

Increasing the Size of the European Labour Force: the Relevant Tradeoffs

Paper prepared for the 2002 ECE Spring Seminar

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Introduction

In March 2000, the European Summit in Lisbon subscribed to the very ambitious goal of raising the employment rate by almost 10 percentage points in less than 10 years. More precisely, the task set out in Lisbon was to increase the employment to working-age population ratio from 62.4 per cent in 1999 to 70 per cent by the year 2010, attaining at least 60 per cent in the case of women. These targets reduce the gaps with the employment-to-population ratios prevailing in the US (respectively 74 and 68 per cent). The economic rationale behind targets defined in terms of employment rather than unemployment rates is mainly in the opportunity offered by a broader employment to reduce tax rates on labour without necessarily reducing in the scope of redistributive policies.

Closing the gap in employment rates with the US would also, at least in principle, allow to close the gap in GDP per capita across the two sides of the Atlantic as labour productivity in Europe has significantly converged towards the US levels. However, this income convergence scenario (in Lisbon the EU Heads of State promised that, by 2010, the EU would have been “the most dynamic Continent of the World”) will materialise only if the EU succeeds in increasing dramatically employment rates without experiencing reductions in labour productivity. The experience of the US over the 1990s suggest that it is possible to combine strong employment growth with productivity enhancements, but the task is dauntingly difficult particularly in Europe.

In order to achieve the Lisbon targets, many EU countries should not only absorb long-term unemployment, but also increase participation rates and reduce the size of the informal sector. Jobs involving individuals who have been on a dole for a long-time and persons with a weak attachment to the labour force typically attain relatively low productivity levels. The formal sector is itself

mainly composed of low-productivity jobs surviving just because employers (often in agreement with their employees) do not pay taxes and social security contributions and/or do not apply contractual or minimum wages. Thus, creating these types of jobs is actually likely to *reduce* average labour productivity in the EU area because of compositional effects.

Moreover, the creation of more low-productivity jobs will challenge labour market and social policy institutions prevailing in many EU countries. In particular, it will require some sort of relaxation of institutions which are compressing the structure of wages from below as low productivity jobs can only survive by paying lower wages. Faster employment growth has indeed occurred in the last decade mainly in the countries with less compressed earning structures.

Two strategies can be used to deal with the trade-offs imposed by the convergence to the Lisbon targets, enabling countries to increase employment without experiencing strong reductions in labour productivity and, above all, without having to phase out the redistributive institutions which characterise the European landscape. The first strategy is represented by the introduction of in-work benefits and activation measures, along the Scandinavian and British welfare-to-work experience. The second strategy involves more reliance on migration within the EU and from non-EU countries, as a way to arbitrage away the large differences in productivity levels which characterise different regions in the EU, increasing at the same time employment and productivity.

The purpose of this paper is to provide an overview of the main tools to be activated if these strategies have to be pursued. Thus, we will first address feasibility constraints and then dwell on specific policy proposals. In particular, Section 1 characterise the trade-offs, Section 2 moves on to discuss welfare-to-work policies and, Section 3, migration and its potential impact on productivity. Finally, Section 4 concludes arguing about the role that EU supra-national authorities can play in this context.

1. The Trade-offs

There is currently a large variation in employment rates across the European Union (Chart 1). They range from a high 76.5 per cent in Denmark and levels exceeding the 70 per cent threshold in Sweden, the UK and the Netherlands, to a low 52 to 56 per cent in Italy, Spain and Greece. Mediterranean countries of the EU face the greatest challenge for making progress towards the Lisbon target. In order to attain the target, these countries will have to increase their employment to population ratios by about 2 percentage points per year. More importantly, in many EU countries (Italy, Spain, Luxembourg, Greece, Belgium, Ireland and France), the convergence to the “Lisbon scenario” will require increasing labour force participation rather than simply absorbing unemployment. The “de-commodification” operated by social policies (Esping-Andersen, 1999), that is, the freeing of individuals from the need to toil and work to survive, will have to be reconsidered, notably in the Southern country group, if the targets agreed upon in Lisbon are actually to be achieved.

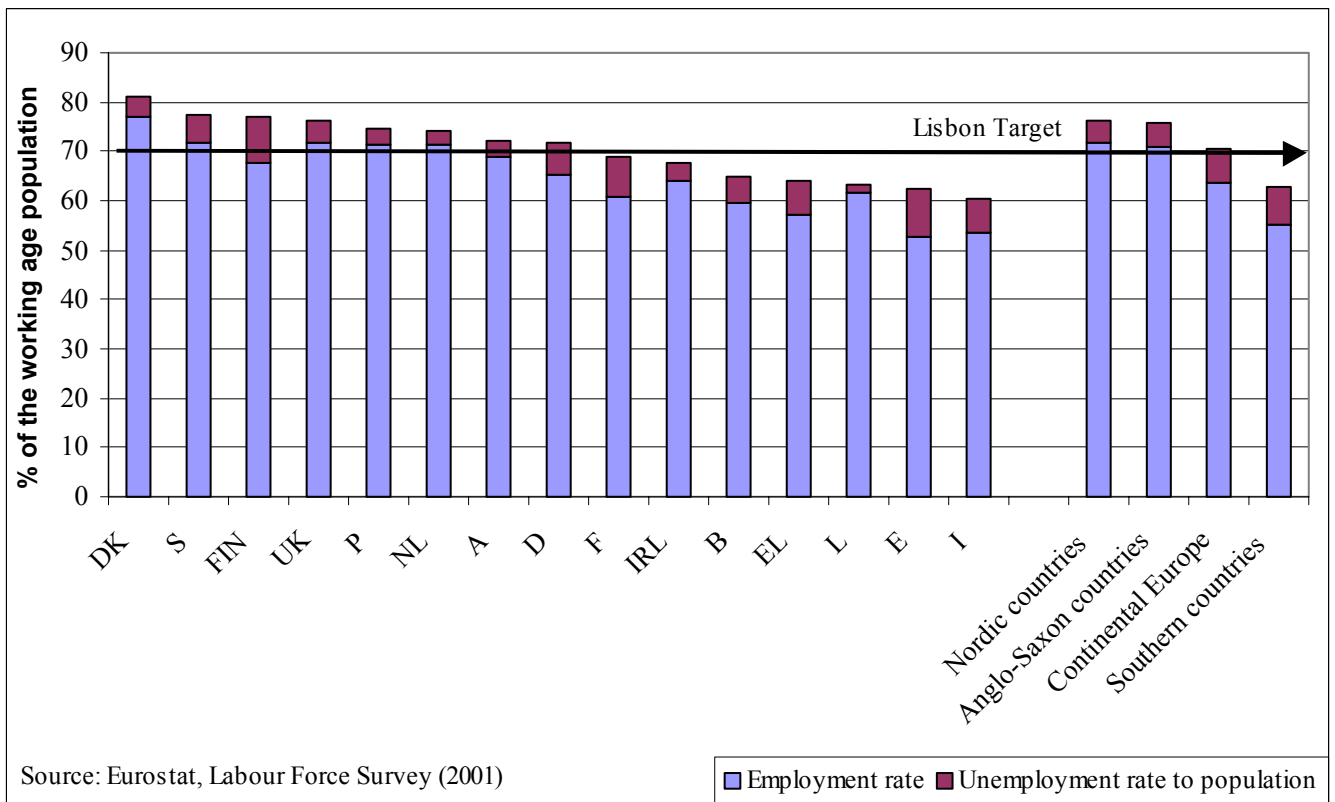


Chart 1
“How far from Lisbon?”

Another factor statistically reducing employment rates in Southern Europe is the presence of a large informal sector. There is not much deep economic thinking on this phenomenon. The puzzle to be investigated is why the “shadow sector” has increased in many countries (Schneider and Enste [2000]) in spite of improvements in tax collection technologies, which make it easier to detect and repress irregular employment. One explanation is that the informal sector is mainly composed of low-productivity jobs, which are viable only if employers and workers evade labour taxes or operate below contractual minima. Under these circumstances, repressing the informal sector may backfire increasing unemployment (Boeri and Garibaldi [2000]).

More broadly, the low employment rates prevailing in many EU countries are the byproduct of the exclusion from the world of work of youngsters and women as the employment rates for the core group of middle-aged men is more or less the same across the EU (and not much different from that of the US). Even if this was not explicitly stated in Lisbon, the attainment of the target is likely to involve a further expansion of part-time and temporary jobs, as well as more low-wage/low-productivity jobs. These are the jobs that have been for the most created in recent years (Chart 2) in the countries which are further away from Lisbon. Part-time jobs are, in any event, needed to accommodate higher participation in the labour market of women and young people.

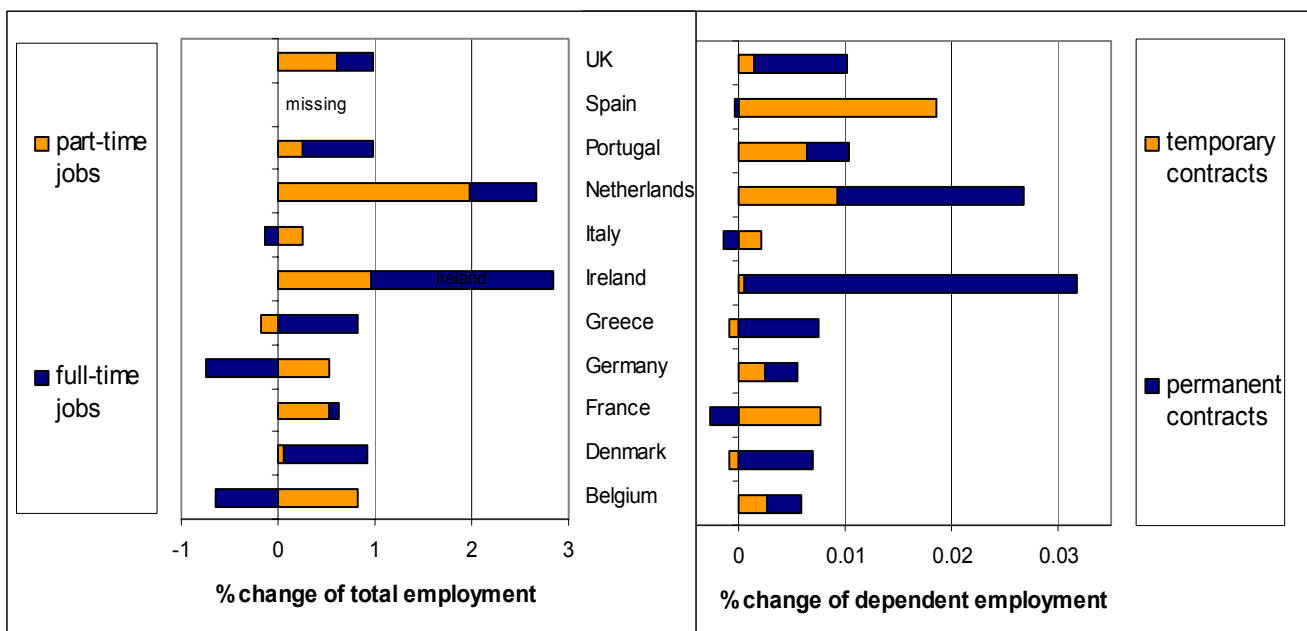


Chart 2 Contribution to job creation of part-time and temporary employment 1983-2000

Redistribution hinders job creation. Stronger employment growth has occurred in the 1990s in the countries allowing for more dispersed earning structures (Chart 3). Competitive pressures associated with the “globalization” and the process of European integration, notably the price transparency induced by the circulation of the Euronotes, are bound to further increase the employment bias of institutions compressing wage structures (Bertola and Boeri, 2001).

Under these circumstances, attaining the Lisbon target is likely to require reforms of labour markets and changes in bargaining institutions or unions' strategies in many EU countries, allowing for more flexible working-time arrangements and more wage dispersion, as well as adjustments of social welfare systems in the direction of increasing the rewards from labour market participation also for individuals with potentially low productivity.

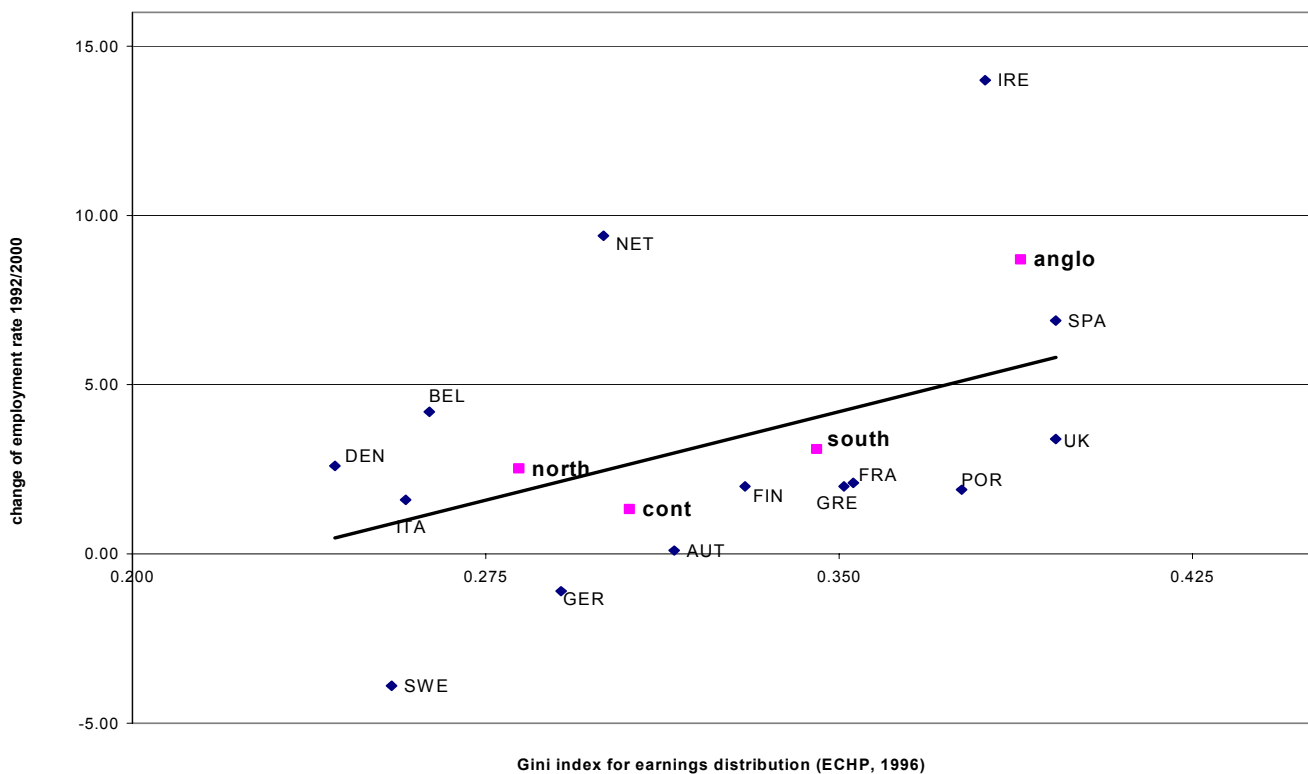


Chart 3

The issue is that the institutions to be reformed play a useful role. Broadly speaking, they trade-off lower productive efficiency against ex ante distributional equity. This is desirable, from an ex ante point of view, in the presence of market failures, e.g. the absence of private insurance against the

risk of becoming or remaining unemployed, because moral hazard and adverse selection¹ stand in the way of such potential contractual arrangements. However, provision of insurance in the presence of asymmetric information unavoidably decreases productive efficiency, as workers have no less incentives to seek job and protection from “unfair” developments decreases the labour market's speed of adjustment.

Limits to competition for jobs, e.g. in terms of minimum wages and contractual agreements preventing wage underbidding also fulfil a useful purpose from the point of view of at least some economic agents. Otherwise, it would hardly be possible to see why they were introduced in the first place, and to understand why it is so difficult to reform them in the face of major structural change. The combination of wage and quantity (employment protection) rigidities is indeed successful if its aim is protection of some workers from negative labour market development: not only are wages compressed and stable, but also tenure lengths of “regular” workers are longer in more rigid labour markets. It would be quite misleading, especially in Europe, to suppose that all labour market reforms should aim at achieving productive efficiency at the expense of distributional objectives.

Thus, it is important to pursue reform trajectories which reconcile redistribution and employment growth, as those discussed in the next section.

2. Strategies reconciling redistribution and employment growth

Redistributive policies in most EU countries involve the presence of a Minimum Guaranteed Income (MGI) scheme. The countries that still do not have this institution (e.g. Greece and Italy) are planning to introduce it. A MGI has negative effects on participation of low-skill individuals, and potentially involves high costs in terms of the windfall effects on workers who become eligible for the MGI.

These problems can be addressed in two ways:

- i) via activation strategies enforcing work-tests and sanctioning with benefit reductions those who do not actively seek employment;

¹ Workers would not try as hard to avoid unemployment and find new jobs if they were covered against the negative consequences of the event. And workers who know their unemployment risk is particularly high would make the scheme unprofitable for insurance providers and/or unattractive to workers with average risk.

ii) by introducing financial incentives to work at relatively low wages.

Financial incentives, unlike activation strategies, not only reduce disincentives to participation of low-skilled individuals, but also take care of the second problem, namely the large windfall effects on workers. The main design features as well pros and cons of the two measures are analysed below.

2.1. Activation Strategies

Experimental evidence on the effects of activation strategies of the Public Employment Service is limited mostly to the US. Some, non-experimental evidence, is available for European countries. While there are still some grey areas, important lessons (also negative lessons as to policies that do not work) can be drawn from this literature. Let us review these lessons by main policy instrument.

Job search assistance and tests. After the disappointing experience of the 1980s, many Anglo-Saxon countries have moved increasingly towards a "shortest route to re-employment" approach that, rather than placing the unemployment on hold in large scale training or work-experience programs, tries to reintegrate them into a job as fast as possible.² This strategy relies heavily on job search assistance and tests. Experimental evidence supports the role of job search assistance and tests for women and non-long-term unemployment benefit recipients. The Canadian Self Sufficiency Project and the Minnesota Family Investment Project in the US (both targeted at welfare recipients) were designed specifically to test the *incremental* effect of policies aimed at an early reintegration into employment, primarily job search assistance, then short-term training and job counseling, over and above the effects of financial incentives. Other experiments conducted in cooperation between several US states and employment services have shown considerable cost savings from job search requirements (see Grubb [2000]). Thus, in Switzerland, the United Kingdom and the United States individuals must now achieve a minimum frequency (usually determined by the PES based on each individual case) of job applications.

Job counselling. Experimental evidence from Maryland is supportive of significant effects of job counselling efforts on outflows from unemployment to jobs (Benus et al. [1997]). Significantly, most of the increase in exits from unemployment occurred just before a compulsory four-day job search training workshop, which acted as an increase in the opportunity costs of drawing

² This is perhaps best exemplified by the Alberta overhaul of its unemployment benefit system, and by the introduction in 1996 in the UK of the Job Seeker's Allowance that emphasizes job-search assistance over training or work experience programs. See Boeri, Layard and Nickell (2000).

unemployment benefits. The workshop attendance itself did not have significant effects on outflow rates. In other words, it is the “help and hassle” approach followed in that case that stimulated exits from unemployment, rather than the job search training scheme per se.

"Suitable job" tests and sanctions. Insufficient action to prevent the loss of a job and refusal to take-up a "suitable"³ job or to be involved in training schemes can be sanctioned with a reduction in benefit amounts. These sanctions (ranging between 5 and 35 per cent of the benefit amount) proved rather effective in The Netherlands (Abbring et al. [1999]; Van den Berg et al. [1999]; Engelen et al. [1999]): transition rates to employment were significantly enhanced by the imposition of sanctions.

Activation policies have been more successful from some groups of beneficiaries than for others. In particular, policies for women returning to the labour market have empirically been the most successful. For this group, job search assistance, counseling and training directed at the immediate return to work have been found successful in several experimental evaluations. In the case of unemployed youths with limited or no labour market experience, successful policies proved to be extremely elusive. There is increasing evidence that training per se has very little effects on this group: constant monitoring and testing of their activity is crucial⁴. The British New Deal is to date perhaps the most articulated effort to deal with this problem. Key features of the New Deal are: (i) the combination of lump-sum wage employment subsidies with job search assistance and on the job training;⁵ (ii) the initial 4 months Gateway period, to screen out individuals who are more easily unemployed and minimize deadweight costs; (iii) a separation of young unemployed into two types according to age and duration of the unemployment spell. Empirical evidence on the New Deal, concerns on outflows from unemployment in the Gateway period and is rather encouraging: Blundell et al. [2001] and van Reenen [2001] estimate that the New Deal is responsible for an increase in the probability of exiting unemployment by about 20 percent, of which one fifth can be attributed to the stricter job search requirements.

³ Among the most relevant issues to be addressed by the definition of a “suitable” job offer, the amount of travel time required to get to the workplace. In the UK and the Netherlands, no more than two hours travel daily are contemplated. In Belgium and Switzerland, the upper limit is four hours, although it is rarely enforced. Occupational protection (allowing unemployed people to refuse job offers involving a change in occupation) is typically provided only at the beginning of an unemployment spell (OECD [2000]).

⁴ According to surveys of young unemployed people in Britain (Atkinson et al., [1994]), many jobseekers feel that unemployment benefits are an entitlement with few obligations. Thus if a person’s benefit is £200 and he is offered a job paying £240, he will often say ‘I will be working for £40.’

⁵ Note that this is exactly the policy package recommended for youths by Katz [1996], after a thorough review of US based programs.

Sanctions and controls policies do not occur in a vacuum. There are two fundamental prerequisites for these policies to work: an effective Public Employment Service (PES), separate from but communicating with the administration of social assistance benefits, and an effective and fast systems of sanctions. The whole approach of activation policies is based on a "help and hassle" or "back to work" approach that cannot work without a clear legal framework and effective sanctions. Responsibilities and prerogatives of the various agencies should be clearly identified; in particular, the PES should be able to sanction violations of the "suitable work" criteria and "job search" requirements quickly and terminally, without endless administrative litigation. One survey of eligibility requirements for unemployment benefits concluded that "the surveillance of independent job search can be the most important intervention by the PES to activate the unemployed" (Grubb [2000]). International experience supports these conclusions. A study by Ernst and Young Consulting commissioned by the Swiss government found that in some Regional Placement Offices "the implementation of a sanction takes several months, and recommended that employment counsellors should be able to implement sanctions independently and immediately, without any need for prior authorisation by another part of the organisation." Auer [2000] observes that "all [four European countries that have had some labour market success] resorted to a much stricter enforcement of job search and suitable work provisions". Recently, a report by the National Audit Office of Sweden, as summarised in Grubb [2000], concluded that "institutional arrangements are a fundamental obstacle to the development of effective control mechanisms for unemployment insurance and leave room for wide fluctuations in the interpretation and application of suitable work criteria, and that the application of suitable work criteria should be overhauled as an urgent matter of national significance".

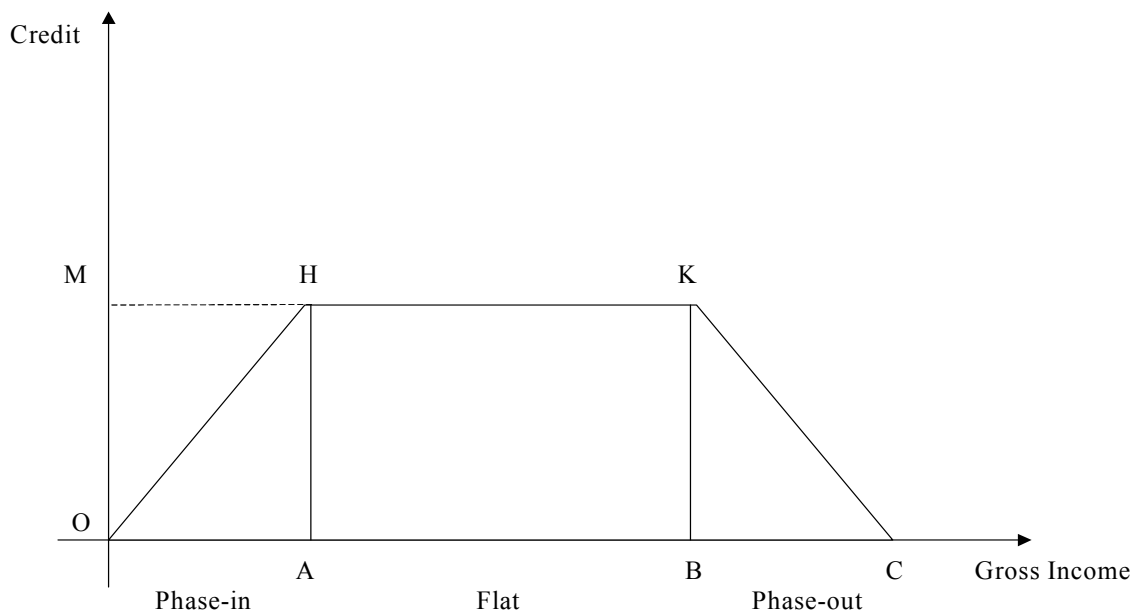
2.2. Financial incentives

There are two main types of financial incentives to employment: an Employment Conditional Incentive (ECI) and a wage subsidy. The former is a subsidy to labour supply, the latter acts on the to labour demand side.

The *Employment Conditional Incentive* complements the earnings of individuals who work at relatively low wages. As such, an ECI, unlike the MGI, encourages participation in the labour market. By adopting appropriate design features -- e.g., by restricting access to some classes of individuals (like long-term welfare recipients or unemployed) or by imposing a full-time work

requirement -- it is also possible to reduce the windfall problem thereby individuals who are already working opt-in the ECI ("windfall beneficiaries"). It is also possible to deal with incentives to reduce working hours of individuals who, at the existing earnings do not qualify for the ECI, but may decide to substitute leisure for work in order to get access to it ("opt-in beneficiaries").

Chart 4



Employment-conditional benefits typically involve a phase-in region, a constant region, and a phase-out region⁶ as depicted in Chart 4. They can be provided either as a tax credit or as a benefit. In the former case, they do not involve an increase in expenditure (which is particularly appealing for countries with large public debts), but work only if refunds are quick (which is frequently not the case) and does not reach those individuals who do not fill a tax form. Eligibility can be assessed on individual or family incomes. In the latter case, it can be better targeted to those actually in need of income support, but may have adverse effects on participation decisions of secondary earners in couples.

⁶ Suppose the income tax rate is 20%. If the phase in region is, say, between 5 and 10 thousand Euros and the phase in rate is 30%, an individual who earns 5,000 will receive a net income of 5,500 (5,000 less 1,000 in taxes plus 1,500 in tax credit), and an individual who earns 10 mlns will receive a net income of 11,000, inclusive of the tax credit. If the flat region is between 10 and 15,000 Euros, an individual with earnings in this region will receive a tax credit of 3,000 (30 percent of 10,000, the end of the phase in region), regardless of her actual earnings. If the phase-out region is between 15,000 and 20,000 Euros, the tax credit is exhausted at 20,000 Euros; hence, an individual who earns 15,000 will receive 15,000 (her earnings less 3,000 in taxes plus 3,000 in tax credit); an individual who earns 20,000 receives a net income of 16,000 (her earnings less her taxes). It is readily apparent that the ECI reduces the overall tax rate in the phase in region (in fact, in this example, mimicking the US *Earned Income Tax Credit*, it is negative), but it increases it in the phase-out region.

An ECI works best when the wage distribution at the low end is sufficiently dispersed, and when taxes on labour income are sufficiently low. With enough dispersion at the low end, the “phase-out” region – and its associated disincentive to hours and upskilling (e.g., via investment in training) -- involves a relatively small share of the workforce. The programme is also less costly in this case. In addition, the wage at the low end of the distribution is relatively low, hence a small increase in taxes at the high end implies a large relative increase in benefits to the low end and hence strong incentives. When taxes are low, the distortions generated by higher (implicit) taxes in the phase out region and (explicit) taxes in the financing region (those not affected by ECI) are also lower.

*Wage subsidies for low-wage employees*⁷ can also take the form either of employment subsidies to employers or of reductions of employers’ social security contributions⁸ and can take several forms (e.g., subsidies or credits proportional to part or all of the annual wage, lump-sum amounts or re-employment bonuses to be redeemed by employers, etc.). Perhaps the most successful (at least in terms of take-up) in Europe is the Dutch SPAK (see Doudeijns, Einerhand, and Van de Meerendonk [2000]) which is relatively simple to administer and it is permanent, that is, provided along the entire work experience, conditional on wages being below a given threshold. Most wage subsidies in the EU are instead temporary, which may have perverse effects on turnover and reward high-turnover firms and industries.

⁷ An ECI and a wage subsidy are not necessarily mutually exclusive. Virtually all countries that have an ECI also have some wage subsidy.

⁸ Conceptually, there is no difference between the two. A subsidy is the negative of a tax, and both measures shift out the labour demand curve. Given that a system of social security contributions is already operating, there seem to be obvious administrative advantages in choosing a reduction in employer contributions over a standard wage subsidy. The only downside is that an employer contribution reduction has an upper limit: the implicit subsidy cannot exceed the current rate of contribution, which is 32 percent. For larger subsidies, one should have an explicit subsidy. Indeed, the *New Deal* for young unemployed in Britain is based on (large) explicit subsidies to the young unemployed.

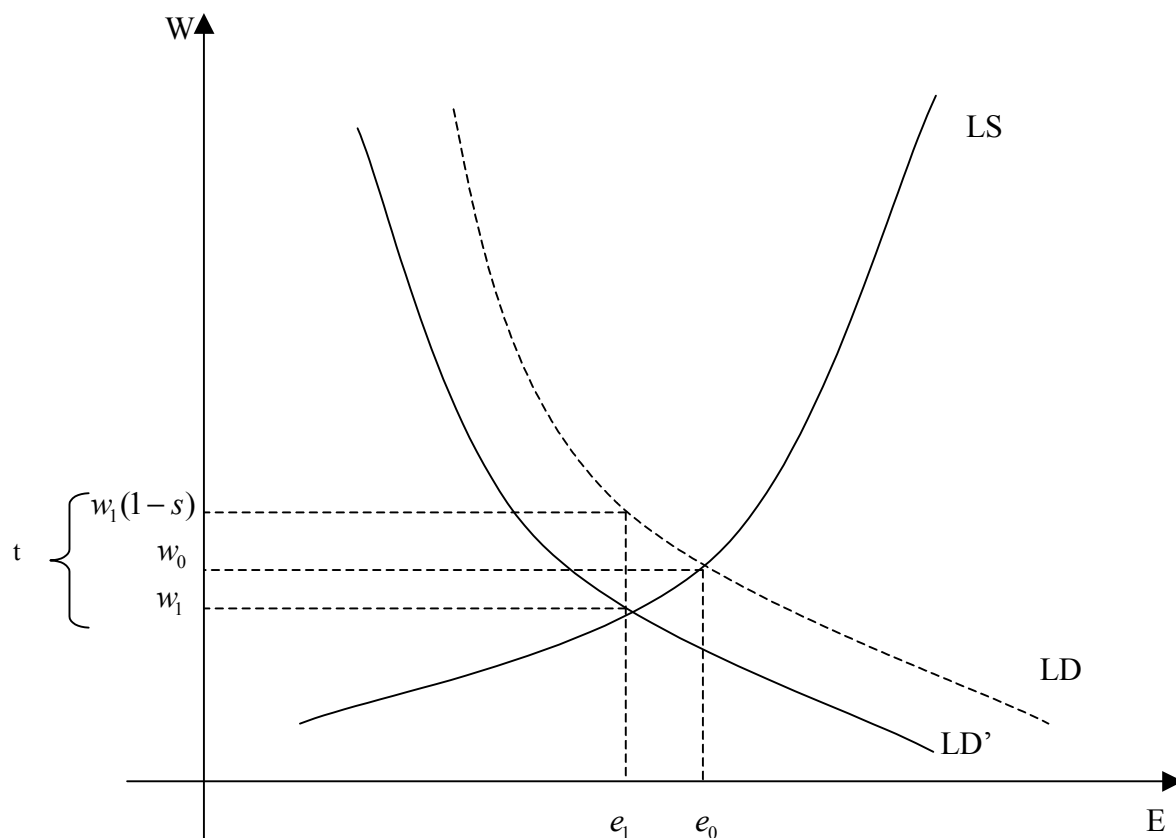


Chart 5
Effects of Wage Subsidies

Wage subsidies shifts out the labour demand, as depicted in Chart 5, hence their effects on employment are larger the more elastic the labour demand and supply are. There is considerable uncertainty as to the labour demand elasticity for low-wage workers, a bit less on elasticities of labour supply. Many calculations underlying the proposal for payroll tax reductions in Europe (Drezè and Malinvaud [1994]) have probably overestimated these elasticities, notably the labour demand elasticity. When the labour supply elasticity is larger than the demand elasticity, the earning effect of a wage subsidy is larger than the employment effect.

Wage subsidies, like an ECI, can generate deadweight losses in the form of windfall beneficiaries, i.e. individuals who would have found employment anyway, substitute between subsidised workers and other groups, like employed young workers, and displace firms not using subsidised workers might. They can also exert fiscal crowding out effects, associated with the financing of the scheme. The deadweight costs generated by windfall beneficiaries could be eliminated by using true marginal employment subsidies, i.e. subsidies only to job openings beyond those that would have occurred in the absence of the subsidy. But clearly the informational requirements for such subsidies are unattainable. Many countries have proxied marginal subsidies with incremental subsidies, i.e. subsidies to employment beyond a certain increment over the previous year's

employment and restrained access to firms that did not layoff workers in the previous year. But these subsidies can generate perverse incentives for firms to implement large layoffs followed by large hirings, and more generally subsidise high turnover sectors and firms.

Finally, when integrated with (low) minimum wages, wage subsidies can be rather effective in reducing the informal sector as they create incentives to both – employer and employees – to declare low productivity jobs. This can be very important for the countries of Southern Europe, which all exhibit a sizeable “shadow sector”.

3. “Greasing the Wheels” of European Labour Markets

As Europeans are, for a number of reasons, less mobile than Americans, they do not “arbitrage away” the large spatial differences in labour market conditions across nations and regions which are present in Europe. Unemployment and labour productivity differentials are marked. Importantly, they are also highly persistent (Employment Outlook [2000]).

It is mainly the European population of non-EU citizens to accomplish the task of “greasing the wheels” (Borjas, 2002) of European labour markets. Migrants locate in the areas which offer the best employment opportunities. They may initially set in at a location close to the border-crossing, but if local labour market conditions appear to be less favourable than elsewhere, it is highly unlikely that they will settle down therein. Migrants from Eastern European countries to Germany jumped over the eastern Länders to find a residence in the western part of the country, which offers better chances to find a job and higher wages. Similarly, migrants from North Africa move to the North-East regions of Italy, where there is virtually full employment, “jumping over” the depressed labour markets of the Mezzogiorno. Thus migration prevents overheating in local labour markets, contributing to contain inflationary pressures.

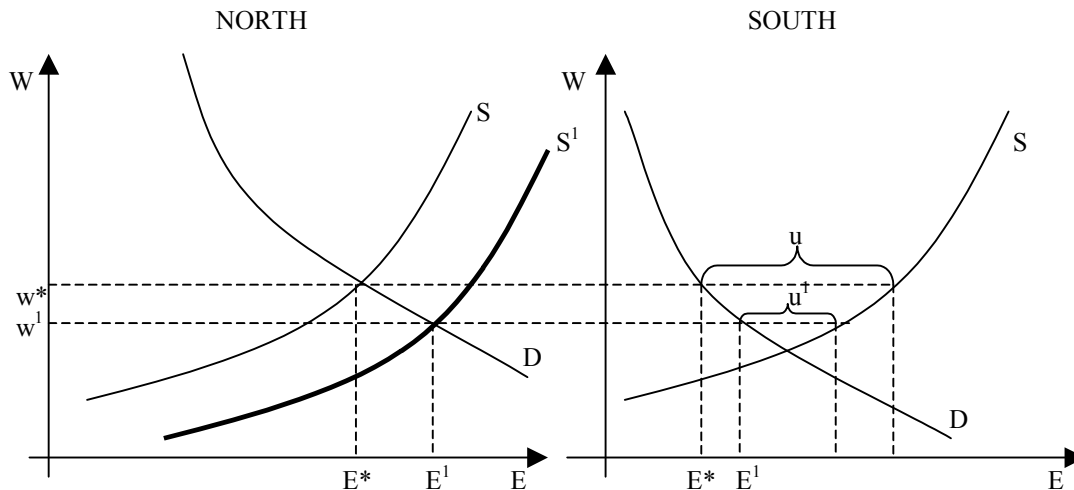


Chart 6

Effects of Migration in Countries with Centralised Bargaining Structure and No Mobility

Migrants play an even more important role in allowing for non-inflationary and productivity enhancing employment growth in presence of wage compressing institutions as those characterising the European landscape. This additional role of migration is visually characterised in Chart 6. The left-hand side diagram shows the market-clearing wage prevailing in the dynamic regions (the North) which is also used – due to the imposition of the same contractual minima throughout the country – also in the South. At the initial equilibrium, the South experiences unemployment as the Northern wage acts as a binding minimum wage. Migration flows, in this context, play two useful functions. On the one hand, they increase employment and reduce wages in the North by shifting to the right labour supply (as shown by the bold line, S'). On the other hand, migration, by acting on Northern wages, reduces labour costs also in the South (from W^* to W^1) allowing to partially absorb its unemployment pool (which shrinks from u to u^1).

This stylised example suggest also why the native population may oppose migrant flows. This is because they tend to reduce wages of those who already have a job. However, the effects of migration on wages tend to be limited (as discussed in the paper by Herbert Bruecker prepared for this conference) also because they act dynamically, that is, migration prevents overheating of labour markets and wage inflation rather than involving reductions in real wages.

Final Remarks

Are the goals set out in Lisbon attainable?

Very much will depend on the pace and comprehensiveness of ongoing reforms of European labour markets and social policy institutions. The European institutional landscape will have to change further and quite radically to accommodate such higher employment rates. There are important policy trade-offs to be addressed.

Europe needs more pro-work social policies (e.g., conditioning income support to employment) and activation measures to increase significantly employment rates in Continental and Southern European countries. It also needs more decentralised collective bargaining, allowing for larger wage differentials across regions having different levels of labour productivity.

It is also important to adopt more realistic migration restrictions, allowing migrants to “grease the wheels” of European labour markets. More mobility of the European workforce is particularly needed to reconcile employment growth with productivity enhancements, allowing Europe to reduce the income gap with the US.

Needless to say these policies also involve some losers. Denying this simple fact is not a good strategy as it would prevent Governments from devising ways to compensate the losers and maximise the support to the reforms.

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