How the New Deal works

In the first of two articles looking at the Government's role in the UK labour market, ***Michal Myck,*** *of the Institute for Fiscal Studies, explores the rationale for the New Deal. The second article (in the following issue) will investigate how effective it has been*

One of the flagship initiatives of the Labour Party when it came to power in 1997 was a comprehensive programme of assistance for the long-term unemployed, the New Deal. The aim of the initiative was to help those who found it difficult to compete actively in the labour market, and to address various labour market inefficiencies. This article examines ways of dealing with some of these inefficiencies, and analyses the potential for the success of the New Deal.

Improving the functioning of the labour market

The importance of information

Information is crucial if the labour market is to work efficiently. Job-seekers need to be well informed about available jobs, and employers need to know who is willing to take the jobs they offer, otherwise inefficient job-matching will cause unemployment.

Employers also need good information about the productivity of their potential employees. This is potentially difficult when those looking for jobs have been unemployed for a long period. This problem can be alleviated by reducing the cost of employees in the initial period of employment. For example, by providing subsidies to employers the government can encourage them to hire specific groups of unemployed people, enabling them to learn about the true productivity of new workers without paying their full cost.

Education and training

Education and training play a very important role. If wages reflect the level of people's productivity, economic theory suggests that people lacking skills will be offered correspondingly low wages. This may make them reluctant to take jobs rather than staying on benefit. Education and training may therefore make people 'employable' by increasing productivity and thus wages. Due to uncertainty about people's potential – and because there is no guarantee that once trained, employees will not leave the job – employers are often unwilling to provide general training and to bear its cost.

Learning on-the-job

Productivity also increases 'on-the-job' through the process of *learning-by-doing*. Workers can acquire general skills, like driving trucks or using general computer software, as well as skills specific to their jobs, such as operating a specific type of machinery or an internal computer system. Providing on-the-job training can be costly, and again, there is an economic rationale for subsidising employment for some period.

Subsidies can be paid either to the employee or to the employer. Employee subsidies make employment more attractive when wage offers are low due to employers' uncertainty about the actual employees' productivity levels and because of employers' unwillingness to pay the full cost of training. Employer subsidies allow employers to learn about their new workers' actual productivity at a lower cost.

Another way of enhancing employment experience and providing on-the-job training is through work in the public or voluntary sector. This also aims to improve the level of general skills of the unemployed to increase their ability to compete for jobs.

The New Deal

The New Deal has been designed by the government to target specific groups of the unemployed who are considered to be especially prone to inefficiencies in the labour market, and to developments which have changed the nature of work in the last two decades. These 20 years have seen an important shift in the demand for skilled versus unskilled labour. This left many people on wages barely above the level of benefit.

> Stephen Machin discusses this issue in an article in the September 2001 issue of *Economic Review.*

The main part of the New Deal is assistance to young unemployed people (NDYP), but the programme also covers long term unemployed people aged over 25 (ND 25+), unemployed aged over 50 (ND 50+), and some other target groups. The New Deal has been financed from the windfall tax on privatised utilities and between 1997 and 2002 is expected to cost about £2.6bn.

New Deal for young people

The NDYP is the most comprehensive of all the schemes, and is compulsory. Failure to participate leads to the withdrawal of benefit. The government believes that long-term unemployment after leaving full-time education can be very detrimental to employment opportunities later in life, so providing assistance for the young unemployed is believed to be of crucial importance.

Young people (aged 18-24) become eligible for the programme once their unemployment spell reaches six months. They then enter the so-called 'Gateway' period where they are assigned a personal advisor to assist and advise them about available jobs and provide contacts with potential employers. This is designed to improve the job-matching process.

If the intensified job search period lasting up to four months proves unsuccessful, participants enter the second stage of the programme and are offered one of four options: full-time education or training for twelve months, a job with the voluntary sector for 6 months, work for the environmental task force for six months, or subsidised employment for six months with provision of employer on-the-job training. This last option is sometimes made available to people before the end of the 'Gateway' period.

On the first three options, individuals continue to receive the equivalent of Job Seekers Allowance (unemployment benefit). In addition, for working in the voluntary sector or on the environmental task force they receive an extra £400 spread over the six months. The value of the employer subsidy is £60 per week and employers receive an additional £750 to cover the costs of training they are supposed to provide.

Following all of these options, if permanent unsubsidised employment has not been found, individuals enter another phase of intensive job search - the "Follow through" which lasts up to 13 weeks. A simplified structure of the NDYP is shown on Figure 1, while Table 1 outlines some details of other New Deal schemes.

The New Deal and unemployment

Following the introduction of the New Deal, unemployment in the UK fell from 6.3% to 5.2% between spring 1998 and winter 2000. In the same period, youth unemployment fell from 12.0% to 10.4%. However, unemployment fell among all age groups, and was lower also among short-term unemployed who are not eligible for the programme. As Figure 2 shows, unemployment in the UK has been falling since 1993, long before the programme was introduced.

This suggests that some other factors apart from the New Deal, like the overall performance of the economy, may have been responsible for the recent reductions in unemployment. Many economists have addressed the problem of what would have happened to unemployment without the New Deal. This requires careful economic analysis, and will be considered in the next issue of *Economic Review*.

For more information on the New Deal see: John Van Reenen, IFS Working Paper WP01/09, available on IFS web-site: www.ifs.org.uk.