stable. The percentage on full-time schedules was 71 percent in 1968 and 72 percent in 1985 (Burtless, 1989, pp. 131-132). Changes in the welfare formula affected the fraction of single mothers who collected assistance benefits and the average value of the assistance grant, but they had little discernable impact on the unemployment rate and overall work behavior or earnings of the adult population at greatest risk of receiving social assistance, namely, single mothers. The change in the federal welfare law in 1996 gave states great flexibility to reform their benefit formulas, and some used this flexibility to permit adults to earn more wages while still remaining eligible for cash public assistance. A number of recent experiments have demonstrated that these provisions contribute to higher employment rates – but only if they are combined with strict requirements that assistance recipients look for work and accept a job or training if it is offered.

It is worth describing an economist's view of the effect of social assistance benefits on work. The two basic features of the welfare formula – the basic grant level and benefit reduction rate – have distinctive effects on work behavior. A reduction in the basic benefit level encourages work for an obvious reason. Those who receive payments will have less unearned income, so the necessity for earned income rises. A basic benefit reduction encourages work for a less obvious

reason as well. It reduces the fraction of low-income breadwinners who will be eligible to draw benefits. If the basic grant level is reduced from \$500 to \$300 a month, for example, a worker who earns \$400 a month in wages may no longer be eligible to receive social assistance benefits. When the basic grant level is \$500, she might be eligible to collect, say, \$100 a month in cash aid. When the basic grant is \$300, she will probably become completely ineligible for assistance.

The response to a change in the benefit reduction rate is more complicated. When the tax rate is lowered, people who initially collect social assistance are permitted to keep a higher percentage of any wages they earn. This kind of reform is widely interpreted as a work incentive, which is unquestionably true in the case of people who initially work very little or do not work at all. Yet the lowered benefit reduction rate also increases the size of the eligible population, because it raises the income cutoff point for program eligibility. For example, if the basic grant level is \$500 per month and the benefit reduction rate is 100 percent, a worker who earns \$500 a month cannot collect social assistance. (Her assistance grant will be reduced by 100 percent of \$500, leaving her a monthly benefit of \$0.) If the benefit reduction rate is reduced to 50 percent, however, the \$500-per-month wage earner will now be eligible to receive aid. (Her grant will equal the \$500 basic monthly grant minus 50 percent of her monthly earnings, giving her a monthly assistance payment of \$250.) The workers who become *newly eligible* for benefits are faced with two disincentives for work. First, because they are now eligible to receive more nonwage income, earned income is less necessary. Second, because on the margin their earnings are subject to a 50 percent benefit reduction rate, work is less rewarding – their net hourly wage has declined.

It is not clear whether the work reductions among new social assistance recipients will offset the work increases among potential workers who are already receiving cash aid when a benefit-reduction-rate cut takes effect. Some economists believe that, on balance, a cut in the benefit reduction rate is a work incentive for low-income single mothers. Other economists, including me, interpret the U.S. evidence to imply that a cut in the benefit reduction rate tends to reduce overall work effort among people who are eligible for social assistance payments after the tax cut is implemented. All economists who have done careful studies agree, however, that the overall work effect one way or the other is probably very small. A cut in the benefit reduction rate in a social assistance program is therefore no panacea for long-term unemployment.

*Work subsidies outside of the unemployment insurance and assistance systems.* Another approach to offering work incentives is to increase the net incomes available to workers who leave

the assistance rolls and join the work force. The Earned Income Tax Credit, or EITC, is the oldest and most important U.S. program based on this idea. It supplements the wage earnings of low-income breadwinners by providing them with refundable income tax credits. The credit was established in 1975 to offset Social Security payroll taxes and to encourage job holding among poor breadwinners who had child dependents. (Until the 1990s, only breadwinners with child or aged dependents were entitled to claim the credit, and the credit continues to be much more generous for workers who have dependents.) Instead of shrinking as a recipient's earnings grow, the credit rises, at least up to a specified limit. At low earnings levels the credit increases by \$0.34 or \$0.40 – depending on whether the worker has one or more than one dependent child – for each extra dollar earned by the breadwinner. Parents who have no wages are not eligible to receive the credit, so the credit provides a big incentive for unemployed parents to find work.

The maximum credit is now about \$3,900 a year for families containing two or more children. (In comparison, the annual earnings of a full-time worker who is paid the U.S. minimum wage is \$10,300.) This credit level is achieved when annual earnings reach about \$9,800. When a family's annual earnings rise above a moderate threshold (about \$12,500), the credit is gradually phased out. It is eliminated altogether when a family's income exceeds about \$31,000 a year. Since its introduction in the mid-1970s, the program has enjoyed steady popularity among U.S. lawmakers and the working poor. Liberalized in 1986, 1990, and 1993, the EITC now transfers substantially more money to low-income families than the traditional cash social assistance program for indigent children.

The EITC is a distinctive American innovation in policy toward the working poor, one which other rich countries, including Great Britain, have adopted in modified form. The Canadian government tested an even more generous, but time-limited, subsidy to spur social assistance recipients to accept jobs and leave the assistance rolls. One feature of the Canadian program made it especially potent in boosting work effort in the eligible population. Workers did not qualify for a subsidy payment unless they worked at least 30 hours per week. Thus, participants in the experiment had a powerful inducement to hold full-time rather than part-time jobs. The evidence obtained in Canada's randomized trial showed conclusively that the financial incentive had a large impact on the employment rate and earned income of assistance recipients, many of whom left the assistance rolls in order to take advantage of the time-limited offer. However, the earnings supplement carried a high price tag for taxpayers, since the cash

supplements and administrative costs of the program were substantially greater than the savings in cash assistance payments (Michalopoulos, Card, et al., 2000).

Both the Canadian supplement and the EITC are forms of income supplementation known as earnings subsidies. Many economists are more enthusiastic about earnings subsidies than other types of government transfers because this form of aid can encourage rather than discourage work among the eligible population. Most transfers induce behavior on the part of recipients that offsets part of the intended redistributive effect of the transfer. An old-fashioned social assistance program discourages work among recipients for the reasons described earlier. It raises recipients' non-wage incomes, thus diminishing the need for recipients to work. And it reduces recipients' net wages, thus lowering the reward from work. An earnings subsidy raises recipients' non-wage incomes, like other transfer benefits. But for many low-wage workers, it raises rather than reduces the reward for work by increasing the recipient's net wage.

If an earnings subsidy is to be restricted to the low-income population, however, it must be limited in some way. Otherwise, highly paid workers would receive much larger subsidies than the poor. The EITC does not give any extra subsidy for working to breadwinners who earn more than about \$9,800 a year. This implies that it provides an inducement to work extra hours only for those who are unemployed or have very low earnings. People whose wages are already above \$9,800 are made better off by the credit, but their reward for working longer hours is left unchanged or actually reduced.

When breadwinners' earnings exceed \$12,500 a year, the EITC constitutes an unambiguous work *disincentive*, no different in effect than traditional social assistance. In this range, breadwinners' incomes are higher than they would be without the credit. Moreover, the phase-out of the credit raises the marginal tax rate on earnings by 16 or 21 percentage points, more than doubling the marginal federal income tax rate faced by low-income Americans. Both the need for extra work and the reward for working have been reduced by the credit. Results from the U.S. and Canadian negative income tax experiments of the 1970s suggest that for breadwinners in this income range the EITC will almost certainly reduce work effort by a small amount.<sup>4</sup>

Most labor economists who have examined the EITC conclude that it has contributed to a sizable increase in job holding among unmarried mothers (Meyer and Rosenbaum, 2000). Some potential breadwinners who would otherwise be unemployed have been encouraged to take jobs as a result of the credit. Not all of these people were drawn from the ranks of the long-term

unemployed. Many were probably out of the labor force when they decided to enter the job market to take advantage of the EITC. (This is certainly true of the even more generous earnings supplement offered to Canadian social assistance recipients.) By raising the net income a family can receive when the breadwinner goes to work, the earnings subsidy can tip the balance in favor of work and against continued collection of unemployment or social assistance benefits. From the point of view of public perceptions, this is by far the most powerful argument in favor of the program. It is difficult to avoid the conclusion, however, that this effect of the program must be offset, at least in part, by the program's work disincentive effects among families earning between \$12,500 and \$31,000 a year. There are more breadwinners in the income range where work effort is discouraged than there are breadwinners earning less than \$9,800, who are encouraged to begin working or to work longer hours. On balance, however, U.S. economists who have studied the EITC conclude that the program's positive work incentive effects on the unemployed have outweighed the adverse incentive effects on single parents and married couples with modest earned incomes (i.e., between \$12,500 and \$31,000).

A powerful argument in favor of the EITC is that it raises the employment rates and net incomes of participating families without causing a sizable reduction in their own self-support. In comparison with other methods of reducing the tax burdens or raising the transfer benefits of the working poor, the EITC offers a powerful inducement to work, has positive effects on the earned incomes of people who earn the lowest wages, and has a relatively small work disincentive effect on people with modest earnings. From the taxpayers' perspective, however, the earnings supplement represents a costly commitment to low-wage workers. The program modestly reduces joblessness among indigent parents, and it may eventually lead to greater self-support among disadvantaged breadwinners. But for the foreseeable future, taxpayers have assumed a costly burden to encourage and reward employment among the poor.

## **Changing employer incentives**

The supply-side policies discussed so far aim to change the skills of the long-term unemployed and the financial incentives facing the unemployed. Another approach to reducing joblessness is to modify the financial incentives faced by employers. By reducing the cost of hiring an unskilled or unemployed worker, the government can increase employers' willingness to place unskilled workers on their payrolls. Such policies are complementary to strategies that improve the skills of the unemployed and increase the net reward to work.

OECD countries have considered or tested a variety of policies that might increase employers' willingness to hire the unemployed. Among these are reductions in the legal minimum wage, lower social insurance contributions (especially on the earnings of the poorly paid and newly hired), modification of laws that require employers to provide costly fringe benefits, and cutbacks in employment protection. The United States has adopted only one of these policies over the past two decades. The American minimum wage has been allowed to fall in relation to average production-worker wages. In comparison with the average hourly wage in manufacturing, the American minimum wage fell approximately one-quarter between 1980 and 1996. Recent empirical analysis suggests this drop in the minimum wage has had a comparatively small impact on employment, with most of the effect concentrated on workers under the age of 22. U.S. legislators have not changed other features of labor market regulation or social insurance law to make it less expensive for employers to hire the less skilled or unemployed. However, the American social insurance system, like Australia's, imposes light tax burdens on employers (OECD, 1994, p. 243). Unlike labor law in continental Europe, U.S. law does not require that employers provide workers with costly fringe benefits in addition to a minimum wage. Nor does U.S. regulation obligate employers to provide workers with much employment security (Nicoletti, Scarpetta, and Boyland, 2000).

The comparatively small burden imposed by U.S. law helps explain the willingness of American employers to add to their payrolls when demand is rising. (Lenient employment protection also helps account for the rapid growth in U.S. joblessness when product demand is shrinking.) In comparison with labor markets in which minimum wages and social insurance contributions are higher, employment protection is stronger, and mandated employer-provided benefits are more expensive, the American labor market provides more attractive incentives for employers to hire the unemployed. The success of the U.S. economy in generating jobs and maintaining high employment rates is due in some measure to these characteristics of the labor market. However, U.S. lawmakers have not consciously changed minimum wage laws, insurance contribution rates, employment protection, or regulations regarding employee fringe benefits in order to achieve a lower unemployment rate. Their main policy aim has been to change the work incentives facing unemployed and less skilled workers while maintaining the hiring incentives available to employers.

Governments can improve hiring incentives by offering explicit, targeted subsidies to employers who hire from among the long-term unemployed. The United States and other OECD countries have tested this policy option. American economists have assessed evidence about the effectiveness of this policy in comparison with the alternative of providing subsidies directly to workers if they leave unemployment and find a job (Dickert-Conlin and Holtz-Eakin, 2000). The evidence suggests that providing earnings supplements directly to workers rather than hiring subsidies to employers is more effective in boosting the employment rates of the hard-to-employ. This finding might seem strange to someone who believes firmly in the supply-and-demand model taught to first-year economics students. In that model, the impact of a hiring subsidy would be identical whether the government offers a \$1,000 hiring bonus to employers who hire target-group workers or it offers a \$1,000 earnings supplement to target-group unemployed workers.<sup>5</sup> The experience of the United States suggests, however, that the two policy approaches differ dramatically in their effectiveness.

In real-world labor markets, unlike college classrooms, information is costly to obtain. Moreover, the asymmetry of information available to buyers and sellers can have important consequences for labor-market equilibrium. If a hiring subsidy is payable to employers and is targeted on a specific class of workers, the government must consider how employers will identify the workers who are covered by the subsidy. This raises two questions about hiring subsidies. How expensive is it to provide critical information to employers about workers' eligibility for the subsidy? Will the identification of a worker as a member of the target population cause adverse effects on the employer's willingness to hire?

The U.S. evidence on both these questions is reasonably clear. It is expensive to inform employers of the identity of eligible, target-group workers. The United States has provided subsidies to employers if they hire workers from disadvantaged target groups for most of the past two decades. Employer take-up of these subsidies has been extremely low. At least 90% of eligible workers who found employment did not generate any subsidy payments for their employers. Employers did not know they had hired eligible workers, so they did not claim a subsidy payment from the government. Take-up of the subsidy was low even though the hiring subsidy could amount to as much as one-half of a target worker's first-year wage and one-quarter of his second-year wage. In contrast, at least 90% of workers eligible for the EITC – an earnings supplement payable to workers – file claims for benefits under that program. Evidently, it is

much cheaper to inform workers of their eligibility for a subsidy than it is to inform employers of the identity of eligible workers.

Other evidence suggests that even when the government is successful in informing employers of the eligibility of target-group workers, employers may use the information in a way that harms rather than helps job seekers covered by the subsidy. Two U.S. experiments tested subsidies payable to employers. Both found that these subsidies significantly harmed eligible job applicants' chances of obtaining employment (Burtless, 1985). Job seekers who were told to advertise their eligibility for hiring subsidies to employers achieved a significantly lower employment rate than did job seekers in the control group, who were not eligible for the hiring subsidies. (Members of the experimental and control groups were drawn from an identically disadvantaged population and assigned to treatment status by the flip of a coin.) This finding implies that when employers learned that job applicants were covered by a hiring subsidy they tended to discriminate against the workers covered by the subsidy. Some employers may have reasoned that if the job seekers were so disadvantaged that they required a wage subsidy to find work, they were poor prospects for hiring and training. Others might have learned that the hiring subsidy was only available for economically and socially disadvantaged job seekers. The employers evidently used this information to eliminate some eligible job applicants from their hiring pool. The adverse stigma effect outweighed the potential financial gain from the hiring subsidy. U.S. experience with employer-based and employee-based incentives strongly implies that subsidies payable directly to employees are more effective than subsidies payable to employers.

### **Political acceptability of supply-side incentives**

Recent changes in U.S. policy to “make work pay” have affected the labor market status of several million former, current, and potential recipients of government transfers. U.S. policy has been reformed to expand tax credits for the working poor. At the same time, state and federal lawmakers have slashed the cash assistance available to the *nonworking* poor. In 1996 the federal government abolished the main social assistance program for indigent adults with children and replaced it with Temporary Assistance to Needy Families (TANF). The new federal program places pressure on all states to adopt aggressive policies to curtail assistance benefits to poor parents who are capable of working. The head of each family on social assistance is required to work within two years after assistance payments begin. Work-hour requirements are stringent, and states face increasingly harsh federal penalties if they fail to meet them. The new

federal law stipulates that the great majority of families may receive benefits for no longer than five years, it and permits states to impose even shorter lifetime limits on benefits.

Along with the strong U.S. economy, the new welfare law helped produce an unprecedented drop in the nation's social assistance rolls. Since reaching a peak in 1994, the number of families collecting cash public assistance for children has dropped almost 3 million or over 50%. No drop of this magnitude had occurred in the previous 40 years (see Figure 5). The sharp decline in the assistance rolls from their peak in 1994 is at least partly due to state-level reforms that began even before Congress passed the federal reform law in August 1996. The decline is also due to changes in the EITC that greatly increased the amount of earnings supplementation available to low-wage workers. The increased generosity of the EITC after 1993 combined with much tougher federal and state work requirements has contributed not only to a decline in the U.S. social assistance rolls but also to a large jump in labor force participation and employment among lone parents, especially single mothers.

The change in labor force behavior of the group most likely to receive assistance payments – never-married mothers who live with their own children under 18 – is shown in Figure 6. The chart shows a sharp rise in the employment rate of never-married mothers in relation to that of married mothers who live with their spouse. The jump began in 1994. The employment rate of never-married mothers remained relatively constant from the late 1970s through 1993, while the employment rate of married mothers living with husbands rose steadily over that period. Starting in 1994, the employment rate of unmarried mothers began to rise sharply (Burtless, 2000). There is no evidence in Figure 6 that the employment rate of married mothers increased by a comparable amount. The unemployment rate of never-married mothers fell 8.4 percentage points (43 percent) between 1994 and 2000. The liberalization of the EITC, new welfare-to-work reform programs at the state level, and the 1996 federal welfare reform produced major changes in the labor market behavior of unmarried mothers. If the American job market has had a serious problem absorbing indigent parents who have been pushed off the welfare rolls, the fact is not evident in these data.

*Boosting employment on the supply side.* On the whole, U.S. social policy has become much less generous to the nonworking (but working age) poor, while it has become much more generous to the working poor who accept jobs and remain employed. For many low-wage breadwinners with children, the increased generosity of the EITC and enlarged child care

subsidies have more than offset the loss of potential earnings due to shrinking hourly wages. The net incomes of low-wage workers who remain steadily employed have increased significantly, even though the hourly wages paid by employers to these workers have declined.

Recent American policy changes have had important economic effects in addition to offsetting the drop in wages. Poor single mothers with children have been induced to enter the work force – and stay there. The increase in employment far exceeds the employment gains that occurred among *all* mothers, since mothers living with their spouses have experienced only small gains in employment in recent years. The entry of never-married mothers and other disadvantaged new workers into the U.S. job market contributes to downward pressure on wages of the least skilled Americans. In effect, public subsidies to the working poor and cutbacks in social assistance benefits to the nonworking poor have helped keep employer costs low and have encouraged U.S. companies to create millions of poorly paid jobs.

More generous public programs have improved the circumstances of many low-income American workers – if they can find and keep jobs. But the new social policies have not been so generous that poor, working-age Americans have shared proportionately in recent U.S. prosperity. Compared with the rest of the OECD, the United States continues to experience very high rates of poverty, particularly among working-age families and families that contain children (see Figure 7). One reason is that the U.S. policy mix offers Americans much less assurance they will enjoy comfortable or even minimal incomes should they become and remain unemployed

A different set of policies, such as those adopted in Continental Europe, can obviously produce different results. Some differences, such as low poverty rates and high hourly wages, make Continental Europe a more congenial place to live for low-wage workers and the long-term unemployed. But some side effects of European policies, particularly high joblessness and heavy taxpayer burdens, are not especially attractive. It is not obvious that American voters, even those on the political left, would welcome the alternative outcomes or approve the policies needed to achieve them. Few U.S. voters favor giving undisguised cash transfers to people who are old enough and healthy enough to work. Yet the policies that help support wages and incomes in Continental Europe include several that provide steady and generous transfers to able-bodied people who do not work.

In contrast with policies in Continental Europe, the U.S. mix of harsh and open-handed policies toward the working-age poor has spurred high employment, rapid job creation, and the expansion of a large and flourishing low-wage sector. While the combination is broadly consistent with popular American attitudes toward work and self-reliance, it would be much tougher to sell these policies in other rich countries. Any credible assessment of the effects of employment-oriented supply-side policies must take into account their impact on the distribution of living standards. While Americans may tolerate or even approve the distributional consequences of supply-side policies, voters in other countries find them much less acceptable. The U.S. experience suggests, however, that strong doses of supply-side medicine can boost the employment rates of the hard-to-employ.

## Endnotes

<sup>1</sup> Evidence on the impact of insurance replacement rates on unemployment can be found in Scarpetta (1996), Nickell (1998), and Carling et al. (2001). For evidence on the relation between benefit duration and unemployment duration, see Atkinson and Micklewright (1991), Burda (1988), Katz and Meyer (1990), and Moffitt (1985).

<sup>2</sup> See Gueron and Pauly (1991), Burtless (1995), and Orr et al. (1996).

<sup>3</sup> See Manpower Demonstration Research Corporation (1980), Orr (1986), Burtless (1989), and Gueron and Pauly (1991).

<sup>4</sup> The Canadian earnings subsidy was designed in a way that minimized the adverse impact of the subsidy on hours of work. Because workers could not collect the subsidy unless they worked at least 30 hours a week, participants in the Canadian experiment could not use the subsidy to enjoy the extra leisure that is available in a part-time rather than a full-time job.

<sup>5</sup> The effect of the two kinds of hiring subsidy would differ if there is a binding minimum wage. I assume that there is no minimum wage or that the minimum wage is well below the wage available to target-group workers.

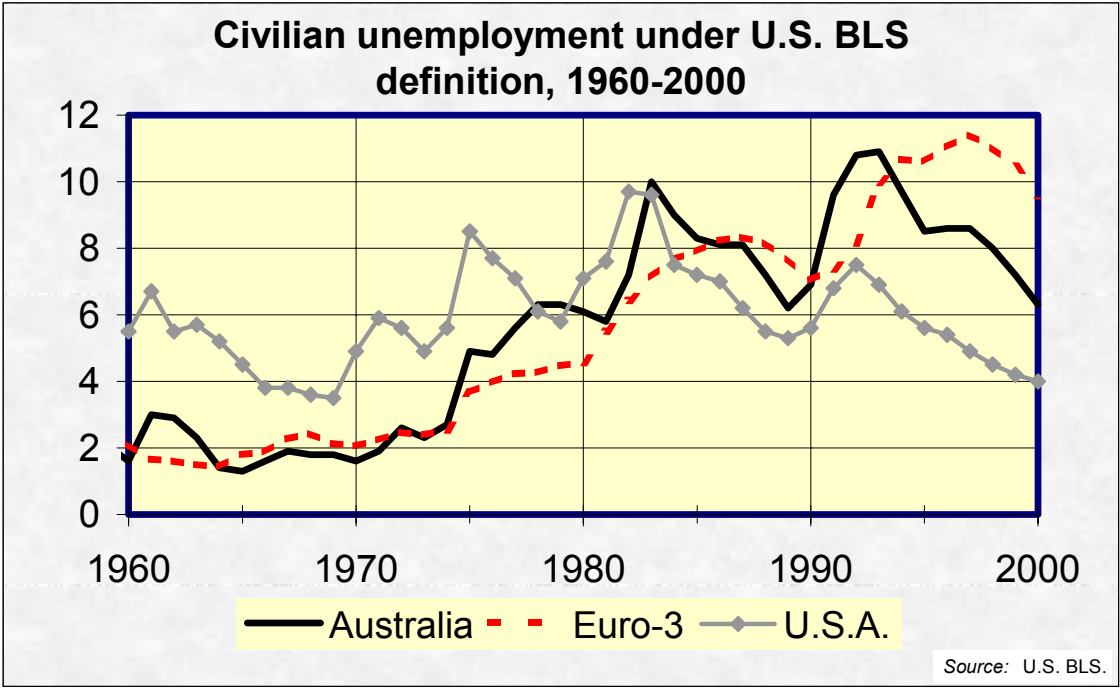
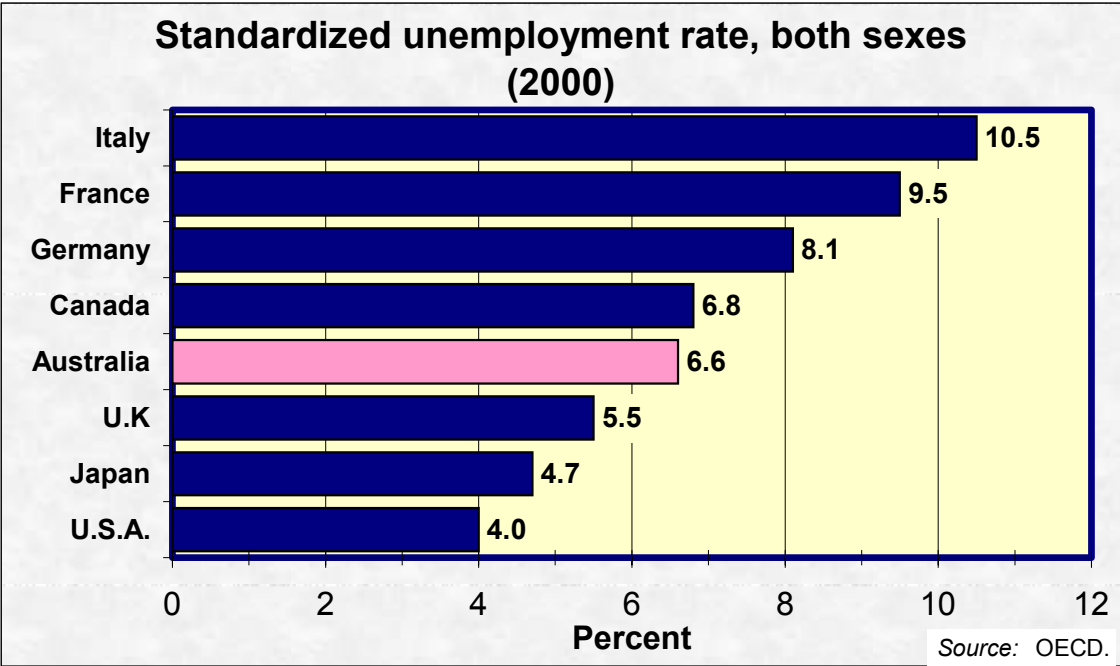
## References

- Atkinson, A. B. and Micklewright, J. (1991), 'Unemployment Compensation and Labor Market Transitions: A Critical Review', *Journal of Economic Literature*, 29, 1679-1727.
- Bloom, D. and Michalopoulos, C. (2001), *How Welfare and Work Policies Affect Employment and Income: A Synthesis of Research*, Manpower Demonstration Research Corporation, New York.
- Bloom, H., Schwartz, S., Lui-Gurr, S. and Lee, S.W. (1999), *Testing a Replacement Incentive for Displaced Workers. The Earnings Supplement Project*, Social Research and Demonstration Corporation, Ottawa.
- Burda, M. (1988), 'Wait Unemployment in Europe', *Economic Policy*, 7, October, 391-416.
- Burtless, G. (1985), 'Are Targeted Wage Subsidies Harmful? Evidence from a Wage Voucher Experiment', *Industrial and Labor Relations Review*, 39, October, 105-109.
- Burtless, G. (1989), 'The Effect of Reform on Employment, Earnings, and Income' in Cottingham, P.H. and Ellwood, D.T. (eds) *Welfare Policy for the 1990s*, Harvard University Press, Cambridge, Ma., 103-140.
- Burtless, G. (1990), 'The Economist's Lament: Public Assistance in America', *The Journal of Economic Perspectives*, 4, Winter, 57-78.
- Burtless, G. (1992), 'When Work Doesn't Work: Employment Programs for Welfare Recipients', *The Brookings Review*, 10, Spring, 26-29.
- Burtless, G. (1995), 'Employment Prospects of Welfare Recipients' in Nightingale, D.S. and Haveman, R.H. (eds) *The Work Alternative: Welfare Reform and the Realities of the Job Market*, Urban Institute Press, Washington, 71-106.
- Burtless, G. (1998), 'Relative Unemployment in Canada and the United States: An Assessment' *Canadian Public Policy*, 24, February, S254-S263.
- Burtless, G. (2000), 'Can the Labor Market Absorb Three Million Welfare Recipients?' in Kaye, K. and Nightingale, D.S. (eds) *The Low-Wage Labor Market: Challenges and Opportunities for Economic Self-Sufficiency*, The Urban Institute Press, Washington, 65-84.
- Burtless, G., Weaver, R.K. and Wiener, J.M. (1997), 'The Future of the Social Safety Net' in Reischauer, R.D. (ed) *Setting National Priorities: Budget Choices for the Next Century*, Brookings, Washington, 75-122.
- Cameron, S.V. and Heckman, J.J. (1993), 'The Nonequivalence of High School Equivalents', *Journal of Labor Economics*, 11, January, 1-47.

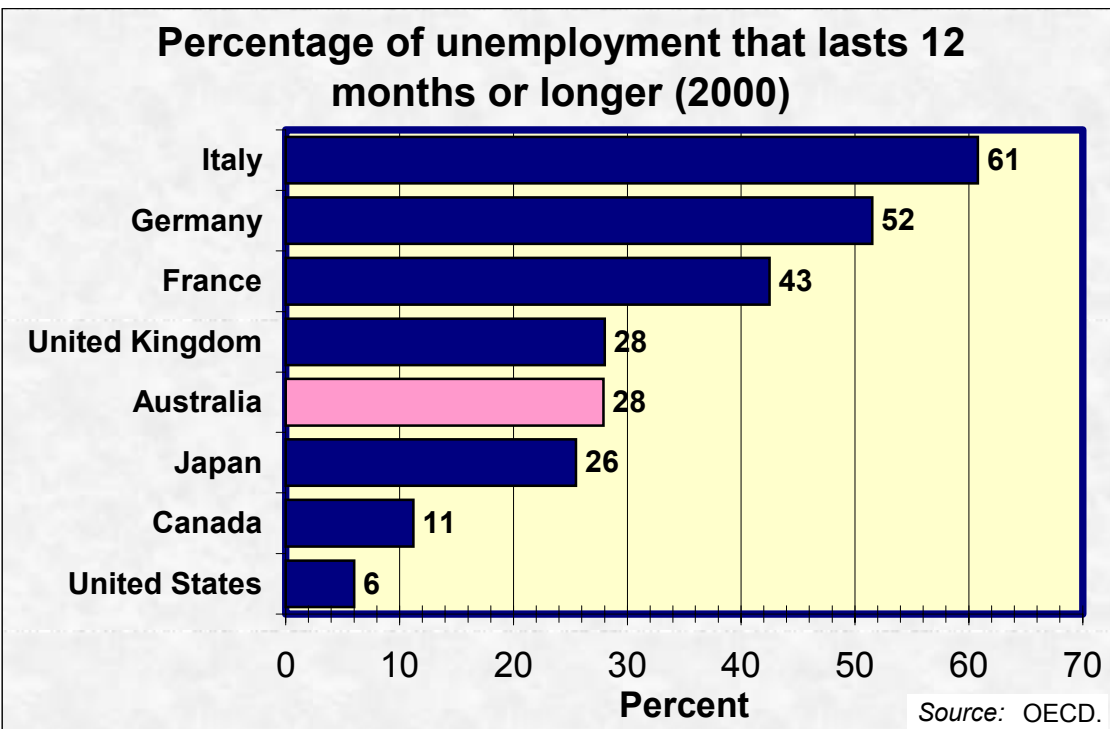
- Carling, K., Holmlund, B. and Vejsiu, A. (2001), 'Do Benefit Cuts Boost Job Finding? Swedish Evidence from the 1980s', *Economic Journal*, 111, October, 766-790.
- Dickert-Conlin, S. and Holtz-Eakin, D. (2000), 'Employee-Based versus Employer-Based Subsidies to Low Wage Workers: A Public Finance Perspective', in Blank, R. and Card, D. (eds) *Finding Jobs: Work and Welfare Reform*, Russell Sage, New York, 262-395.
- Decker, P. and O'Leary, C.J. (1995), 'Evaluating Pooled Evidence from the Reemployment Bonus Experiments', *Journal of Human Resources*, 30, Summer, 534-550.
- Freedman, S., Knab, J., Gennetian, L. and Navarro, D. (2000), *The Los Angeles Jobs-First GAIN Evaluation: Final Report on a Work First Program in a Major Urban Center*, Manpower Demonstration Research Corporation, New York.
- Friedlander, D. and Burtless, G. (1995), *Five Years After: The Long-Term Effects of Welfare-to-Work Programs*, Russell Sage, New York.
- Friedlander, D., Hoerz, G., Quint, J. and Riccio, J. (1985), *Arkansas: Final Report on the WORK Program in Two Counties*, Manpower Demonstration Research Corporation, New York.
- Gueron, J.M. and Pauly, E. (1991), *From Welfare to Work*, Manpower Demonstration Research Corporation, New York.
- Katz, L. and Meyer, B.D. (1990), 'The Impact of the Potential Duration of Unemployment Benefits on the Duration of Unemployment', *Journal of Public Economics*, 41, February, 45-72.
- Manpower Demonstration Research Corporation (1980), *Summary and Findings of the National Supported Work Demonstration*, Ballinger, Cambridge, Ma.
- Meyer, B.D. and Rosenbaum, D.T. (2000), 'Making Single Mothers Work: Recent Tax and Welfare Policy and Its Effects', *National Tax Journal*, 53, December, 1027-1062.
- Michalopoulos, C., Card, D., Gennetian, L.A., Harknett, K. and Robins, P.K. (2000), *The Self-Sufficiency Project at 36 Months: Effects of a Financial Work Incentive on Employment and Income*, Social Research and Demonstration Corporation, Ottawa.
- Michalopoulos, C., Schwartz, C. and Adams-Ciardullo, D. (2000), *National Evaluation of Welfare-to-Work Strategies: What Works Best for Whom: Impacts of 20 Welfare-to-Work Programs by Subgroup*, Manpower Demonstration Research Corporation, New York.
- Moffitt, R.A. (1985), 'Unemployment Insurance and the Distribution of Unemployment Spells', *Journal of Econometrics*, 28, April, 85-101.

- Moffitt, R.A. (1992), 'Incentive Effects of the U.S. Welfare System: A Review', *Journal of Economic Literature*, March, 1-61.
- Nickell, S. (1998), 'Unemployment: Questions and Some Answers', *Economic Journal*, 108 (448), May, 802-816.
- Nicoletti, G., Scarpetta, S. and Boyland, O. (2000), 'Summary Indicators of Product Market Regulation with and Extension to Employment Protection Legislation', Economics Department Working Paper no. 226. OECD, Paris.
- OECD (1994), *The OECD Jobs Study: Evidence and Explanations – Part II: The Adjustment Potential of the Labour Market*. OECD, Paris. [Unemployment benefit duration and unemployment duration covered in Chapter 8 and pp. 171-91 within Chapter 8.]
- Orr, L.L. (1986), *AFDC Homemaker-Home Health Aide Demonstrations: Benefits and Costs*, Abt Associates, Cambridge, Ma.
- Orr, L.L., Bloom, H.S., Bell, S., Doolittle, F., Lin, W. and Cave, G. (1996), *Does Training for the Disadvantaged Work? Evidence from the National JTPA Study*, Urban Institute Press, Washington.
- Riccio, J., Friedlander, D. and Freedman, S. (1994), *GAIN: Benefits, Costs, and Three-Year Impacts of a Welfare-to-Work Program*, Manpower Demonstration Research Corporation, New York.
- Riddell, W.C. and Sharpe, A. (1998), 'The Canada-US Unemployment Rate Gap: An Introduction and Overview', *Canadian Public Policy*, 24, February, S1-S37.
- Scarpetta, S. (1996), 'Assessing the Role of Labour Market Policies and Institutional Settings on Unemployment: A Cross-Country Study', *OECD Economic Studies*, 26, Spring, 43-98.
- Smeeding, T.M., Rainwater, L., and Burtless, G. (2002), 'United States Poverty in a Cross-National Context', in Danziger, S.H. and Haveman, R.H. (eds) *Understanding Poverty*, Harvard University Press, Cambridge, Ma., 162-189.

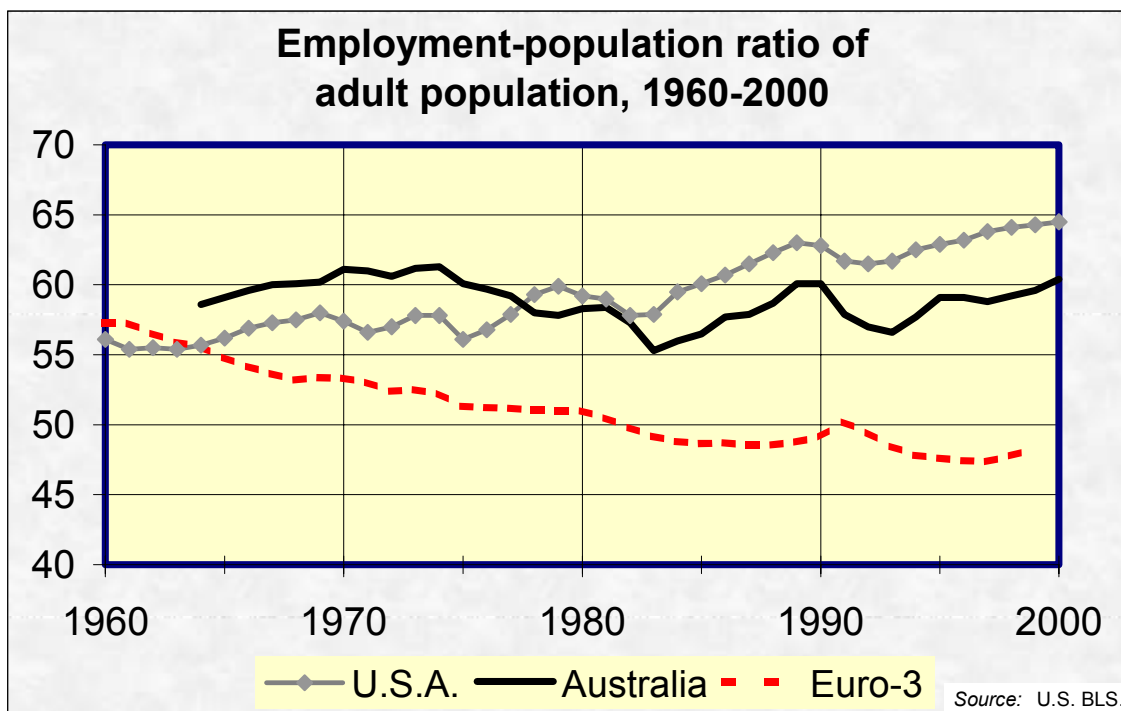
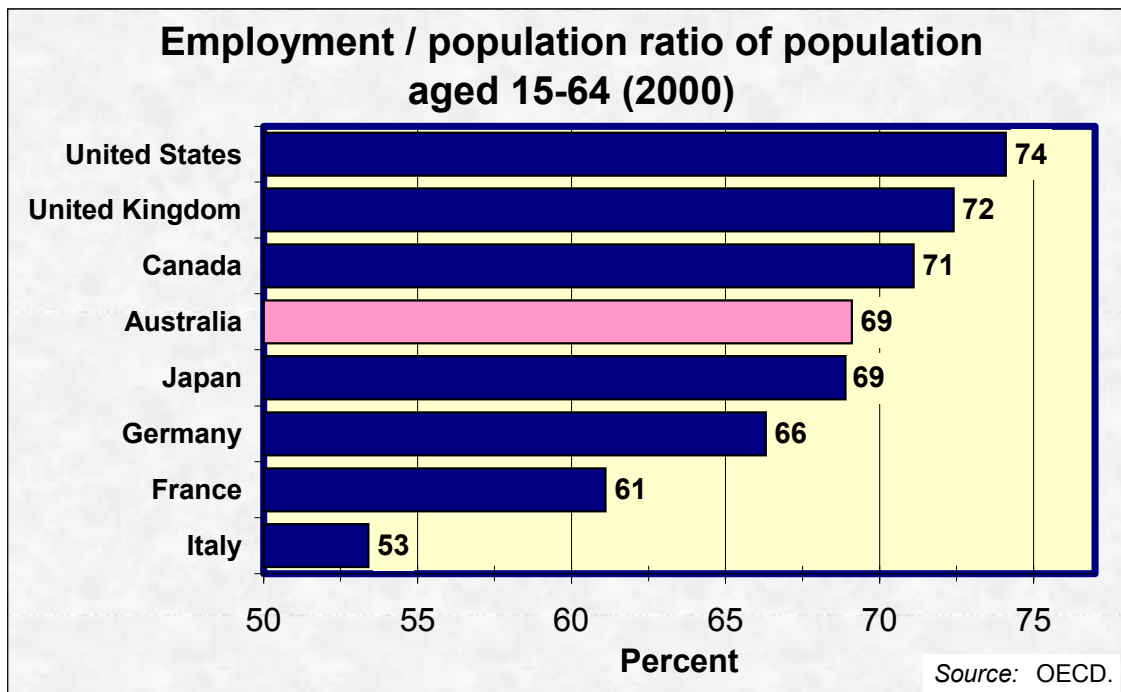
**Figure 1. Unemployment in Australia and the G-7 Countries**



**Figure 2. Character of Unemployment in Australia and the G-7 Countries**

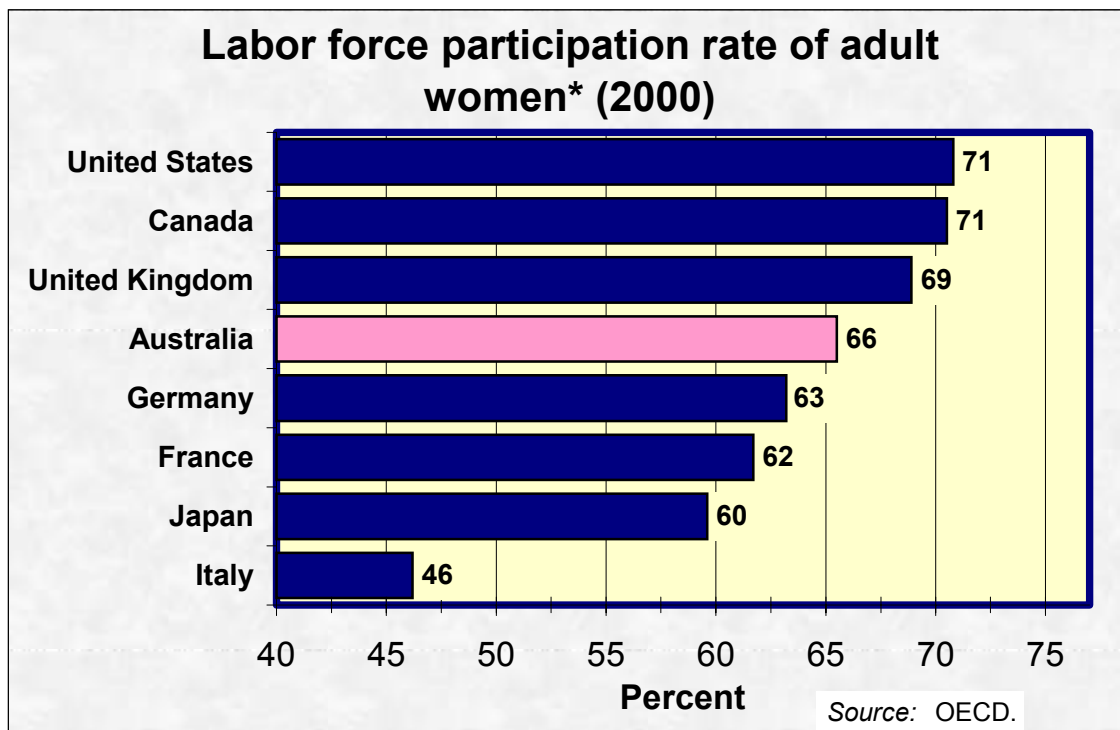
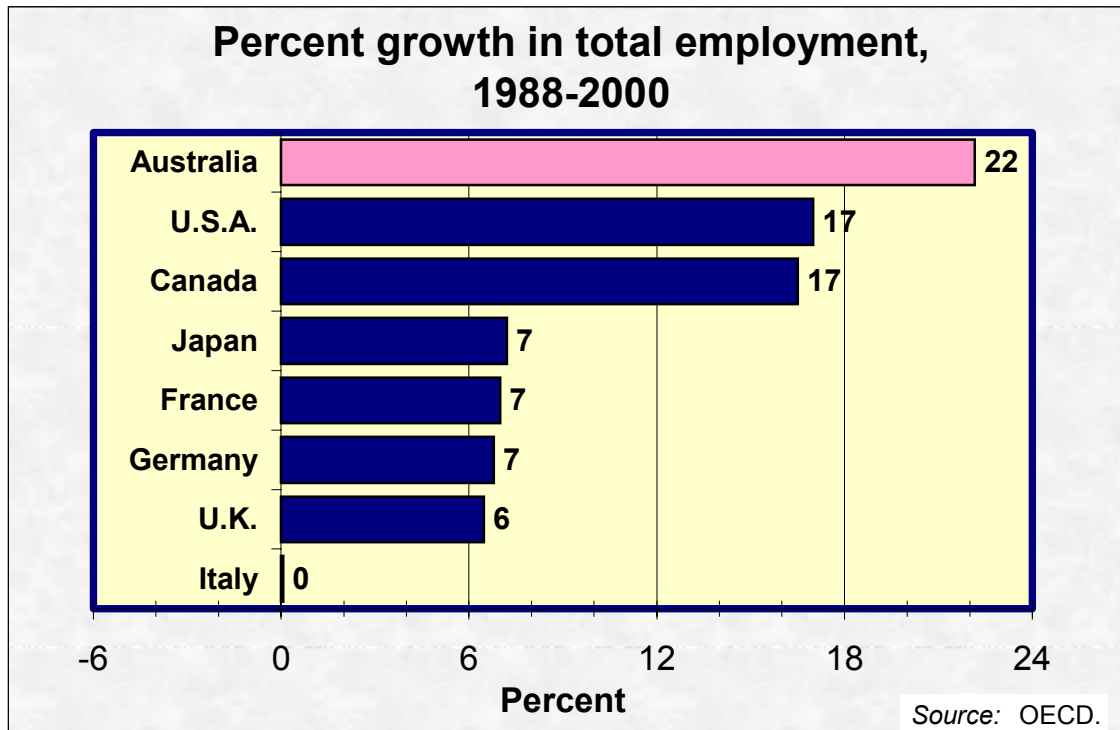


**Figure 3. Employment-Population Ratios in Australia and the G-7 Countries**



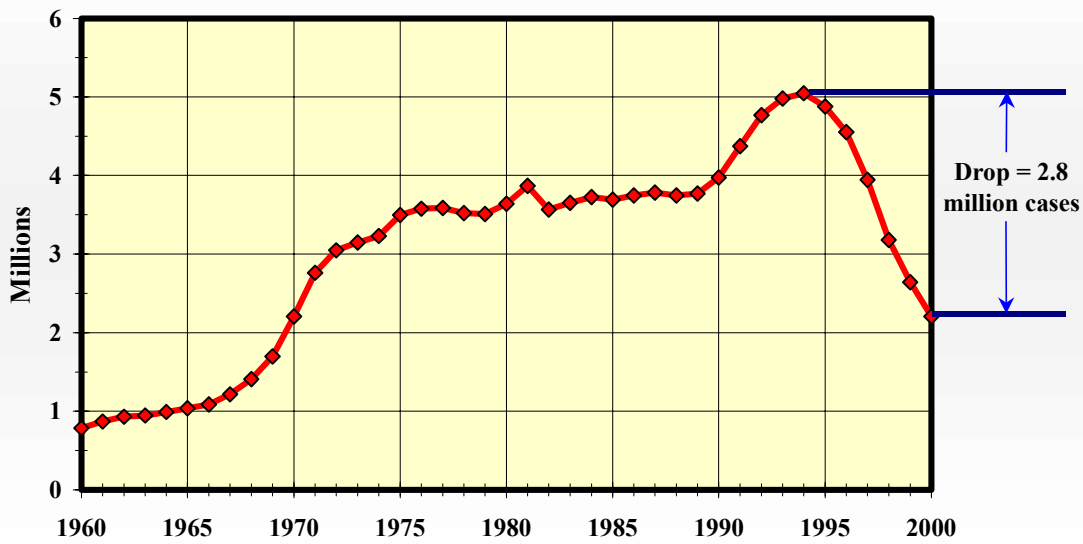
Note: "Adult population" is the population 14-16 and older depending on the country and year.

**Figure 4. Indicators of Employment Growth in Australia and the G-7 Countries**

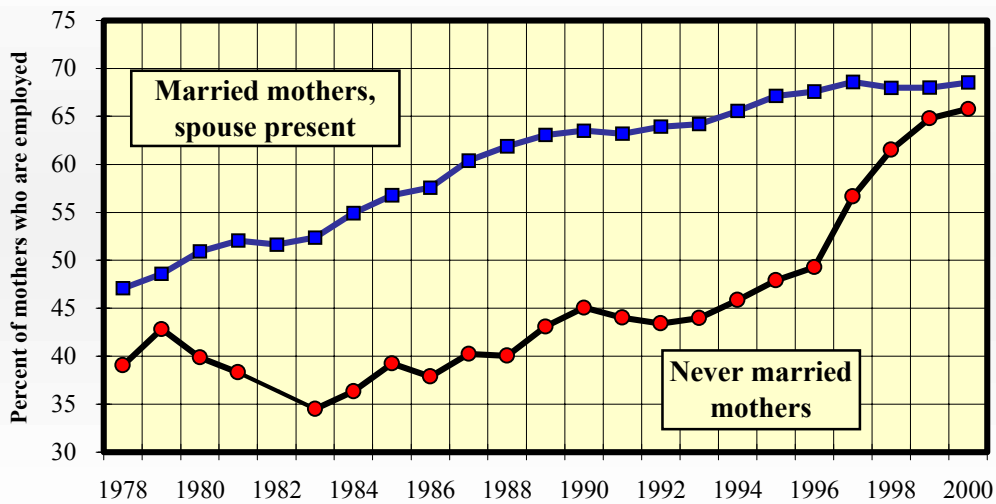


\* Defined as female labor force aged 15-64 divided by female population aged 15-64.

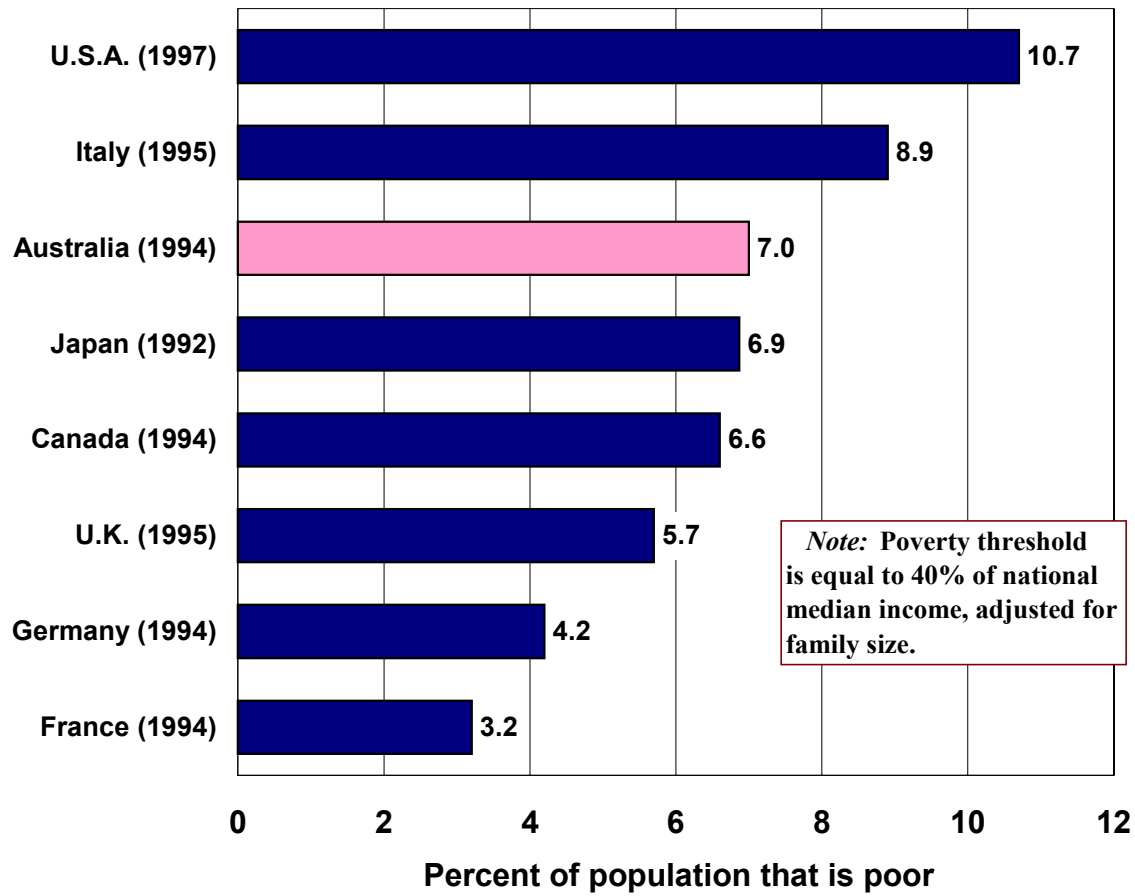
**Figure 5. Number of Social Assistance Cases for Indigent U.S. Families with Children, 1960 - 2000**



**Figure 6. Employment-Population Ratio of U.S. Mothers Who Live with Their Own Minor Children (1978-2000)**



**Figure 7. Poverty Rates in Australia and the G-7 Countries**



Source: Smeeding, Rainwater, and Burtless (2001).