Analysis of costs and benefits of active compared to passive measures

Executive summary

Client: European Commission, DG Employment, Social Affairs and Inclusion

Rotterdam, 29 March 2012

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Preface

This publication is supported by the European Union's Programme for Employment and Social Solidarity - PROGRESS (2007-2013).

This programme is managed by the Directorate-General for Employment, Social Affairs and Inclusion of the European Commission. It was established to financially support the implementation of the objectives of the European Union in the employment and social affairs area, as set out in the Social Agenda, and thereby contribute to the achievement of the Lisbon Strategy goals in these fields.

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- providing analysis and policy advice on PROGRESS policy areas;
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1 Background and aims

1.1 Background to the study

As the 2011 Annual Growth Survey[1] highlighted, the economic crisis has had far-reaching impacts on the European Union's Member States, for unemployment, productivity, as well as public finances. The crisis came on top of some longer-term trends that already challenged European societies, notably those related to increasing international competition, the development of new technologies, and an ageing society.

If the EU is to achieve its headline target of a 75 per cent employment rate for women and men aged 20 to 64 by 2020, it requires adequate instruments to ensure greater labour market participation of its citizens and of young people, older workers and low skilled workers in particular. It requires so-called passive and active labour market measures that will facilitate and promote this objective and that are suitable to the needs of societies finding a way out of a crisis and preparing for the times after.

1.2 Study objectives and tasks

This study analyses active and passive labour market policies, and in particular their effectiveness in ordinary times and times of crisis. It does so, with a view to formulating recommendations for an employment strategy in the framework of crisis exit and longer-term sustainable strategies.

For the implementation of the study six tasks were accomplished, to identify and analyse:

- Why? - the rationales between passive and passive labour market policies were identified –the objectives formulated by policy makers, as well as an analysis of their place in socio-economic theory and the associated benefits as well as the potential risks;
- How much? - the development of expenditures on measures indicates both their importance in employment and social policy, as well the costs associated with them. We paid specific attention to the impact of the business cycle on these developments;
- How? - funding mechanisms and implementation structures were examined as they may affect effectiveness as well as costs;
- How well? - the costs and benefits of measures in 'ordinary times', i.e. before 2008
- What in times of crisis? – measures taken since the 2008 crisis and a review of their potential impacts based on what is known from the previous analysis
- What next? – conclusions and recommendations for the Europe 2020 and the exit strategy.

[1] COMMUNICATION FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT, THE COUNCIL, THE EUROPEAN ECONOMIC AND SOCIAL COMMITTEE AND THE COMMITTEE OF THE REGIONS - Annual Growth Survey: advancing the EU's comprehensive response to the crisis, Brussels, 12.1.2011, COM(2011) 11 final.

2 Approach and methodology

2.1 Data sources

This study was based on desk research, by a core team in Rotterdam and Bonn, as well as national experts in ten selected countries. An extensive body of national and international literature on the rationales and effectiveness of labour market policies was collected and reviewed. The Eurostat Labour Market Policy database has proved to be a key sources of information, both for the content of policies in place in Member States and for data on their participants and the money spent on them. Furthermore, in describing these measures, referred to as interventions in the nomenclature of Eurostat, we adopt the classification of Eurostat.[2]

2.2 A synthetic review of effectiveness

The methodology chosen for the analysis of the effectiveness of active and passive measures is a so-called *synthetic review*. Existing meta-studies tend to take a quantitative approach. An important advantage of this choice of course is their wide coverage and the constructive and systematic review of a large body of evidence. The limitations associated with this approach relate to their treatment of contradicting findings. Recent meta-studies statistically averaged such findings, without assessing the variation of reliability between studies. In such meta-studies, a strong coefficient may just reflect high homogeneity rather than reliability of findings and a low coefficient may only reflect a small number of observations for a specific measure.

2.2.1 High quality evaluation studies

The present study takes the existing meta-studies into account. Its added value though stems from a qualitative assessment of existing findings of high quality evaluation studies. Many of the research on which such studies are based, only take into account a limited number of the pitfalls evaluators face when assessing the benefits of programmes. Few adequately address such issues as deadweight, substitution and displacement. Again fewer studies are based on an experimental design and are able to properly measure the 'average treatment effect of the treated'. For the present study we have therefore chosen to identify and examine only studies that meet high standards of evaluation analysis. This approach aims to deal with the conflicting results obtained from other meta studies and a more in-depth qualification and explanation of findings. In order to assess the reliability of existing findings, we have considered the following criteria:

- Internal validity of a study in terms of logical consistency;
- External validity in terms of compatibility with related findings from other studies;
- Methodological appropriateness;
- Quality of the underlying data.

2.2.2 Countries and measures reviewed

National experts of 10 countries have presented a literature overview of evaluation studies for all measures, and have indicated which are of high quality. From these, 20 well evaluated measures in

[2] Eurostat (2006), Labour market policy database, Methodology, Revision of June 2006, ISSN 1725-0056.

10 Member States have been selected. This approach ensured the inclusion of evaluation studies in the national language.

Table 2.1 Countries and types of measures selected for synthetic review

Country group	Continental		Mediterranean		Anglo		Nordic		New MS	
Type of policy measure	DE	AT	ES	IT	UK	IE	NL	SE	HU	PL
1. Out-of-work income support										
2. Early retirement										
3. Labour market services										
4. Training										
5. Employment incentives										
6. Supported empl. & rehabilitation										
7. Direct job creation										
8. Start-up incentives										

3 Labour market measures and the business cycle

3.1 Overall trends

The overall trend in labour market policies between 1990 and 2009 is that expenditures on passive measures are countercyclical but with an overall downward trend. Expenditures on active measures have become less countercyclical since the early 1990s and are strongly affected by the introduction and discontinuation of measures. The cyclicality of passive measures implies a need to prepare for higher expenditures in recessions. For active measures the results indicate a need for evaluation to avoid premature discontinuations after disappointing results.

3.2 Individual Member States

At the country level, countries with the strictest targeting and the lowest expenditures on passive measures tend to extend eligibility the most in recessions, in particular in 2009. Between the EU, Japan and the US this applies to the US (extension of maximum duration), and within the EU this applies to Estonia and Italy (broader targeting). On the other hand the expenditures on passive measures were much lower in 2009 than in 1992/1993 in the Scandinavian countries, Germany and the UK, despite unemployment rates that were similar to 1992. The Scandinavian countries and Germany had implemented major reforms to make benefits more activating. These reforms combined a reduction of the generosity of benefits with requirements to search and especially to accept jobs, although income support in Scandinavian countries is still among the most generous in the EU. The UK sought to achieve the same through continuous reforms of public employment services. The reforms in all these countries were effective in reducing costs, since expenditures on other social policies such as disability benefits, family or housing allowances did not increase in the same period.

3.3 Individual measures

The trends between the various labour market policies also indicate a shift in the focus towards (effective) job placements and incentivizing regular job matches: the shares of expenditures on training, early retirement and direct jobs declined in favour of labour market services and employment and start-up incentives. In recessions, expenditures on training and subsidies to preserve jobs tend to increase, in 2009 partly in the particular shape of short-time work. An expansion of active measures in 2009 in some new Member States might have limited the increase of the unemployment rate, but if so, it is at the cost of higher expenditures.

4 Rationales and effectiveness of measures

4.1 Passive labour market measures

The main rationale for passive measures, mainly out-of-work income support, is public provision of insurance against loss of income due to unemployment. Combating poverty and providing more equity of income are other, more social reasons for out-of-work income support, as part of a wider system of social protection including family allowances, disability benefits, housing allowances and social assistance.

4.1.1 Out-of-work benefits

Out-of-work benefits are very valuable as a cost-effective means to insure workers against loss of income because private savings would result in a great loss of utility due to long postponed consumption. An estimated utility gain of cost-effective public insurance outweighs the calculated costs caused by prolonged unemployment durations. Out-of-work income support seems to increase the inflow into unemployment, however this negative effect is not decisively quantified. Out-of-work income support is likely to maintain consumer demand but again the literature lacks reliable empirical evidence.

The effectiveness of activation requirements in out-of-work income support is better known. Reforms to make job search and acceptance requirements more strict and to extend these to other benefits as well appear successful in reducing expenditures without increased expenditures on other benefits. Some of the literature based on international comparisons, notably Coquet (2011), argues that requirements to search and accept jobs are more important for re-employment rates than benefit levels and durations.

4.1.2 Early retirement

A rationale for early retirement that exists mostly in Mediterranean countries is that older workers make place for younger workers by withdrawing early from the labour market. However, according to evaluations, early retirement does not contribute to youth employment. Another rationale is to facilitate inactivity, in particular in some Nordic countries. An underlying rationale could be to save expenditures on active measures for old workers with few employment prospects. However, as early retirement prompts workers to retire years in advance, it is a costly measure. Most EU countries already have reduced expenditures on early retirement, from an average 0.3 per cent of GDP in 1992-1994 (EU-15 plus the four largest new Member States of 2004) to an average 0.08 per cent of GDP in 2006-2009 in the EU-27. There is no evidence of an increased use of early retirement as an alternative for unemployment benefits, at least not in 2009.

Most EU countries plan to further reduce early retirement benefits. However, the bigger challenge for an ageing society is the funding for the old age pension past the legal retirement age, on which 11 per cent of GDP was spent in 2009, compared to only 0.08 per cent on early retirement benefits.

Restricting early retirement does not necessarily lead one-on-one to higher employment of older workers; as unemployment still is an alternative, with often longer maximum benefit durations for older workers, while wages that increase with age and a high degree of employment protection for older workers may make firms reluctant to recruit older unemployed workers. Reforms of the labour market for older workers should therefore be considered at the same time.

4.1.3 *Short-time work measures*

Short-time work measures enable workers to draw an unemployment benefit for reduced working hours while being employed for the other hours. This measure has been newly introduced or rapidly expanded in response to the latest recession, and as a consequence is less rigorously evaluated yet. The measure seems to have been effective in countries with a high level of employment protection for the whole population. In countries with a segmented labour market where temporary workers have little employment protection, employers had and used the option to dismiss temporary workers. Inducing employers to make use of the measure by paying the full wage salary as long as the employment contract is not terminated, seems not effective, because that amounts to an unemployment benefit without job search requirements. This kind of measure should be temporary, but according to Hijzen and Venn (2011)[3] there is a risk of prolonged use in Finland, Italy and Spain due to long durations of short time work exceeding two years.

4.2 Active labour market measures

Active labour market measures are expected to overcome disincentives of passive measures and market failures such as non-transparency and discrimination due to (perceived) lower productivity of particular groups. The main disincentive of passive measures is that the differences between benefits and wages can be small for low-skilled workers, who are willing to work but not at minimum wage. Compared to fifty years ago, the demand for low-skilled has decreased, which has led to an increasing risk of social exclusion for this target group. Hence, the primary rationale of most active measures is to increase employment, but the reduction of social exclusion is a secondary aim and for some active measures even the primary aim.

The effectiveness of the six groups of active measures distinguished in this report is assessed in terms of re-employment rates of participants in comparison to non-participants, taking into institutional settings, and comparing the effectiveness with the costs involved. Some other effects of active measures not included in most evaluation studies are discussed at the end of this section.

4.2.1 *Labour market services*

Job search assistance and counselling are cost-effective and should be applied to vulnerable groups from the start, to avoid diminishing job prospects as the unemployment spell lengthens. For groups that are expected to be able to find a job on their own, job search assistance should initially cover only basic services to avoid deadweight costs of intensive counselling. Job search assistance should be continued in times of crises when fewer job opportunities are available, if only to keep the unemployed in the habit of searching for a job when the economy picks up again. Job search monitoring is less effective in times of crisis when unemployed need to search harder for the fewer available job opportunities. Administrative reforms such as planned by France in 2010, could in principle reduce expenditures, but not by much from previous Dutch experience.

4.2.2 *Training*

Training is effective for all groups of unemployed workers who lack specific skills that are required in the labour market. Training comes with large lock-in effects because people in training generally do not apply for jobs in the meantime. Job placement rates should therefore be targeted at and evaluated for the mid-term, to avoid the typically less effective types of short training programmes. Training is more costly than job search assistance and offering training after a few months avoids

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[3] Hijzen, A. and D. Venn (2011), The Role of Short-Time Work Schemes during the 2008-09 Recession, OECD Social, Employment and Migration Working Papers, No. 15, OECD Publishing, http://dx.doi.org/10.1787/5kgkd0bbwvxp-en , page 36

higher potential deadweight losses. In times of crisis, a particular group for which training seems to be effective consists of workers who have lost a job in an unviable profession. These are typically older workers. However, a rapid expansion comes at the risk of loss of quality, focus and recognition of trained skills by employers; training in Spain has been criticized for this reason. Employers can train their own employees to avoid teaching employees skills that employers do not need, or teaching skills the employers need but would have invested in even without the programme.

4.2.3 Employment incentives

Employment incentives seem to be more effective in promoting the employment of specific groups than in increasing overall employment. The deadweight loss risk of persons finding a job they would have found even without the subsidy is particularly high for this measure. Targeting employment incentives at long-term unemployed who were unable to find a job in the first 12 months on their own, reduces this risk. An old Hungarian study indicates that some employers wait to recruit unemployed until the subsidy is available, in this case after six months of unemployment. Employment incentives to promote the creation of more permanent jobs compared to temporary jobs seem effective in the short run but not in the long run. Therefore, other and more structural solutions should be sought to reduce segmentation of the labour market, such as reducing the legal differences between different employment contracts, or to allow only one or two types of employment contracts. Three countries used employment incentives to provide young workers with work experience in response to the 2009 crisis; but the outflow out of work experience posts in the past was low in other countries.

4.2.4 Sheltered work and rehabilitation

Sheltered work offers meaningful activities to disabled workers. The main risk involved is that sheltered work is offered to workers who are not or only slightly disabled, since the outflow out of sheltered work into regular jobs is low. This risk of “parking” workers was apparent in 2009 in some new Member States, suggesting that local governments referred large groups of workers to State-funded sheltered work to save expenditures on local welfare programmes. Rehabilitation, like training, is not effective in the short run; evidence on effects in the mid-term is scarce. Rehabilitation is cost-effective if disability benefits are high and indefinite and if participation is voluntary, as observed in evaluation studies and explained by self-selection of motivated voluntary participants. Of course, voluntary participation reduces the reach of the programme.

4.2.5 Direct job creation

Directly created jobs are costly and cause prolonged high expenditures due to the low outflow rate into regular employment even when the economy improves. Displacement of regular jobs by directly created jobs leads to additional costs, because easily twice as much production as that realized in public works is lost. Direct job creation is therefore not advisable as a crisis measure. However, a totally different use of directly created jobs could be highly effective if offered selectively to those suspected of having informal jobs in order to terminate their benefits if they refuse the job.

4.2.6 Start-up incentives

Start-up incentives are effective if offered to a selected group of persons judged to be able to support themselves through self-employment. This measure entails a particular deadweight loss risk of regular start-ups quickly registering as unemployed in order to obtain a subsidy for an enterprise they would have started anyway. This measure seems less appropriate in times of crisis because of the higher risk of business failure.

4.2.7 Methodological shortcomings of evaluations in Member States

Most evaluation studies lack a quantification of deadweight losses, substitution and displacement of workers in regular jobs. Furthermore, it is not always easy to identify groups with comparable characteristics among participants and non-participants. Academically, randomized experiments could help address all these problems, if well designed and applied in selected regions, with other regions serving as a control group. Failing that, unavoidable shortcomings of data, econometric methods and surveys with questions on the deadweight loss and substitution effects are likely to result in only indicative results with a high degree of uncertainty.

5 Funding and implementation of measures

The primary aspects of funding and implementation considered here, are how funds are raised and which institution is responsible for the implementation. Less visible but not less important are institutional settings such as the arrangements between stakeholders, budget mechanisms, and incentives.

5.1 Current practice

The funding and responsibility of passive measures is typically done through a combination of social security funds to which employers and employees contribute and through general taxes, where the funding by the central government is more focused on minimum income support. Central governments fund a larger share of the active measures, but active measures are implemented largely by public employment services for unemployment beneficiaries and by local governments for social assistance beneficiaries.

5.2 Some considerations

The main issues that came to the fore during the analysis of funding and implementation arrangements are summarised below.

The alignment of budgets and responsibilities. Where funding and responsibilities are in different hands, it is important to build in incentives to provide measures efficiently. Such incentives involve awarding the actor investing in a measure with a bonus for job placements rather than setting targets only.

Both local governments and Public Employment Services (PES) are involved in the implementation of –passive and active- labour market measures. Local governments have a higher degree of autonomy than public employment services. There is a risk that local governments responsible for social assistance and welfare “park” beneficiaries in centrally funded measures, including direct jobs, sheltered work and disability benefits.

An important goal of funding is to make money available in times of high unemployment. Since at a time of high unemployment, tax revenues are lower and expenditures increase, labour market policies tend to further strain the government budget. To anticipate on higher expenditures, options include (1) increasing tax rates to reduce the government debt and to borrow money on the financial markets when needed, or (2) increasing contribution rates and investing excess contributions in a fund.

6 Recommendations

The Commission has recently proposed recommendations based on the Annual Growth Survey 2012.[4] On the subject of this study, tackling unemployment and the social consequences of the economic crisis, this communication focuses on mobilizing labour, supporting youth employment and protecting the vulnerable. In the following sections, we consider these recommendations in further detail, and add some recommendations.

6.1 Mobilizing labour

To mobilize labour, the Commission considered that Member States give particular priority to "adapting unemployment benefits further … to facilitate the return to work". The evidence gathered in this study enables the identification of priorities for the activation of benefits, with adaptations in decreasing order of urgency:

- Integration of different benefits to avoid the unemployment trap, including accumulation with other benefits such as housing and family allowances;
- Extensions of job search and acceptance requirements for other benefits such as social assistance, disability and widows pensions, direct jobs and possibly supported work in a mild form;
- Reduction of the implicit benefit of a non-working spouse if his or her tax threshold is transferable to the breadwinner;
- Sanctions, preferably discretionary rather than automatic.

The Commission furthermore called for more "effective activation and appropriate training and support schemes". This can be furthered by:

- Continued job search assistance oriented on employer demand based on sound information systems;
- Training for all groups that lack specific skills needed in the labour market, in particular workers who have lost a job in an unviable profession;
- Controlled expansion of training activities to avoid loss of quality, focus on required skills and skills recognition by employers;
- Mid-term job placement targets for training to avoid less effective short training programmes.

With regard to policies to improve the functioning of the labour market for older workers, the Commission has recommended (quotes in italics):

- *Restricted access to early retirement schemes and other early exit pathways*; this is an on-going process in which most Member States already have made effective progress;
- *Providing better access to life-long learning*; however, training of their own employees is by economic logic the primary responsibility of employers;
- *Adapting work places to a more diverse workforce*; for the disabled, this could be hard to incentivise especially for small companies where costs of adapting workplaces are likely larger related to turnover;
- *Developing employment opportunities for older workers, including through incentives*; however, the design of employment incentives is crucial to its effectiveness.

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[4] European Commission, Annual Growth Survey, Communication from the Commission, 23 November 2011, COM(2011)815 final.

Further suggestions from this study to improve the functioning of the labour market for older workers include:

- Reduction of maximum unemployment benefit durations, especially if duration is currently related to age or the number of contribution years;
- A social dialogue between government and social partners on the reduction of age-dependency of wage levels, especially for newly hired older workers.

The following is relevant with respect to aspects of the promotion of business creation and self-employment, with quotes from the Annual Growth Survey in italics:

- *Improving the quality of support systems for business creation and self-employment;* part of this can be achieved by reducing administrative requirements; business appreciation and the provision of business loans requires specific expertise that needs to be built or hired.
- *Promoting entrepreneurial skills*; acquisition skills (skills to win work) and accounting principles have been mentioned as primary skills in qualitative evaluations.
- Expansion of start-up incentives is advisable in countries where this measure virtually does not exist, rather than in countries that already devote many resources to this measure;
- When promoting self-employment, social protection of self-employed should also be considered in order to cover risks of old age and disability in general as well as unemployment if a self-employed worker has an apparent employment relationship with one company.

6.2 Supporting employment especially of young people

Our study confirms that segmentation of the labour market increases the risk of social exclusion of vulnerable groups and the low level of employment protection of young workers. A structural way to achieve this is by:

- Reducing legal differences between temporary and permanent contracts.

The Commission advocates a comprehensive approach to “target in particular young people who are not in employment, education or training”. This study points out that it should be taken into account that:

- Requirements and targets are not necessarily effective if different actors are involved, as each actor may cede the responsibility to activate hard-to-place workers to others;
- The actor investing in activation of hard-to-place (young) workers should be rewarded for successful activation.

With regard to the recommendation in the Annual Growth Survey to promote quality apprenticeships and traineeship contracts, and engage social partners in this, this study confirms that:

- These measures ensure the focus on skills needed in the labour market;
- These measures improve the recognition of trained skills by (other) employers;
- Employment protection may increase job stability and the willingness of employers to invest in training.

The Commission also recommends that particular attention is given to obtaining work experience. It is likely that Member States that focus on increasing youth unemployment increase or introduce employment incentives for work experience places. This comes at the risk of less job search for regular jobs. Therefore, it is advisable to ensure that this measure is discontinued when the economy improves again.

6.3 Protecting the vulnerable

For countries with ungenerous social protection, structural extensions of coverage and eligibility are advisable. Extensions in response to the crisis should not be withdrawn. To achieve a more universal approach to social protection, options include:

- Coverage based on “apparent employment relationship” or “assimilated workers” rather than on specific forms of employment contracts.
- More generous social assistance with strict job search and acceptance criteria.

The following is recommended with regard to social inclusion strategies for vulnerable groups:

- Active measures in general; to be applied from the start of unemployment for vulnerable groups whose employment prospects are low and decrease from the start;
- Rehabilitation; choose between a more cost-effective voluntary approach or a wider reaching but likely not cost-effective compulsory approach;
- Employment incentives are specifically appropriate for vulnerable groups; for purposes of cost-effectiveness it is recommended to focus on the long-term unemployed among these groups;
- Direct jobs and sheltered work can offer meaningful activities for vulnerable groups but come with high costs of prolonged wages and loss of high-productive work of those who would have found a regular job otherwise.

6.4 Improving effectiveness of measures and funding

Recommendations to improve effectiveness of measures and funding are:

- Raise tax or contribution rates sufficiently in advance, either to build up funds or to reduce government debts;
- Address potential risks associated with the combination of central funding and local implementation to avoid parking of non-vulnerable groups in such programmes; possible solutions include strictly capped budgets per municipality, or result-based funding (e.g., 50 per cent pre-financed and 50 per cent conditional on re-employment).
- If different actors are involved in the implementation, award a bonus to the actor investing in a measure for re-employment, even if another actor realizes the final job placement;
- Build in flexible arrangements to facilitate budget shifts if needed, e.g., to second staff from active to passive measures within or between organizations, or to closely monitor expenditures to start up fewer programmes in anticipation of budget shortages;
- If budgets are cut and the effectiveness of individual programmes is unknown, start fewer of the costliest measures to assist larger numbers of unemployed with the available budget;
- Reduce the use of benefits by persons with an informal job, by offering a public sector job at the minimum wage in order to terminate the benefit if the job is refused, rather than increase monitoring or employment incentives;
- Make continuation of measures contingent on evaluation results.

6.5 Improving the quality of evaluations

Whilst current knowledge allows conclusions on broad policy directions, too little is known about the effectiveness of measures for fine-tuning the design. It is important to design labour market measures in such a way that policy makers can learn from them. To further this, the following considerations are given:

- Include ex ante evaluations of policy proposals;

- Start with experiments in selected regions to compare results with other regions as a control group;[5]
- If it is difficult to choose between two policy options, experiment with both options in different regions;
- Study evaluations of experiments in the US, even though results from the US do not necessarily apply to the EU because of institutional differences;
- Evaluation studies of passive measures should use net household income rather than gross replacement rates as the relevant income;
- Evaluation studies of active measures should distinguish between the initial and long-term effect of a measure, the former being the negative lock-in effect and the latter the intended positive effect;
- Evaluation studies of active measures should attempt to estimate deadweight loss, substitution and displacement effects, e.g., for deadweight loss by directly asking in a survey whether the job would be found / the person would be hired without the subsidy, and for substitution by analysing dismissals and hiring at the company level; however, displacement effects are virtually impossible to identify because they are an equilibrium effect.

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[5] For discussions of social experiments, see e.g. http://www.urban.org/pubs/digest/introduction.html and http://www.evidencebasedpolicy.org/docs/Orr-Basic_Concepts_of_Social_Experiments.pdf.

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