Workfare and Welfare: Britain's New Deal

by

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“Workfare and Welfare: Britain’s New Deal.” Richard Beaudry.

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Abstract/Résumé/Zusammenfassung

This paper focuses on the economic debates surrounding Britain's New Deal in order to measure the effectiveness of workfare as a response to socio-economic problems and the call for changes in state social welfare programs. The author demonstrates how Britain's Labour government learned from errors made in the American workfare experiments in shaping a programme that, among other salient characteristics, targeted youth unemployment. Drawing upon results from other jurisdictions, recent studies of New Deal's impact, economic theory, as well as modelling both general and partial equilibrium effects, the paper delivers a balanced assessment of Britain's workfare program as a model for a welfare state of the future.

Cet article examine les débats économiques concernant le *New Deal* en Grande-Bretagne, afin d'arriver à une conclusion sur l'efficacité du *workfare* comme réponse aux problèmes socio-économiques et aux appels à des modifications des programmes d'État d'aide sociale. L'auteur démontre comment le gouvernement travailliste a construit son programme tout en prenant soin d'éviter les erreurs commises aux États-Unis en cette matière. Cette étude fait appel aux résultats obtenus dans d'autres pays, à des études récentes sur l'impact du *New Deal*, à la théorie économique et développe des modèles généraux et partiels des effets d'équilibre. Elle se conclut par une appréciation mesurée du programme de *workfare* de la Grande-Bretagne comme modèle possible pour l'État-providence de l'avenir.

Diese Arbeit diskutiert den New Deal in Großbritanien und die Effekte der *workfare*-Strategie. Der Verfasser zeigt, wie die Labourregierung Großbritaniens beim Aufbau ihres Programms aus den Fehlern der U.S.-amerikanischen *workfare* Experimente gelernt hat. Die Nutzung von Modellen der allgemeinen und partiellen Gleichgewichtstheorie erlaubt eine Bewertung des englischen *workfare*-Programms und gibt der Debatte über den Wohlfahrtsstaat der Zukunft eine weitere Perspektive.

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I. Introduction

Across the developed world, the traditional Keynesian welfare state has found itself the subject of dramatic reform. Coinciding with a general disillusionment with state-centred solutions to socio-economic problems, welfare systems across the world have been under intense pressure to scale-down and reengineer the way they provide assistance.

Reforms, for the most part, have been motivated by a desire to diminish the role of the welfare state, particularly its negative impact on work incentives. Reduced benefits and stricter eligibility criteria became the norm during the late 1980's and early 1990's. Workfare models emerged from the periphery of policy discussion, to the forefront of America's reform of its welfare system.

Britain, although not a pioneer in revisiting workfare models, has recently begun to implement the similar reforms. Learning from the errors in American experiments, Britain's Labour government introduced its New Deal program. Initially targeted to young people, the government has promised to eventually extend coverage to other groups. Many, within and outside of Britain, are studying with interest how effective Britain's unique version of workfare will be in tackling the problems of long-term unemployment, while still providing a compassionate social safety net.

Although early in the life of the reforms, critics and supporters have made predictions about its effects, slammed its deficiencies, and praised its strengths. This paper presents the arguments of both sides of the debate, but exclusively focuses on the economic arguments. These draw upon empirical results from other jurisdictions, recent studies of New Deal's impact, economic theory and the modelling of both general equilibrium and partial equilibrium effects.

Can we conclude that the reforms will better equip Britain's welfare state to deal with the challenges of long-term unemployment? Can the reforms do so in a way that doesn’t sacrifice the sound fiscal position inherited by the Blair government? This paper concludes that the New Deal opens opportunities for a welfare state of the future, one that assists the development of human capital and potential while still providing a compassionate safety net. Britain’s New Deal is a progressive step in this direction.

II. Background

The demise of Keynesian economics and the inability of the state to simultaneously control inflation and maintain full employment set the stage for the resurgence of classical (now ‘neo-classical’) ideas of political economy. With the discrediting of state-sponsored answers to economic challenges a new consensus emerged, resurrecting an emphasis on personal responsibility, incentives and the efficiency of free markets. One of the first casualties of this new consensus was the ‘unconditional’ welfare state.

Welfare assistance universally has always had some criteria that required satisfaction in order to receive benefits. These conditions are not workfare. What distinguishes the conditionality of workfare apart from the traditional Keynesian ‘unconditional’ welfare state is that a transaction is required for benefits in workfare. Entitlement to assistance ceases with workfare, as benefits become a wage for labour rendered. This work might be direct provision of a service to the state, or it might imply personal work, such as participation in a program of self-development.

The long-term unconditional receipt of public assistance by the able-bodied was not a goal of the Keynesian welfare state’s original designers. In the quest to ascertain why the welfare state was a failure – why it failed to alleviate unemployment, and in fact seemed to exacerbate the problem –, policy makers re-examined the early intents and ideas behind it. Layard (92) quotes Lord Beveridge, the British peer credited with designing the type of welfare state that eventually took shape in most of the English-speaking world, on the problems attending long-term unconditional benefits:

> The normal period of unconditional unemployment benefit will be six months […] after that, complete idleness even on an income demoralises.

Echoing Beveridge's sentiments, a stream of modern commentators have written about the problems associated with the current welfare state. They question the prevailing view that suggested all benefit recipients couldn't find work, and put forward their own radical interpretation, referred to as the "poverty by choice thesis." They preach that the welfare system created a 'moral hazard' dilemma, particularly if welfare benefits were higher than wages (Dolowitz 88). They emphasise mutual obligation, as provocatively expressed by Lawrence Mead: "The rest of us work in order to achieve our income. It is necessary that the poor do the same" (qtd. in Dolowitz 51).

These ideas resonated with the electorate in Britain and the Thatcher government was brought to power on a platform of reducing the 'nanny' state. The government's first priorities were control of inflation and reducing the large public sector deficit (Dolowitz 61). The government's achievements for the period were not illusory: from a peak of 46.5% of GDP, public sector spending was reduced to 43.3% of GDP by 1986; tax rates had fallen to the lowest level in Europe, with basic rates falling from 33% to 25%; from 1979 to 1988 the economy grew by 20% (Digby 106). These impressive achievements, however, were made at the cost of mass unemployment. Initially able to ignore the rise in unemployment, the government was finally forced to act, fearing the political and economic costs of ignoring the emerging crisis (Dolowitz 61).

Although aggressive toward inflation and public sector spending, the government seemed passive to the rise of unemployment and social welfare expenditures (Peck, "Workfare" 265). Initially this was politically expedient, but the spiralling costs of social expenditures endangered the government's fiscal achievements.

Social security spending, on a secular rise since 1966, had risen from 8% of GDP in that year, to near 15% by 1981 (Digby 73). The government couldn't afford not to tackle welfare reform.

By the mid-1980s a stronger economy had emboldened the government to finally address welfare reform, and it introduced measures that restricted benefit eligibility (Peck, "Workfare" 266). Public opinion supported the changes. In 1987 *British Social Attitudes* presented survey results that showed 1/3 of the public felt that benefits were too high and were discouraging job searching activity (Digby 123). The government's commitment to a reform agenda was finally confirmed in an address by John Moore, then Secretary of State for Social Services, in which he stated: "1987 is very different from 1947 […] life has changed [...] and it is necessary for what we call our welfare state to change as well" (Digby 109).

Despite the rhetoric, the Conservative government resisted large-scale changes. They had inherited a welfare system that "minimised fraud" rather than "maximised work," and the initial changes were not dramatic (Peck, "Workfare" 273). Their reforms instead focused on restricting eligibility, and reducing the 'replacement ratio' (the ratio of benefits to wages). From a high of 43% in 1972, the ratio was reduced to 16% by 1990 (Peck, "Workfare" 284).

Pressure groups and think tanks continued to press for more dramatic reforms, and directionally aimed at a workfare model. Administrators in American workfare programs visited Britain and promoted their achievements (Dolowitz 70). Arguments in favour of more actively reintegrating the unemployed, and breaking the dependency culture motivated the government to become more active in its policies (Dolowitz 52-53). The rise of youth unemployment, in particular, led the government to look at elements of the Swedish system of workfare and benefit eligibility for youth (Dolowitz 154-155).

From an initial hesitancy toward implementing workfare, a 'workfare consensus' gradually emerged. Conservatives avoided promoting workfare lest the state became the employer of last resort, and British leftists abhorred the use of coercion (Peck, "Workfare" 265). The concerns of both camps gradually waned, and by 1997 all three major political parties in Britain openly embraced workfare in their election platforms (Peck, "Workfare" 264).

III. U.K. Unemployment

British unemployment numbers are notoriously difficult to interpret, as unemployment was redefined and revised, usually downward, a number of times during the 1980s[1]. The most recent figure, for January 2002, is 5.1%. This compares to an average rate of nearly 10% in 1992 (Layard 136). Although the U.K. economy has certainly performed strongly, given the significant decline in unemployment, particular aspects of British unemployment pose ongoing challenges to policy makers.

Unemployment in Britain is more concentrated among certain age groups and skill classes. Manual labourers make up ¾ of unemployed workers, and young people are also more likely to be unemployed (Layard 67). Long-term unemployment is concentrated geographically, particularly in the north of England, where Layard (69) refers to the labour market as being in a "steady-state disequilibrium." The growth in long-term unemployment, mirroring the experience in many countries across the Channel, has been dramatic. Between 1979 and 1986, the proportion of long-term unemployed out of total unemployment doubled, rising from 20% of total unemployment to 40% (Layard 59). What is particularly disconcerting is that these statistics point out a secular trend that appears unresponsive to the business cycle (Layard 67).

[1] Richard Layard, a well-known labour economist at LSE, provides *two* unemployment series for the UK – one from UK Department of Employment, the other from the OECD - in *The Unemployment Crisis* (1994).

The rise of long-term unemployment has been a recent malaise for a number of European economies. A common measure of structural unemployment, the Beveridge curve, gives the ratio of unemployment to job vacancy rates. Layard (55-58) points out that the Beveridge curve shifted outward in many European countries, implying an increase in structural unemployment. Layard suggests two possibilities: skills mismatch, or more selective workers. Mismatch indices reject this as a possible source of the problem (Layard 58).

In all countries that witnessed a rise in long-term unemployment, the unemployment-benefits period was of long duration (Layard 59). Conversely, nations with short benefit periods, such as Norway, Sweden, Canada, the United States and Japan, all have low proportions of long-term unemployed (Layard 62). In those countries, unemployment typically rises due to cyclical forces, or structural forces. If such forces were the cause of the unemployment problem in Britain, it would be noticeable in continuously large inflow numbers (inflow to unemployment), which has not occurred. As Layard (70) points out: “the secular rise in unemployment is associated with increased duration and not an increase in rate of job loss.”

Why has a problem of long-term unemployment emerged? Skills mismatch fails to explain it. Cyclical forces don’t seem a significant factor either. Layard (62,70) suggests a supply-side cause, produced by a generous benefit system and a cycle of dependency. High benefits de-intensify job search activity and allow workers to become more selective. Over time, their skills atrophy because of disengagement from the labour force, and employers then use long-term unemployment as a screening device. This is exacerbated by what Layard (62), one of the most vocal academic supporters of workfare in Berlin and a consultant to the Blair government[2], refers to as an “unemployment culture.” When everyone in the neighbourhood is unemployed, how much impetus is there for someone to find a job, and in a sense become an outsider?

[2] Peck “Workfare” 356-357.

If the problem of long-term unemployment is indeed rooted in the corrosive effect on work incentives of an unconditional benefit system, then workfare is indeed a policy option at least worth examining. Richard Layard is one of the most vocal academic supporters of workfare in Britain, and a consultant to the Blair government (Peck, "Workfare" 356-357).

IV. Workfare in the U.S. and Sweden

The workfare models in two jurisdictions are alleged to have been strong influences in shaping Britain's version of workfare. Dolowitz (79) points out that U.K. policy makers intensely studied the American and Swedish versions of workfare. This section briefly describes key characteristics of both systems.

U.S. workfare has its origins in the 1988 Family Support Act. This Act was part of a package of reforms designed to reintegrate AFDC[3] recipients into the labour market (Dolowitz 39). The Act provides funding to states for a number of programs, a key one being the Community Work Experience Program (CWEP). The CWEP program requires AFDC recipients to work for their benefits; the number of mandatory work hours was set at the number of hours, at minimum wage, required to reimburse the state for the amount of the benefits cheque (Dolowitz 41). Workfare was already widespread across the U.S. before 1996, but became more popular with state and local governments through the passage of the Personal Responsibility and Work Opportunity Reconciliation Act in that year. This Act eliminated the entitlement to cash benefits and set up the Temporary Assistance for Needy Families (TANF) program. This program provides states with funding for time-limited, work-based welfare programs (Cancian 309). The program has targeted single parents with school-age children, and requires the parent to work 30 hours per week for their benefits

[3] AFDC - Aid to Families with Dependent Children

cheque. There is a lifetime limit of 60 months, but states can choose to impose shorter limit periods (Cancian 309).

The Swedish system used to be characterised by an Active Labour Market Policies Approach. In that model, the state acted as an employer of last resort, and participation in work programs was framed in terms of rights and opportunities, and less emphasis was placed on obligations and sanctions (Kildal 2). The inability of state-guaranteed full employment to deal with the job losses of the new economy in the early 1990s has led Sweden (and Denmark and Norway) to reform their welfare states along workfare lines (Kildal 6). In Sweden in particular, the explosion in youth unemployment and a doubling in social assistance expenditures over the period from 1990-97 forced a movement toward tighter eligibility criteria, reduced benefits, and a more direct linking of benefits to work (Kildal 9).

Before Sweden's move toward a more workfarist approach, the two systems of Sweden and the U.S. superficially appeared reasonably alike, but the guiding principles behind both differed significantly. The Swedish system previously emphasised a "right to work," and even with the new approach there is greater emphasis on building human capital than in American programs. Workfare in the U.S. is founded on the belief that poverty is rooted in personal fault, and as a consequence, the American workfare approach is mostly aimed at deterring people from accessing benefits (Digby 15).

V. Britain's New Deal

The New Deal reforms promise eventual reform of welfare assistance for all benefit recipients. There are four New Deals, each for a different group facing particular unemployment challenges. They are:

- **New Deal for Young People (NDYP)** – has received by far the greatest proportion of New Deal funding (£3.15 billion through to 2002). It is targeted to unemployed youth (aged 18-25) who have been unemployed for 6 months or longer.
- **New Deal for the Long-term Unemployed** – is targeted to adults (aged 26+) who have been unemployed for two years or more. In terms of funding, £350 million was allocated through to 2002.
- **New Deal for Lone Parents** – addresses, as the name suggests, the employment reintegration needs of single parents with school age children. £200 million has been directly allocated to the program, not including additional assistance for child-care.
- **New Deal for the Disabled** – assists those receiving disability benefits to return to work. £200 million has been budgeted for this program through 2002 (Peck, "Workfare" 304-305).

The greatest emphasis of the government so far has been the NDYP, which is obviously being used as a pilot phase for the more ambitious New Deal reforms with other groups. The NDYP begins with an initial counselling session, referred to as *Gateway*, that focuses on improving job search and interview skills. If the search for employment is still unsuccessful after the Gateway sessions, in order to receive benefits, one of four options must be chosen:

- A subsidised job placement. The subsidy is £60 per week, and lasts 6 months; a £750 training allowance is also available to participants.
- Full-time education and training, for up to 12 months.
- Work in the voluntary sector.
- Work with the Environmental Task Force.

(DWP website; Peck, "Workfare" 304; Glyn 53)

Participation in one of the four options is mandatory in order to receive benefits. The NDYP program differs in this respect from the current design of the other

New Deals, where participation is voluntary (Glyn 53). Since the goal of the program is reintegration into the labour market, work in the voluntary sector or the Environmental Task Force are intended as options of last resort, and are not to become permanent employment.

VI. The Case Against the New Deal

Criticisms of the New Deal, and workfare in general, can be broadly categorised into five arguments. One, workfare pushes the unemployed into employment that is unstable, contingent and low pay; the result of workfare is therefore poorer earning outcomes. Two, the New Deal suffers, like its American workfare counterpart, from under-investment in training. Three, the statistical data that appear to support workfare are skewed to being favourable because these reforms are taking place during a period of high economic growth and results are confounded by a selection bias. Four, long-term unemployment is largely a product of disability; workfare is therefore an inappropriate policy tool for this issue. Five, the unemployment problem that workfare and the New Deal intend to remedy will not respond because they work through the supply-side; long-term unemployment is a feature of insufficient labour demand, not a widespread problem with indolence.

One of the most powerful indictments against workfare is that its success at reintegrating the unemployed into the job market is achieved at the expense of earnings and employment stability. The evidence to support this accusation certainly qualifies any notions of successful outcomes:

- In some U.S. studies of workfare programs, the outcomes of women who participated were examined five years after leaving the program. 40% had earnings below the poverty level. The average working wage (in 1996 dollars) was $6.73/hr. Only ¼ of the women worked full-time year round (Cancian 312).

- Manpower Development Corporation, a leading promoter of American workfare programs, studied the impact of workfare in 4 cities[4] and identified job retention as being an ‘area of concern’ (Brock ES:12-13).
- Although an average of 34% of participants in the NDYP had employment that lasted 13 weeks or more, women and visible minorities experienced lower success rates (31% and 27% respectively) (JRF 2).

The basic premise of workfare is that any work experience is superior to none. Peck (“Work First” 126) points out that this assumption is refuted by evidence from U.S. labour market analyses that show job insecurity and stagnant wage growth are a common feature of the ‘lower reaches’ of the labour market. If this is indeed the case, pushing people from benefits into the labour market inevitably turns into a subsidy of ‘contingent’ (i.e. insecure) labour (Peck, “Work First” 123). Since greater power is given to employers, existing inequalities within the job market persist or are accentuated (Peck, “Beyond” 739). Fears about the New Deal experiencing the same poor outcomes as American experiments are not helped by the absence of a guarantee that employment will not result in a worsening of a participant’s financial situation (Dolowitz 57).

Jamie Peck (“Work First” 122) identifies high-quality training as a prerequisite of better employment outcomes. Workfare in other jurisdictions has suffered from poor investment in skills up-grading and it is feared that the New Deal experience will be no different. The costs of high-quality training are a challenge, particularly given the Labour government’s fiscal agenda. The Blair government has committed not to raise the tax burden, and has budgeted increases to social spending at a mere 1.5% per annum[5] (Glyn 57, 59). It is no coincidence that there is a strong emphasis in NDYP on counselling, e.g. the *Gateway* program, since these counselling initiatives cost 5-10% of an average training placement (Peck, “Beyond” 734).

[4] The 4 cities were Cayahoga**,** Los Angeles, Miami-Dade and Philadelphia.
[5] This compares to annual increases under the Thatcher and Major governments of 3.5% and 3.8% respectively (Glyn 59).

Although there is evidence in support of workfare from the U.S. and Britain, optimistic interpretations need to be questioned. Labour market success stories, allegedly due to welfare reforms, are - not coincidentally - occurring at a time of strong economic growth in both countries (Peck, "Work First" 123). Selection biases could also be contributing to a positive bias in the data. In one U.S. study, the Pennsylvania Blue Shield program could boast about an 86% success rate[6]; closer scrutiny of the program's eligibility criteria, however, reveals that all participants had high school diplomas, passed a reading test and could type at least 25 wpm (Perlmutter 47). Peck ("Workfare" 322) suggests that the New Deal's focus on youth is due to the greater ease of reintegrating this group into the job market. Preliminary data for NDYP showed a modest increase in employment of 13,000; of the 41,000 no longer deemed unemployed, the vast majority were channelled into educational and other options (Glyn 54). The potential of the New Deal for other groups could be more dismal. The New Deal for the Long-Term Unemployed assisted 238,000 participants by February 2000; a mere 13% found employment that lasted 13 weeks or more (JRF 2).

Workfare programs assume that one has the ability to work. These programs are based on what Peck ("Work First" 124) refers to as a "deficit model": people do not work because they simply don't know how to work. What if these assumptions are relaxed? What if long-term unemployment is a by-product of disability issues? Glenn Loury of Boston University questions the idea of a *quid pro quo* arrangement, when recipients are hopelessly unable to produce a sufficient amount to repay their benefits (Solow 47). He suggests that many workfare participants, regardless of supports in the program, seem unable to find regular employment "even after 3 years of effort" (Solow 48). This has been a problem encountered with work requirements, going as far back as the Poor Law; many of the dependent poor are simply unable to support themselves, and employment programs are therefore ineffective at helping them (Digby 112).

[6] 208 of 242 participants were hired after the placement ended (Perlmutter 47).

The New Deal is undeniably a supply-side measure. Which naturally raises a question: what if the problem of long-term unemployment is rooted in depressed labour demand? As noted previously, one feature of long-term unemployment in Britain is its geography. Evidence from the New Deal's preliminary results across the country demonstrate the program's utter inability to tackle the 'spatial disparity' among local economies; inflow and outflow figures suggest that 'churning' in the labour market has increased (Sunley 501). This bears out a prediction by workfare's critics, who suggest that these policies just "re-shuffle the job queue" (Peck, "Work First" 121). New Deal's emphasis on *local* labour market reintegration has been seen as an impediment to any possible success. Since local labour demand isn't really improved, the real effect could be the development of 'ghetto economies' that merely re-circulate New Deal grant funding (Amin 2043). Supply-side measures can have a positive effect on labour demand if and only if wage pressures are alleviated. The recent Irish and Dutch employment 'miracles' were largely a by-product of a wage-bargaining consensus arranged with organised labour; given the Blair government's more distant relationship with the unions, a similar arrangement is unlikely (Glyn 56). In either case, workfare's critics contend that the probability of the program being an ineffective failure is high. As a supply-side measure it is an inappropriate response to a labour demand problem, while from a supply perspective it is undermined by the lack of an arrangement with the labour movement to restrain wage growth.

VII. The Case for the New Deal

The arguments for the New Deal draw on evidence from U.S. workfare projects, economic theory, and preliminary evidence on the New Deal's impact thus far. Four arguments stand out prominently. One, the New Deal programs do differ in key areas that have hindered success for American workfare programs. At the same time, the New Deal has borrowed some of the elements that did work in the American model, and are therefore likely to see much better outcomes. Two, given certain conditions there is a powerful theoretical case for workfare actually improving the welfare of the unemployed. Three, general equilibrium, or macroeconomic effects of the New Deal have been observed in the New Deal's first two years, and they lend strong support for the program. Modelling of future effects have suggested even more impressive results as the program makes its impact felt more throughout the general economy. Four, the New Deal's opponents are somewhat at a disadvantage in that the program has garnered support for its direction from some of its most vocal critics. The New Deal is therefore, at the very least, a first step directionally for any future reform of the British welfare state.

The American experience with workfare has been mixed. Although there are a significant number of participants who end up with lower earnings, even critics such as Maria Cancian (312) have conceded that "on average" earnings seem to rise after participation in workfare. Nor are the concerns over poor job retention fully justified empirically. In a study of 1,777 workfare participants, job retention was found to be significantly higher among the workfare participants than the control group of 16,723 of non-workfare employees (Gooden 83-92). Workfare participants were found to be 1.56 times more likely to retain their jobs after 3 months than the non-workfare group; at 6 months, this difference increased to 2.04 times (Gooden 83-92). To ensure that the New Deal's outcomes are better, greater resources have been devoted to programming than in the American case. The investment per participant in the NDYP is estimated at about £4,000 (DWP website). This is significantly above the average per participant amounts given in Brock's (39-56) study of U.S. programs[7], and thus suggests that the NDYP will not suffer the under-investment problems that have characterised U.S. workfare. Complimenting the New Deal, the Blair government introduced the Working Families Tax Credit, which effectively guarantees any family with a full-time worker a tax benefit equivalent to £214 per week, and increased subsidies

[7] The dollar amounts for the four cities were: Los Angeles - $1302; Philadelphia - $1889; Cuyahoga - $1308; Miami-Dade $6042 (Brock 39-56).

to child-care for low-income workers (Glyn 53). The government has demonstrated a long-term vision for the program by emphasising a 'life-long learning model,' by which tax credits encourage saving in Individual Learning Accounts (with the government contributing an additional £150 to each worker's account) (Glyn 59). The New Deal has borrowed significantly from the U.S. model, but has made adjustments so as not to repeat its mistakes.

Recent work in political economy has boldly challenged some past assumptions that social protection is inimical to economic growth. Attempting to explain and model the international differences in social welfare regimes in terms of microeconomic theory, Soskice et al. (2001) advance a powerful argument that demonstrates how particular systems *compliment* rather than inhibit the functioning of a market economy. Social welfare regimes, they show, reduce risk and allow workers to invest in firm-specific and industry-specific skills, thus complimenting the labour market needs of some of the specialised economies of continental Europe (Soskice et al. 145-183). The New Deal doesn't attempt to fill the role that social welfare regimes play in Germany or France's labour markets. It does, however, open up the possibility that Britain's social welfare system could become a source of strength for the U.K. economy, rather than a burden to it.

VIII. Workfare and Human Capital: A Partial Equilibrium Model

Like other workfare measures, the New Deal has the potential to improve individual welfare, provided certain conditions are in place. What follows is a theoretical model based on the leisure-consumption model of microeconomic theory.

This model compares the utility of two 'states.' In the first state, *the unconditional state*, the recipient receives welfare benefits with no work requirement. In the other, *the workfare state*, workfare is imposed. Workfare allows choice and this is reflected in the model by allowing for two options: *compliance*, where the benefits recipient participates in workfare; and *non-compliance*, where the person chooses to leave the benefit system entirely. Sufficiency conditions will be derived to show that for either choice by a benefits recipient, workfare results in higher utility.

There are two goods: consumption goods (C) and leisure (L). Individuals purchase these by working, i.e. trading time from an initial endowment (Z) for wages, in order to maximise utility (U). There are two sources of income: non-market income [welfare (B) or workfare benefits (b)] and wages (w). There are costs associated with work, child-care (k), and deductions for taxes (t) and benefit 'claw-back' (τ). If workfare is not imposed, the optimisation problem becomes[8]:

1) $$\max_{C,L} U(C,L) \text{ s.t. } C = \hat{w}(Z - L) + B;\ \hat{w} \equiv w(1 - t)(1 - \tau) - k$$

Let L* and C* solve this, yielding two demand functions for L and C:

2) $$L^{*}(\hat{w},y) \text{ and } C^{*}(\hat{w},y);\quad y \equiv Z\hat{w} + B$$

Implicit income – potential income from trading endowment time plus welfare benefits – is defined as (y). Since leisure is a normal good, it is positively related to income. Therefore, raising the level of benefits reduces market work (i.e. increases leisure). This is the foundation of the 'incentive' argument against unconditional (non-work) benefits.

Equations (1) and (2) define the *unconditional state* in which there is no work requirement for welfare benefits. In the *conditional state* a mandatory work requirement (R) is imposed. Since there are two options for an individual,

[8] Full derivation of the model is found in the Appendix.

compliance and non-compliance, and each has a different budget constraint, they are represented separately. Let subscript-w followed by ‘c’ or ‘n’ denote variables from the workfare state, with ‘c’ and ‘n’ denoting compliance and non-compliance respectively.

The imposition of workfare alters the budget constraint of the individual. Instead of a lump sum of unconditional benefits (B), assistance is rendered based on a ‘benefit wage’ paid for the time fulfilling the workfare requirements (R). The new maximisation problem is thus[9]:

3) $$\max_{C,L} U_{wc}(C,L) \text{ s.t. } C = (Z - L - R)\hat{w} + bR; \quad y_{wc} = Z\hat{w} + (b - \hat{w})R$$

Let L_{wc}* and C_{wc}* satisfy the first-order conditions and constraint, yielding:

4) $$L^*_{wc}(\hat{w}, y_{wc}) \text{ and } C^*_{wc}(\hat{w}, y_{wc})$$

Since implicit income is lower with workfare (y_{wc}<y) and net wages (w-hat) is the same, both consumption and leisure are lower for workfare than in the ‘unconditional’ state. Individuals compare the expected utility levels of both compliance and non-compliance options, and choose the option that maximises utility. If non-compliance is chosen, the individual leaves the benefit system entirely. The maximisation problem then becomes[10]:

5) $$\max_{C,Y} U_{wn}(C,L) \text{ s.t. } C = (Z - L)\overline{w}; \; y_{wn} = Z\overline{w}; \; \overline{w} \equiv w(1-t) - k$$

Let L_{wn}* and C_{wn}* satisfy the first-order conditions and constraint, yielding:

[9] Note that child-care costs for workfare time are assumed to be covered by the program.
[10] Note that child-care costs are not covered in this option, therefore the net wage (w-bar) includes child-care costs (k).

6) $$L^*_{wn}(\overline{w}, y_{wn}) \text{ and } C^*_{wn}(\overline{w}, y_{wn})$$

If the indirect utility of both workfare options are compared, compliance with workfare unambiguously leads to lower utility if we assume (reasonably) that there is some benefit 'claw-back' rate (τ>0), and that the 'benefit wage' of workfare is less than the market wage (b<w). This would predict that the imposition of workfare requirements would cause an individual to leave the benefit system if the expected net earnings in the market exceed the 'workfare wage'. The introduction of the New Deal, as with other workfare reforms elsewhere, has witnessed a significant exodus of benefit recipients, apparently making the very choice predicted by this model.

Workfare causes a reduction in caseloads, by acting as a deterrent to benefit collection. That is relatively easy to prove, but doesn't answer a crucial question: can workfare improve utility for a benefits recipient? The human capital perspective would answer in the affirmative, but this rests on the assumption that there is a positive (permanent) increase in net wage earnings. The factors, some relating to policy, that could contribute to this will be discussed, but a proof supporting the human capital perspective follows.

Let us assume that wages are positively affected by work experience. Then either choice by a benefits recipient - participate in workfare or exit to work solely in the market - results in net wage growth (g). Net wage growth (g), therefore, is a function of leisure, and the two are negatively related. Since leisure is highest for the state of unconditional benefits, wage growth in this state (i) will be lower than if workfare is imposed (g>i). Comparing indirect utility (*V*) of workfare versus unconditional benefits, at N periods ahead, the following are proposed[11]:

7) $$V_{wn}(\overline{w}(1+g)^N, \tilde{y}_{wn}) > V(\hat{w}(1+i)^N, \tilde{y}) \quad \text{if} \quad \mathrm{Z}\left[\overline{\mathrm{w}}(1+\mathrm{g})^{\mathrm{N}} - \hat{\mathrm{w}}(1+\mathrm{i})^{\mathrm{N}}\right] - \mathrm{B} > 0$$

[11] Proofs of these are found in the Appendix.

8) $V_{wc}(\hat{w}(1+g)^N, \tilde{y}_{wc}) > V(\hat{w}(1+i)^N, \tilde{y})$ if $Z\hat{w}\left[1-\frac{R}{Z}-\left(\frac{1+i}{1+g}\right)^N\right]-\left[\frac{B-bR}{(1+g)^N}\right]>0$

Both of these are sufficiency conditions. If satisfied, they ensure that workfare increases future utility of benefit recipients. What these conditions imply are:

I. From (7), the difference in net wage growth from workfare must be significant enough to compensate for the loss in implicit income from the removal of unconditional welfare benefits.

II. From (8), again, the difference in net wage growth should be significant enough to ensure that the effect on utility is positive. In addition, however, it suggests that there is a relationship between the work requirement (R), workfare benefits (b), net wages, net wage growth (g), and the time horizon (N). The last factor is important, as it gives a theoretical justification for targeting workfare on younger people (as does the New Deal).

What this model demonstrates is that workfare can be successful if its impact on net earnings over time is significant. What policies might contribute to ensuring that net earnings are higher with workfare?

a) Improve wage growth (g) via high quality training.
b) Target workfare to those with a significant time horizon (N) over which earnings can grow (i.e. invest in youth programs).
c) Improve net wages: net wages are a function of market wages, taxes, the benefit claw-back rate, and child-care costs. Policy actions that raise net wages include: subsidising market wages, reducing personal income taxes on low-income earners, reducing the benefit claw-back rate, and subsidising child-care costs.

How does the New Deal measure up to these conditions? Youth have been targeted and made the initial focus of the program. Significant training and education support is offered (as mentioned previously, up to 12 months of education is paid for by the NDYP). The Blair government, at the time the New Deal was implemented, raised the minimum wage (Riley 8). Although time-limited, the subsidy per work placement participant is nearly £7,000 (Riley 16). The introduction of the Working Families Tax Credit and improved child-care subsidies contribute to raising net earnings from work. In sum, it appears that the conditions that could make the New Deal a success, from a partial equilibrium standpoint, are present or are in development.

IX. General Equilibrium Effects – Macroeconomic Impact of the New Deal

The New Deal will have effects that go far beyond those directly impacted by the reforms. Toward an understanding of these effects, general equilibrium analyses of the New Deal (and workfare in general) have contributed to the theoretical backing for the reforms. In a relatively simple model, calibrated to reflect behavioural parameters in the U.S. economy, John Roemer (in Solow 63-76) suggests that moving toward direct employment subsidies (instead of welfare) can improve economic growth, lessen income disparity, and improve employment levels of low-productivity workers. In another model, Craig Brett (616) demonstrates that workfare could be part of an “optimal tax mix,” provided that workfare and its benefits are targeted to people not “work-averse.”

By far the most statistically rigorous examination of the New Deal’s macroeconomic impact was done by Rebecca Riley and Gary Young of the National Institute of Economic and Social Research (NIESR). Using the Institute’s macroeconometric model of the U.K. economy, they model the four-year impact of the NDYP alone. The results are a powerful endorsement of the New Deal.

Table 1: Impact of the New Deal for Young People on the labour market				
difference from counterfactual scenario (thousands)				
Youth labour market	1999:1	2000:1	2001:1	2002:1
Short-term unemployment	+3	+7	+6	+6
Long-term unemployment	-47	-46	-46	-46
Employment	+13	+16	+16	+16
Government supported training	+14	+14	+14	+14
Aggregate Labour Market				
Short-term unemployment	+1	+5	+3	+3
Long-term unemployment	-48	-49	-47	-48
Employment	+19	+25	+27	+28
Government supported training	+14	+14	+14	+14

Notes: difference between the simulated case with the policy against a counterfactual without the policy; short-term unemployment is unemployment lasting less than 6 months; long-term unemployment is unemployment lasting more than 6 months; employment includes those on the NDYP employer option, but excludes government supported trainees.

Source: Riley, Rebecca and Gary Young. "The Macroeconomic Impact of the New Deal for Young People." August 2001. National Institute for Social and Economic Research.

Table 1 illustrates the past and projected impact on the labour market over the period 1999:1 to 2002:1. The table's results compare the outcome to a counterfactual scenario, in order to isolate the impact of the program. It should be noted that the study was published in late 2001, therefore the projections for 2002:1 are near the model's sample period. The results show an increase in short-term unemployment, with greater increases in the youth labour market. These increases, however, are easily exceeded by much stronger employment growth.

Modelling the impact over a longer horizon, the increases from the program suggest a net increase in employment of 60,000 over 10 years (Riley 15). The estimated supply-side effects are also promising. The NDYP has caused a reduction in the ratio of long-term unemployed from .42 to .40 of total unemployment; this reduction translates roughly into 100,000 jobs, and this has been accomplished with no additional upward pressure on wages (Riley 8).

The expected impact on government balances is surprising, and refutes dire predictions by its critics of the New Deal leading to a possible fiscal crisis, with swelling numbers of participants looking for subsidised jobs and training (Peck, "Workfare States" 309). In fact, as Table 2 suggests, increased tax revenue and a dramatic reduction in social benefits spending largely offset program expenditures. In the first two years, the government spent a total of £668 million on the NDYP; the extra tax receipts flowing in during the four-year period total £600 million, suggesting that the program could eventually become almost self-financing (Riley 18). Overall, the effect on output will have been stimulating, but not excessively so; GDP is expected to grow .1% by 2002 due to the program.

Table 2: Impact of the NDYP on the public finances

Difference from counterfactual (£million)

Receipts	1998-99	1999-00	2000-01	2001-02	Average
Indirect Taxes	77	99	29	27	58
Direct Taxes	40	72	70	74	64
Expenditure					
Social Benefits	-108	-121	-144	-168	-135
Gross NDYP Spending	252	352	360	370	334
Net Cost					
*Net Exchequer Cost**	29	80	187	194	140
Cost per Job (£)	4800	3300	7200	7200	7000

**** The net exchequer cost is equal to the increase in expenditure less the increase in receipts. Total receipts and expenditure include further items not shown in the table. These are debt interest payments, profits on government trading, spending on fixed investment and social contributions paid to government.***

Notes: difference between the simulated case with the policy against a counterfactual without the policy; financial years; jobs include those on the NDYP employer option, but exclude government supported trainees; additional spending of £35.4 million for 1997-8 and DfEE/DSS spending of £28 million not allocated to individual years but included in average net exchequer cost; social benefits include JSA saving.
Source: Riley, Rebecca and Gary Young. "The Macroeconomic Impact of the New Deal for Young People." August 2001. National Institute for Social and Economic Research.

X. Is There an Alternative?

The final supporting argument in favour of the New Deal is the endorsement it receives from its critics, who agree with its general direction. Jaime Peck of the University of Wisconsin is one of workfare's most vocal academic critics, and has, as shown in this paper, relentlessly condemned its failings. That criticism of workfare notwithstanding, Peck acknowledges that the New Deal deviates from America's punitive version of workfare through its better resources for counselling, job training, and its superior delivery system (Peck, "Beyond" 732). In fact, he acknowledges that the New Deal might be a basis for something more long-term in focus, more supportive of the social economy, demand-oriented where it need be, and more inclusive (and effective) at reintegrating groups traditionally excluded from the job market (Peck, "Workfare" 740-744). Robert Solow is also a well-known critic of workfare, but still agrees with a general vision of work-based social assistance. Discussing the possibility of a 'mixed-system' that rewards work but simultaneously doesn't punish unemployment, he proposes:

> The objective of this mixed system should be to achieve a reasonable equilibrium between the norms of self-reliance and altruism. The real trouble with welfare as we know it is that it tended to erode both (Solow 42)

XI. Conclusion

This paper has discussed the background behind the New Deal reforms. The general structure of the program has been described, and comparisons have been made to its main sources of inspiration: the Swedish Active Labour Market Policies approach and American workfare. The New Deal is neither of these.

The economic reality for a medium-sized open economy today, such as the U.K., precludes large-scale, state-financed guarantees of employment. All three

Scandinavian countries discovered this lesson, and have abandoned this model. America's experiments with workfare suggested a general direction that has guided welfare reform internationally for the past decade. Britain has learned from America's experiment, and has crafted a unique system that delicately balances personal responsibility with social obligations to correct what the free market cannot remedy. If the New Deal proves successful – and it is the conclusion of this paper that this is likely –, the welfare state Lord Beveridge created a half-century earlier will have been rescued by a return to the ideas and goal of its chief architect.

<u>XII. Appendix – Workfare and Human Capital: A Partial Equilibrium Model</u>

- The model compares the effect on individual utility of workfare, by comparing two states: the unconditional state without workfare, and the conditional state with workfare. In the workfare state, an individual can choose one of two options: compliance to receive workfare benefits, or non-compliance and exit from the benefit system. Individuals are assumed to be rational, utility maximising, and able to compare both options to make a choice.
- Utility is a function of two goods, consumption (C) and leisure (L); both are normal goods. Preferences are monotonic, transitive, strictly convex, complete and continuous. *U(C,L)* represents these preferences, is quasi-concave, and continuously twice-differentiable.

Derivation of the budget constraints

For the unconditional state, the budget constraint is:

1) $$C = w(Z - L)(1 - t) + B\left(\frac{r - \alpha w(Z - L)}{r}\right) - k(Z - L)$$

(Z) defines the time endowment; (t) is the income tax rate; (r) is the earnings cap (level beyond which earnings have reduced welfare benefits to 0); (α) is a parameter of earnings clawback; (w) is the gross wage per unit of time; and (k) is the cost of child-care per unit of worktime.

Since welfare benefits cannot be reduced below zero:

2) $$\left(\frac{r - \alpha w(Z - L)}{r}\right) \in [0,1]$$

If we let $\tau \equiv \alpha B/r$, this simplifies out to:

3) $$C = \hat{w}(Z - L) + B;\ \ \hat{w} \equiv w(1 - t)(1 - \tau) - k$$

The budget constraints for workfare, compliance and non-compliance are respectively:

$$C = (Z - L - R)\hat{w} + bR \quad \text{and} \quad C = (Z - L)\overline{w};\ \ \overline{w} \equiv w(1 - t) - k$$

Note that (R) is the mandatory work requirement, and w-bar or w-hat represent <u>net</u> wages (after taxes, benefit clawback, and child-care).

'Income' in the leisure-consumption model is defined implicitly. Implicit income (y) is a function of the net wage, time endowment and benefits. For each state and option, implicit income is:

Unconditional state: $y = Z\hat{w} + B$; Workfare – compliance: $y_{wc} = Z\hat{w} + (b - \hat{w})R$

Workfare – non-compliance: $y_{wn} = Z\overline{w}$

Indirect Utilities

If the following satisfy the maximisation problem for all three, the indirect utility functions for each can be defined by the Envelope Theorem:

Unconditional benefits:

$C^*(\hat{w},y)$ and $L^*(\hat{w},y)$ $\therefore U\left(C^*(\hat{w},y), L^*(\hat{w},y)\right) = V(\hat{w},y)$

Workfare – compliance:

$C_{wc}{}^*(\hat{w},y_{wc})$ and $L_{wc}{}^*(\hat{w},y_{wc})$ $\therefore U\left(C_{wc}{}^*(\hat{w},y_{wc}), L_{wc}{}^*(\hat{w},y_{wc})\right) = V_{wc}(\hat{w},y_{wc})$

Workfare – non-compliance:

$C_{wn}{}^*(\overline{w},y_{wn})$ and $L_{wn}{}^*(\overline{w},y_{wn})$ $\therefore U\left(C_{wn}{}^*(\overline{w},y_{wn}), L_{wn}{}^*(\overline{w},y_{wn})\right) = V_{wn}(\overline{w},y_{wn})$

Proposition: $L^* > L^*_{wc}, L^* > L^*_{wn}$

Proof: since leisure is a normal good, leisure is negatively related to the price of leisure (the wage rate), but positively related to income (y).

$\because y > y_{wc}$, $L^* > L^*_{wc}$ $\quad \because y > y_{wn}$ and $\overline{w} > \hat{w}, L^* > L^*_{wn}$

Let net wage growth be a function of experience, either workfare or market work. It is therefore a negative function of leisure. Since the unconditional benefits state has the highest level of leisure, net wage growth in this state will be lower than for either workfare option. Denote earnings growth for unconditional benefits as (1+i) and for either workfare option as (1+g). We now have that g>i.

From the Envelope theorem, if we differentiate the Langrangean of each with respect to w and y, we discover that the indirect utility function *V(w,y)* is positively related to wages and implicit income. When we allow for net wage growth, as mentioned above, and look ahead to N periods, the indirect utility function for each is:

Unconditional benefits: $V\left(\hat{w}(1+i)^N, \tilde{y}\right)$ where $\tilde{y} = Z\hat{w}(1+i)^N + B$

Workfare - compliance:

$V_{wc}\left(\hat{w}(1+g)^N, \tilde{y}_{wc}\right)$ where $\tilde{y}_{wc} = Z\hat{w}(1+g)^N + \left[b - \hat{w}(1+g)^N\right]R$

Workfare – non-compliance:

$V_{wn}\left(\overline{w}(1+g)^N, \tilde{y}_{wn}\right)$ where $\tilde{y}_{wn} = Z\overline{w}(1+g)^N$

The question asked by the model is: what are sufficient conditions for workfare to result in higher utility?

Sufficiency Condition 1: assume $V_{wn}\left(\overline{w}(1+g)^N, \tilde{y}_{wn}\right) > V\left(\hat{w}(1+i)^N, \tilde{y}\right)$

Proof: $\because\ \overline{w} > \hat{w}$ and $g > i,\ \overline{w}(1+g)^N > \hat{w}(1+i)^N$

$$\text{if } \tilde{y}_{wn} > \tilde{y} \quad \rightarrow \quad Z\overline{w}(1+g)^N > Z\hat{w}(1+i)^N + B$$

$$\therefore\ Z\left[\overline{w}(1+g)^N - \hat{w}(1+i)^N\right] - B > 0$$

What this suggests is that utility is higher with workfare if wage gains are enough to compensate for the loss in unconditional benefits.

Sufficiency Condition 2: assume $V_{wc}\left(\hat{w}(1+g)^N . \tilde{y}_{wc}\right) > V\left(\hat{w}(1+i)^N . \tilde{y}\right)$

Proof: $\because\ g > i,\ \hat{w}(1+g)^N > \hat{w}(1+i)^N$

$$\text{if } \tilde{y}_{wc} > \tilde{y} \quad \rightarrow \quad Z\hat{w}(1+g)^N + \left[b + \hat{w}(1+g)^N\right]R > Z\hat{w}(1+i)^N + B$$

$$\hat{w}\left[(1+g)^N(Z-R) - Z(1+i)^N\right] + bR - B > 0 \quad \rightarrow \quad Z\hat{w}\left(1\text{-}\frac{R}{Z} - \left(\frac{1+i}{1+g}\right)^N\right) - \left(\frac{B-bR}{(1+g)^N}\right) > 0$$

What Condition 2 suggests is that, again, net wage gains need to be significant in order for this term to be positive. Also note that N (time horizon) plays a significant role in this condition. A combination of high wage gains (g) and a long time horizon (N) make it more likely this term will be positive.

Note that the Condition 2 is only applicable up to the point that wage earnings are within range of the earnings cap (r). If we allow wage earnings to rise above the earnings cap, welfare benefits are 0, and Condition 1 becomes the relevant condition.

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