
Wage Subsidies and European Unemployment: Theory and Evidence

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Abstract

Wage subsidies are an increasingly popular policy instrument. This survey provides a critical assessment of wage subsidies in the context of contemporary labour market problems in the EU. A selective review of the experience of wage subsidies in the OECD is provided and the development of theory since Kaldor is critically assessed. The paper expounds the merits of Snower's Benefit Transfer Programme, a marginal job-creating subsidy targeted on the long-term unemployed. It suggests modifications to his proposal to distinguish between the tradable and non-tradable sectors and to respond to the growth of part-time employment and to the threat of increasing wage inequality.

1. Introduction

Periodically, arguments are advanced for the introduction of wage subsidies, each generation of economists giving a particular twist to these arguments. Kaldor's original (1936) argument for a general wage subsidy was a second-best one, based on the need to offset various subsidies paid to encourage fixed investment and the taxes on employment. The rapid rise of European unemployment in the late 1970s and early 1980s led to another burst of interest in employment subsidies as a politically acceptable alternative to discredited Keynesian-style reflationary policies. The arguments developed at this time were often

essentially mercantilist in that the employment benefits of the subsidy were dependent upon the output effects resulting from increased international competitiveness. This argument, that lowering the relative price of labour-intensive traded goods in developed economies could promote their international competitiveness, conflicted with the policy proposals emerging from new trade and endogenous growth theory. In these models, fast rates of technical progress and human capital accumulation were crucial to the retention of international competitiveness in developed economies. The lack of clear analytical justification together with the disappointing effects of subsidies in practice led to a tendency to view wage subsidies as anachronistic left-over from labour theory of value and pre-natural rate of unemployment times. Recently, Snower (1994a, 1994c) and Phelps (1994) have resurrected the wage subsidy argument and given it a 1990s flavour. Phelps argues for a non-marginal, low-wage employment subsidy, reflecting his concern about growing wage inequality and the distortions to labour supply caused by traditional benefit systems. In contrast, Snower's Benefit Transfer Programme (BTP) converts benefits into subsidies, offering the prospects of short-run budgetary savings, a sort of Laffer Curve for labour market interventionists. This prospect is proving to be particularly tempting for those EU governments with half an eye on the net government borrowing convergence criteria for EMU.

In this paper we critically assess the arguments for employment subsidies, placing the Snower and Phelps proposals in historical perspective. Initially we present a brief summary of recent EU labour market experience, stressing the problem of long-term unemployment. We also identify the over-reliance of the EU economy on the manufacture of low-tech, labour-intensive goods and the tendency, in developed economies without minimum wages, for wage inequality to increase largely through a decline in the relative earnings of unskilled workers. We then discuss the relative merits of alternative active labour market policies, concentrating upon wage subsidies. Economists' attempts to provide a supportive analytical framework are then critically assessed. This discussion is followed by a review of international experience of wage subsidies, again concentrating upon the EU. Our final section summarises the merits of Snower's proposal and suggest modifications to improve the targeting on both employment and wage inequality in the EU.

2. Labour market problems in the EU

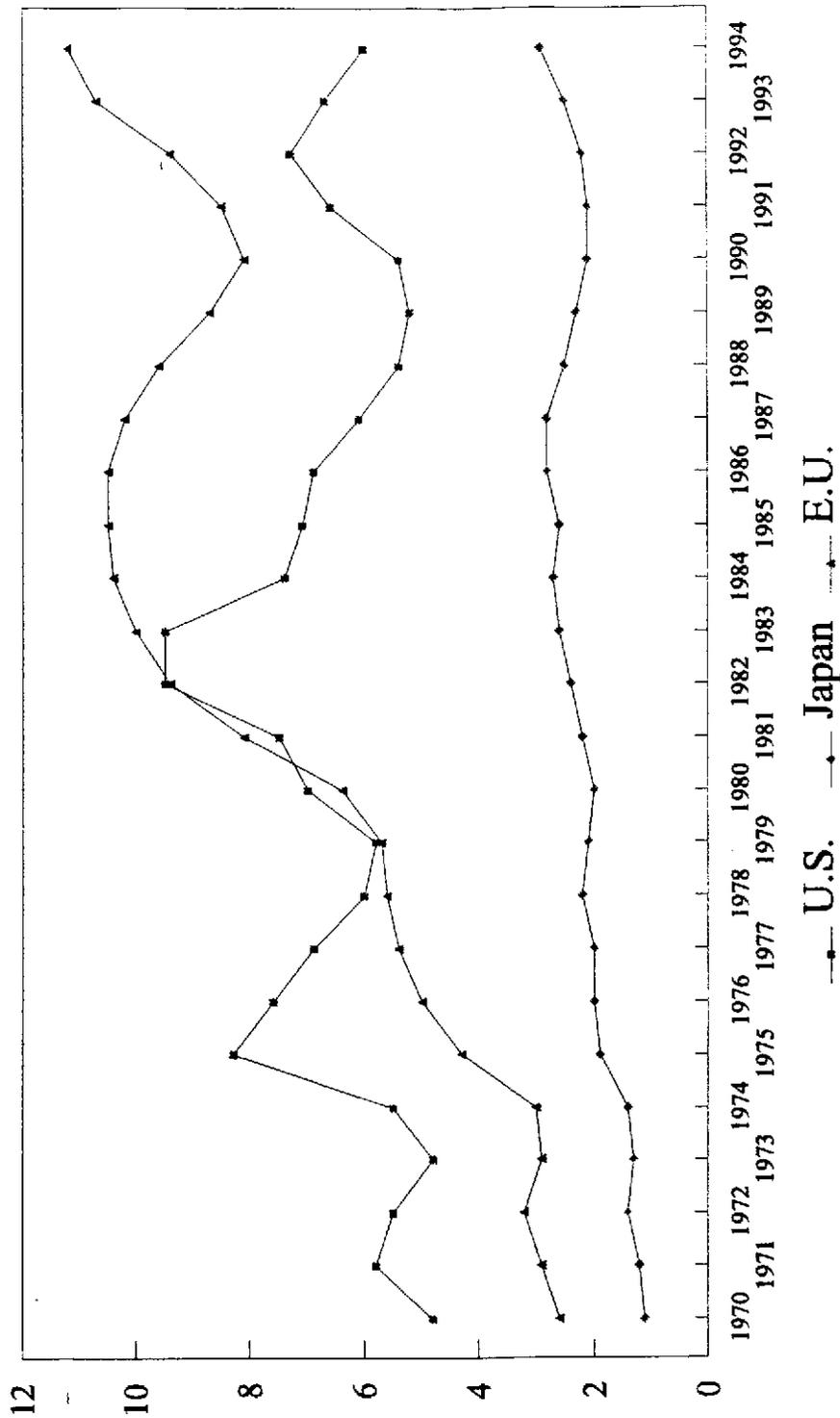
Whilst the rise of unemployment in the EU in the 1970s caused much interest, it is the persistence of high unemployment rates, illustrated in figure 1, which currently arouses the most concern. Apart from its size the most striking characteristic of European unemployment is the relative importance of the long-term unemployed. Only in Austria, Norway and Sweden do those unemployed for over a year constitute less than a third of the total unemployed, whereas in Belgium, Greece, Ireland, Italy, the Netherlands and Spain they constitute over a half. The rise of unemployment in the Europe was largely the consequence of a lengthening of unemployment spells rather than an increased inflow into unemployment. Contrary to the

Eurosclerosis stereotype, Burda and Wyplosz (1994) have confirmed that EU labour markets are active with large flows into and out of unemployment. However, both inflows and outflows are an order of magnitude greater in the US than in Europe. The resulting differences in the distribution of unemployment spells are particularly important given the existence of negative duration dependence: the longer people are unemployed the lower their chances of leaving unemployment. Whether this represents genuine duration dependence or is the result of heterogeneity amongst those entering unemployment remains unresolved (Pedersen and Westergård-Nielsen, 1993). CEPR (1995) and Adnett (1996) provide more detailed analyses of the characteristics of European unemployment.

A common interpretation of the above is that the EU suffers from a hiring problem; a view which also stresses the EU's relatively slow growth of employment. This in turn has been linked to the decline in the EU's competitiveness (European Commission, 1994a). Analysis of shares of world trade indicate that when performance is disaggregated the EU performs particularly poorly in sectors where international demand is growing faster than overall global economic activity. These strong-demand sectors (chemicals, pharmaceuticals, office and data-processing products, precision and optical instruments and electrical goods) tend to have a high technological and labour-skill content. In contrast, where demand is growing more slowly than economic activity in the world economy, the EU retains a much larger share of world trade than the USA or Japan. These weak-demand sectors (ferrous and non-ferrous metals, non-metallic minerals, metal products, textiles, clothing, leather and footwear) tend to have a low-technological content and be either

Unemployment Rates 1970 to 1994

Per cent of total labour force.



1. E.U. Countries shown only Belgium, Finland, France, Germany, Ireland, Italy, Netherlands, Portugal, Spain, Sweden and U.K.
 Source: OECD Quarterly Labour Statistics 1995 no.3

resource or labour-intensive.

The identification of one further trend is important for our later arguments: increasing labour market inequality. The lengthening of unemployment spells in Europe has contributed to this trend as has the rise in non-participation amongst older male workers. In some European countries, especially the UK, a rapid increase in wage inequality has been a further contributory factor. In recent years returns to education have increased in Europe and the less educated and less skilled workers face a greater incidence of unemployment, longer spell-length and, in some countries, lower relative earnings.

Faced with these problems, both the European Commission's White Paper on Growth, Competitiveness and Employment (1994b) and the OECD's Jobs Study (1994b) have encouraged governments to concentrate upon job creation rather than unemployment reduction. Both studies champion the virtues of flexible labour markets and the need for policies of deregulation of labour markets in the EU to emulate US practices. We remain unconvinced by these arguments, especially when such reforms are contemplated in a period of depressed economic activity. In Britain, the Thatcher government's reforms have not prevented a deterioration in the UK's employment and unemployment performance (Blanchflower and Freeman, 1994). Whilst Freeman (1995) has shown the limitations of US-style flexibility in providing a solution to the employment problems of the less skilled workers. Accordingly, we concentrate upon alternative policy proposals.

The OECD Jobs Study (1994b) also argued for a redirection of public expenditures on labour market policies from passive areas like unemployment benefits towards active measures such as training and

job creation. As the figures in Table 1 indicate; currently most EU countries spend at least twice as much on passive measures as on active ones, with only Sweden spending more on active labour market policies. Indeed between 1985 and 1992 spending on active policies as a share of GDP actually fell in Ireland, Luxembourg and the UK. The strength of Snower's (1994a, 1994c) argument for a benefit-transfer program is that it converts unemployment benefits into employment subsidies. Such a policy targets unemployment reduction without adding to the burden of servicing national debts; indeed such policies can be designed to reduce net-expenditure if that is deemed desirable. The European Commission (1993) estimated in 1993 the total costs of unemployment in the EU to be 210,000 million ECU, surprisingly a figure which is broadly compatible with Layard and Philpott's (1991) calculation that each unemployed worker in the UK cost the exchequer just over £8,000 a year. These calculations suggest that even quite large employment subsidies could be self-financing.

3. Active labour market policies: the alternatives

A simplistic interpretation of the previous section would be that Europe needs to find a more efficient way of subsidising unskilled workers. Supporting these workers through unemployment benefits is inefficient and becoming increasingly expensive. Grubb (1994) classifies active labour market programmes (ALMPs) into three broad categories: public employment services, training and job creation schemes, including employment subsidies. In this section we outline the arguments in favour of each of these programmes and consider their appropriateness to the current EU employment problem. A general argument

favouring ALMPs is that whilst passive expenditure on unemployment benefits and the like subsidises idleness and may actually increase unemployment, expenditure on ALMPs is designed to reduce both.

Policies to increase the efficiency of public employment services are aimed at reducing the average duration of vacancies, the presumption being that current duration is sub-optimal and can be reduced without significant reductions in the quality of the matches. Apart from Norway and Spain, governments at the current time are unwilling to countenance that the provision of job information to searchers may be a natural monopoly. Thus in most economies employers are not required to notify vacancies to public employment services nor are private employment agencies prohibited. Given this position it is difficult to see how the public employment service can make a significant additional impact on labour market behaviour, though Belgium, the Netherlands and Germany claim some success from policies specially designed to place the long-term unemployed (LTU) in temporary employment (European Commission, 1995). In Belgium, France, Sweden and the UK focused employment counselling for the LTU has been introduced as part of the reforms of benefit systems. The OECD (1995) points out that currently only about 25 per cent of public employment staff are engaged in job counselling assistance and that to provide just an hour of counselling per month to each unemployed person requires one qualified counsellor per 100 unemployed. Very few European countries get close to this criterion, though Switzerland has adopted this target. Any increased targeting of the LTU by the public employment agency may lead to further growth of private agencies unless the LTU can be made more attractive to employers,

the objective of our next two groups of policies.

As shown in Table 1, training programmes account for a significantly greater share of public expenditure than employment services in most EU countries. The rationale for such policies rests upon training market failures. In the last few years such failures have been more readily acknowledged as economists recognise the weaknesses of a rigid distinction between general and specific training. Where firms have market-power they may be able to obtain some of the returns to even transferable skills training, though fear of poaching may constrain their supply of training. Capital market imperfections and information asymmetry problems may constrain the demand for such training, whilst wage rigidities may prevent the unemployed from purchasing their training by way of lower wage rates. The co-existence of persistent skill-shortages and mass unemployment has been taken as indicating the strength of training-market imperfections. Training unskilled unemployed workers may reduce their probability of both continuing in and re-entering unemployment. At the same time it may eliminate skill bottlenecks and therefore have positive secondary effects on employment, whilst helping to offset widening wage differentials. After an evaluation of training programmes, the OECD (1993) concluded that the most closely targeted programmes tended to be the most effective, with Dutch, German and Swedish broadly targeted programmes having no significant positive effects on the unemployed. The expansion of vocational training programmes in a recession has often been advocated since the costs of training in a recession are low in both the public and private sector. However such expansions tend to lead to a rapid decline in post-training

Table 1: Expenditure on labour market policies, 1994 (as % of GDP)*

	A	B	DK	D	E	F	FI	GR	IRL	I	L	NL	P	SW	UK
	Active measures														
Public employment, services and admin.	0.13	0.21	0.11	0.24	0.11	0.15	0.17	0.07	0.14	0.08	0.04	0.20	0.13	0.27	0.24
Labour market training	0.11	0.27	0.47	0.42	0.15	0.44	0.47	0.16	0.48	0.02	0.04	0.18	0.33	0.80	0.16
Youth measures	0.01	n.a.	0.34	0.06	0.09	0.28	0.13	0.04	0.43	0.80	0.09	0.11	0.27	0.26	0.14
Subsidized employment	0.04	0.62	0.43	0.34	0.18	0.26	0.78	0.08	0.28	-	0.02	0.13	0.07	0.81	0.02
Measures for the disabled	0.06	0.15	0.46	0.26	0.01	0.08	0.15	0.01	0.14	-	0.05	0.59	0.05	0.82	0.03
	Passive measures														
Unemployment compensation	1.42	2.34	3.78	2.03	3.11	1.72	4.56	0.81	2.81	0.62	0.35	2.61	1.00	2.46	1.59
Early retirement for labour market reasons	0.13	0.73	1.41	0.49	-	0.38	0.46	-	-	0.26	0.53	-	0.14	0.02	-
Total expenditure on active and passive measures	1.90	4.33	7.00	3.84	3.64	3.31	6.73	1.20	4.27	1.77	1.12	3.82	1.98	5.44	2.18
Ratio of passive to active expenditure	4.40	2.40	2.90	1.90	5.90	1.70	3.00	2.10	1.90	1.00	3.70	2.20	1.30	0.80	2.70

* Belgium, France, Netherlands, 1993; Italy 1992; Luxembourg and Ireland, 1991; Greece - some data 1993, rest 1992
Source: *OECD Employment Outlook*, 1995, table T

placement rates and the trainees' skills may have often been dissipated by the time an economic upturn appears.

Direct job creation schemes are usually in the public sector and provide periods of employment, normally six months, for targeted groups of the unemployed. Their rationale is usually to increase employability by providing work experience. The inherent contradiction of such programmes is that to ensure 'additionality', preventing the displacement of other workers, the work experience is of work that would not normally otherwise be undertaken. Since the early 1980s these types of schemes have been either scaled down or targeted solely at the LTU. This reflects the findings of studies, surveyed in OECD (1993) which indicated that there was little evidence of significant effects on the immediate employment prospects of participants.

Job-creation subsidies for work in the private sector, if appropriately designed and implemented, appear to have many advantages over the policies discussed above, not least their relative cheapness. Where real wages are sticky in the face of unemployment, subsidies can directly increase total employment. By their very nature, marginal job-creation subsidies concentrate the subsidy on expanding sectors of the economy. Since only firms that are expanding employment attract the subsidy, they may help offset wage rigidities which constrain sectoral and intra-sectoral adjustments. Whereas general wage subsidies may be expropriated by insiders and thus have little employment effect, job creation subsidies cannot be so easily distorted and may even reduce insider power, especially if training costs are also subsidised. Additionally, for a given exchange rate they improve competitiveness and therefore further aid employment growth. At the same

time, wage subsidies for unemployed workers offer the prospects of internalising some of the budgetary externalities of unemployment benefits.

Where financial inducements are given to firms or workers to behave in a prescribed manner there are going to be secondary effects which must be examined if the net effects of the policy are to be established. In the case of subsidies first, there will be 'deadweight' effects, subsidies paid for hires which would have occurred regardless of the payments. These effects may be partially offset by the squeezing of employment in the hidden economy. Second, 'displacement' effects are produced when non-subsidised firms and workers are harmed by competition from subsidised ones. Thus for instance, employment subsidies for the LTU may cause employers to substitute these workers for on-the-job searchers and the short-term unemployed. Third, certain types of employment subsidy induce employers to substitute extra workers for extra hours per existing worker. This change in the desired combination of workers and hours substitutes under-employment for unemployment and has ambiguous effects on efficiency and welfare.

One further problem with conventional employment subsidies targeted at the LTU is that they will tend to favour labour-intensive, low-tech sectors of the economy. This directly follows from their cheapening of labour in general, and unskilled labour in particular. In addition, subsidies indirectly increase the employability of the LTU and therefore increase the supply of unskilled labour and further reduce the relative wage of these workers. The international displacement effect of such subsidies means a further bias in favour of the low-skill low-tech tradable goods and services sectors of the economy. Overall therefore,

conventional subsidies favour the very sectors which we identified above as being over-represented in the EU. Hence if employment is further concentrated in sectors with low income elasticities of demand then the substitution effects of conventional employment subsidies may in the medium-term produce off-setting output effects.

These arguments also imply that conventional wage subsidies may tend to substitute greater wage inequality for the present employment inequality. This would reinforce the processes at work in developed economies' labour markets and indicates the importance of identifying how employment subsidies interact with minimum wage laws and the social welfare system as a whole. Before we consider these issues we wish to examine more systematically how economists have developed the case for employment subsidies.

4. Wage subsidy proposals compared

4.1 General employment subsidies

Kaldor's (1936) original proposal was argued from, as he later admitted (1964), a pre-Keynesian stance and followed the adoption of wage subsidies in Germany in 1932. He expanded the earlier arguments of Pigou, that in the face of 'general' (i.e. non-frictional) unemployment at a time of economic depression, wage subsidies could increase the labour intensity of production. Subsidies were more effective than wage cuts in stimulating employment (Keynes rejected both) through their effects on aggregate demand, which enhanced the operation of a short-run elasticity of real demand for labour which Kaldor took to be not less than 3, about ten times greater than current estimates. Graduated and marginal subsidies

were likely to be more distortionary and less effective in increasing the labour intensity of production as well as being more expensive to the tax-payer. All of these arguments were based upon a scenario where the effective cost of labour to employers was above the free market level. In a later paper on value-added tax Kaldor (1963) introduced the argument that such a tax could be used to finance a wage subsidy for the tradable goods sector where increasing returns were assumed to be available. This emphasis is one which we wish to resurrect later in our discussion.

The OECD's Job Study identified as a central weakness of EU economies their high social charges on employers and recommended a cut in these payroll taxes. For many EU economies such a reduction would be roughly equivalent to Kaldor's general wage subsidy. Nickell and Bell (1995) develop a fundamental criticism of such arguments. They fail to find any significant statistical relationship between unit labour costs and payroll tax rates across OECD countries. In their view this is a consequence of the taxes ultimately being borne by employees and since most income and excise duties are also borne by employees, attempts to cut across-the-board employment taxes are doomed to fail as an employment creation exercise.

Kaldor was particularly scathing of the US system of financing social insurance via a payroll tax. Nearly sixty years later Phelps (1994) and Drèze and Malinvaud (1994) develop a similar point, generating the case for targeted wage subsidies/payroll tax reductions. Phelps argues that payroll taxes are a major cause of the rise since the 1960s of the natural rate of unemployment in OECD countries. This rise impacts disproportionately on disadvantaged workers, whose relative wages are also depressed by

their social security payments and by the impact of globalisation and skill-biased technological change. Given this scenario, Phelps argues for a low-wage employment subsidy, payable to firms on the basis of the number of low-wage workers employed. Stimulation of demand for low-wage workers is also advocated by Pencavel (1994), who argues that such a subsidy is in essence an income maintenance scheme, without many of the labour supply distortions produced by traditional benefit systems. Since minimum wage laws and the benefit system prevent wage flexibility at the bottom of the wage distribution, Nickell and Bell (1995) argue that here payroll taxes are not borne by workers and therefore cuts in these taxes or job subsidies may stimulate unskilled employment, though also reducing the incentive for the unskilled to train.

The Phelps and Pencavel arguments in part reflect the greater degree of wage inequality in the US and the recent rapid changes in wage distribution. Their arguments are also a reflection of the smaller redistributive role of taxes and benefits in the US compared to the EU norm. In the EU employment inequality has remained a bigger issue than wage inequality and therefore the emphasis has been on marginal subsidies for the long-term unemployed. This emphasis seems appropriate given our previous criticisms of non-marginal subsidies, especially any which encourage more intensive use of unskilled labour in production.

4.2 Marginal Employment Subsidies - The Layard and Nickell Proposal

The arguments developed in Layard and Nickell (1980) pay particular attention to the UK macroeconomic environment of the 1970s: chronic inflation and balance of payments problems. At the macroeconomic level, Layard and Nickell argued that

subsidies had only a small effect on demand, since the price cannot fall to the average cost of the marginal firm and the price elasticity of aggregate domestic demand is low. However, in the tradable goods and services sectors export sales would expand rapidly when marginal costs fall since many firms are price-takers. Hence a marginal employment subsidy can produce a large employment effect whilst also improving the balance of payments constraint and in the short term exerting downward pressure on the inflation rate. To maximise the employment effects, Layard and Nickell proposed a scheme of limited life with a flat-rate subsidy per additional worker, which declines with tenure. The subsidy was to be equivalent to one third of average weekly earnings, payable on a firm, rather than establishment, basis to avoid job transfers between plants.

Whilst general subsidy proponents tend to emphasise the importance of the substitution effect, Layard and Nickell emphasise the output effects of a marginal subsidy in the tradable goods and services sector. Their argument is for a small open economy and their 'beggar thy neighbour' policy would not only increase the market share of world trade for a country introducing the subsidy but also increase the labour intensity of its exports and reduce that of its imports. This essentially neo-mercantilist/labour theory of value proposal was rejected by Whitley and Wilson (1983), who questioned the appropriateness of the assumption that export prices respond to lower marginal labour costs. A later version (Layard, Nickell and Jackman, 1991) restates the argument in terms of the Layard and Nickell NAIRU model. Here a firm in monopolistic competition sets prices as a mark-up on marginal costs. In this situation a marginal wage subsidy reduces prices relative to wages

therefore increases the feasible real wage. It follows that the employment level consistent with stable inflation increases.

The original Layard-Nickell approach generated hybrid proposals closer to the Kaldor-Phelps scheme, Jackman, Layard and Pissarides (1986) argued that restructuring existing taxes on jobs could alter the trade-off between wage and employment levels. Such a policy increases the demand for labour in low-wage markets at the expense of reductions in the demand for higher paid workers and overall can raise levels of employment. A self-financing tax/subsidy system was also suggested where firms pay a wage-bill tax and receive a fixed per-worker subsidy. This generates a net subsidy for low-paid workers producing supposedly beneficial demand and supply-side responses. To complement the tax-subsidy changes, employers' National Insurance contributions could be made more progressive. Such a scheme has a close relationship to tax-based incomes policies also popular amongst some economists at this time. Here a tax on the average wage growth of a firm would also increase the relative demand for low-paid employees. More recently, Drèze and Malinvaud (1994) have utilised a similar argument. They propose to eliminate the wedge between the private cost to employers and the real opportunity cost of hiring unskilled labour in the EU. In Europe the social insurance contributions and income taxes can account for around 40 per cent of employers' labour costs, and Drèze and Malinvaud argue for the elimination of this distortion in periods of high unemployment by exempting employers from social insurance contributions for workers employed at minimum wage levels. They argue that this would reduce the attractiveness of hidden economy employment and enable Europe to create

unskilled jobs as in the US, but without the US-style rise in poverty. They estimate the gross cost of this proposal to be around 1.5 per cent of EU12 GDP, but their simulated employment gains indicate no net budgetary costs. The June 1995 new employment initiative (CIE) in France was based upon this argument, though this type of policy will have little impact on countries where employer's social insurance contributions are zero (Denmark) or low (Ireland, the Netherlands and the UK).

Layard, Metcalf and O'Brien (1986) developed a further modification aimed explicitly at the LTU, similar to a contemporary Swedish scheme. Employers hiring the long-term unemployed would receive a flat-rate subsidy for up to a year, provided that non-subsidised employment did not fall. The proposed subsidy was slightly less than the average benefit received by the LTU to generate a net budgetary saving before secondary effects were considered. More recently Layard (1994) argues that employers should be able to recruit for up to ten weeks on a trial and return basis, LTU who would retain their benefits whilst on job trial. This policy was adopted in the 1994 Budget and the Work Trial scheme is planned to cover 50,000 people a year.

The earliest version of the Layard-Nickell proposal may now seem politically unacceptable to all but the most Euro-sceptic. It also directly conflicts with our earlier concern to create 'good' jobs and avoid increases in the (unskilled) labour-intensity of production. The employment advantages of the subsidy disappear if the exchange rate appreciates, and their suggestion that tax cuts can be used to prevent such an appreciation may cause the beneficial effects of the subsidy on the government's finances to disappear.

4.3 The Snower Proposal

Whilst all of the above schemes recognise the possibility of increasing fiscal returns, Snower's (1994a, 1994c) championing of BTP makes this a central feature. Snower propounds the benefits of a voucher system where categories of the unemployed, particularly the LTU, are given the opportunity of using part of their benefits to subsidise their wage costs to firms who hire them. The novelty of the proposal is that the value of the voucher depends positively upon both unemployment duration and the training content of employment but declines with tenure in the subsidised employment.

The BTP possesses all of the advantages of a marginal employment subsidy but in addition assists in combating the training market failures identified above. The long-term unemployed are often credit constrained in the human capital market and fears of poaching reduce the training opportunities offered by potential employers. Insufficient training may also reflect two externalities, what Snower (1994b) has called the 'vacancy supply externality and the 'training supply externality'. The former arises because the expansion of skilled employment by firms raises the expected returns from training for workers, whilst the latter follows from increases in the number of skilled workers raising the returns to firms who are creating additional 'good' jobs. In both cases private returns fall below social returns and too little training is undertaken and too few 'good' jobs created. By providing a financial incentive to employers the Snower scheme helps to increase on-the-job training opportunities for the LTU and hence improve their prospects of retaining employment. Since the scheme is voluntary both employers and employees have an incentive to produce work-related training, incentives not always generated on

government-sponsored training schemes.

Like most employment subsidy proposals, the BTP requires a two-tier wage structure. Insiders are assumed to tolerate the scheme since employers do not attempt to use the threat of selective recruitment to undercut existing workers. Snower argues that the size of the voucher should depend inversely on the size of the deadweight and displacement effects. These effects are reduced by concentrating the vouchers on the long-term unemployed and restricting payment to firms who are increasing net employment.

Before we reach any firm conclusions on the relative merits of the arguments outlined above it will be helpful to briefly summarise the experience of those economies which have already experimented with employment subsidies.

5. Lessons from employment subsidy schemes

Given the importance of secondary effects marginal employment subsidies would seem to be preferable to a blanket subsidy. If we accept the efficiency arguments favouring the marginal employment subsidy then it may take the form of either a job-creating subsidy, which pays firms on the basis of additional employees, or a job-preserving subsidy which induces firms to delay redundancies. Although job-preserving subsidies tend to have a low displacement effect within a national labour market, job-creating subsidies are generally to be preferred. We illustrate these conclusions by selective examples from recent policies. Gregg (1990) and Employment Policy Institute (1993) provide comprehensive surveys of the development of active labour market policies in the UK whilst de Wachter and Somers (1989) and OECD (1993) provide international surveys.

Job-preserving subsidies present severe

policing problems; in general counting new jobs is much easier than counting jobs not lost. To illustrate, the first and one of the largest Special Employment Measures in the UK was the Temporary Employment Subsidy (TES), a marginal job preservation subsidy scheme introduced in August 1975. At its peak it covered about 200,000 workers, providing employers with a subsidy to defer redundancies. TES was output-augmenting and the strong international displacement effect, especially within the EC, led to the abandonment of TES in 1979 since it was in contravention of the Treaty of Rome. Deakin and Pratten (1982) estimated that TES saved in the short run around 39 per cent net of the jobs covered. TES was replaced by the Temporary Short-Time Working Compensation Scheme (TSTWCS), a subsidy aimed at inducing employers to substitute work sharing for redundancies. TSTWCS essentially subsidised worker leisure and it substituted under-employment for unemployment. TSTWCS covered nearly a million workers at its peak. Metcalf's (1986) inter-industry study of redundancy rates suggested that TSTWCS delayed rather than avoided redundancies. Experience indicates the difficulty in distinguishing firms and industries in long-term decline from those who, given short-term assistance, have a 'sound' future. Experience also indicates that governments rarely have the political resolve to support only the latter.

Job-creation subsidies in the UK have been more varied, though on a much smaller scale. Various marginal job-creation subsidies have been targeted at young entrants and small firms. Following a proposal from Alan Walters, the New/Young Worker Scheme (YWS) paid employers a subsidy for each youth employed at a 'realistic' i.e. low wage, and covered about 60,000 young workers at the beginning of 1986. These schemes

suffered from large deadweight effects. Rajan (1985) estimated a net job creation ratio of just 16 per cent for the YWS. The Enterprise Allowance Scheme (EAS) provided a subsidy for unemployed workers to become self-employed. It has since evolved into the Business Start-Up Scheme. About half of the EAS ventures survived for at least eighteen months, Meager (1994) provides an assessment of this and similar schemes in the EU. The British government also experimented with a subsidy given to the long-term unemployed themselves, the Jobstart Allowance. This was a six month subsidy for those taking a low-paying job. The scheme never attracted more than 7,000 participants at any time and was rapidly abandoned. In summer 1993, following the arguments of Snower and others, the Workstart scheme was piloted in four locations, funding was only £2.6 million and it was designed to cover 1,000 unemployed. The scheme provided subsidies for employers of the long-term unemployed but contained no anti-displacement restrictions on take-up. Early assessments by the Institute for Employment Studies (1995) suggest that the scheme was effective in changing employers' perceptions of the long-term unemployed, with half claiming that they would not have recruited from the LTU without the subsidy. The 1994 Budget announced a further expansion of the Workstart pilots, but only up to a maximum of 5,000 workers and the scheme appears to have been designed to maximise deadweight and displacement effects. Britain's approach can be contrasted with the German government's announcement in January 1995 of a £1.25 billion scheme to pay wage subsidies for about 180,000 long-term unemployed. This extension of a previous scheme pays a subsidy to employers of up to 80% of the wages paid, a much higher rate than has been

contemplated in Britain. Workstart, only offers employers £60 per week for six months and half that for a further six months, against a weekly cost to the Treasury of keeping a worker on benefits of between £150 and £190. Workstart scheme together with NICs holidays for employers of the LTU (beginning in April 1996) and the reduction in NICs employers' contributions for the lowest paid workers which were also announced in the 1994 Budget will all tend to lower wage rates at the bottom of the labour market, widening further the wage distribution.

A marginal job-creating subsidy must be designed so that higher labour turnover is not rewarded, only net recruitment should be subsidised with displacement and deadweight effects minimised. Since 1984 Sweden has offered a hiring bonus to employers of unemployed workers of at least six months duration. The bonus was substantial, up to 60 per cent of wages for six months. Early subsidy schemes in Australia and Ireland had deadweight effects of up to two-thirds and a Dutch voucher scheme had a three-quarters displacement effect. In Norway, wage subsidies up to 50 per cent are available for employers of the LTU and those at risk of so becoming, such as young and older workers. Previous experience was that Norwegian employers were hiring only for the length of subsidy and the scheme has been modified to try to restrict subsidies to permanent jobs. Similar problems occurred in Finland where employers often screened out non-subsidised applicants.

The attractiveness of a scheme to the fiscal authorities will depend upon the duration of the subsidy and regulations covering eligibility. Belgium in the 1980s introduced a scheme whereby the very long-term unemployed were placed into permanently subsidised jobs; Denmark, Finland, France,

Germany, Spain and Sweden have also introduced subsidies for the LTU. The Danish Job Offer scheme, for example, provides subsidised jobs of up to nine months duration for the LTU. In the same period the Belgian government allowed benefit claimants who found part-time jobs to retain some of their benefits to top-up their earnings. Essentially this was a subsidy for part-time workers and their employers; a similar scheme operates in Norway. Denmark and France have specifically targeted employment subsidies at the home services sector, arguing that such policies have a particularly large displacement effect on 'hidden economy' employment. More detailed explanations of these schemes can be found in European Commission (1995) who also identify the high deadweight and displacement effects of these subsidies, especially when not targeted at disadvantaged groups. For example, recruitment subsidies in the Netherlands had displacement and deadweight effects of the order of 70-90 per cent of the jobs supported. On the other hand, evaluations of the Danish Job Offer scheme found that around 40 per cent of participants are in work a year after finishing the scheme, half of these with different employers than those they were initially placed with.

In Italy the reluctance of the government to modify the permanent nature of employment contracts induced a massive expansion of subsidised 'temporary' lay-offs in the mid-eighties. The long duration of these spells and the low search activity of workers on this scheme led to various policy experiments, including marginal employment subsidies. Subsidies of up to two thirds of annual labour costs were available to employers. Felli and Ichino (1988) concluded that the effects of the policy were to significantly reduce the duration of those on

the lay-off subsidy by around half, though the displacement effects on non-subsidised workers was not modelled.

Australia has experimented with several employment subsidies in the 1990s, aimed at current and potential LTU. Sloan (1993) reports displacement and deadweight effects of up to 85 per cent, these secondary effects were especially large when subsidies were paid on a recruitment rather than an additional employment basis. Young people who have been unemployed for over a year are eligible for six months vocational training and a 'job start' card on completion of their training. This card allows employers to receive a wage subsidy for up to six months of up to the equivalent of £115 per week depending upon the age and unemployment duration of the person hired. The OECD (1994a) reports a high retention rate in employment after the subsidy terminates. The Australian Government announced in May 1994 a £3.25 billion expansion of subsidies for all long-term unemployed, employers receiving an additional bonus if they retain the recruit for a year.

In the United States the New Jobs Tax Credit was introduced in 1977 and provided a tax credit to firms who hired additional workers. The scheme was biased towards low-paid employees, being payable only up to a wage limit, and in 1979 was re-targeted at high-unemployment risk groups. Assessments suggest that the NJTC had a large employment effect, but that the revised targeted scheme was less successful in stimulating employment prospects for the disadvantaged groups (Haveman and Saks, 1985). Woodbury and Spiegelman (1987) report the results of an Illinois employment subsidy experiment. They concluded that offering the unemployed a chance of assigning a hiring bonus to potential expenditure on unemployment benefits than

assigning that bonus to the unemployed. Other studies have suggested that the reason may be the stigma attached to such a voucher which often leads to its concealment from potential employers. Decker (1994) compares the Illinois experiment with one in New Jersey, where the bonus offered to benefit claimants declined over time. He concluded that a constant bonus was more effective at reducing the number of benefit claimants. The small scale of this experiment, together with the small one-off bonuses payable, caution against too much stress on the results of these interesting experiments.

The popularity of targeting subsidies on the LTU is not limited to those countries where unemployment benefits are of fixed duration. Such targeting produces several advantages which are important to examine. As discussed previously, in the UK the probability of males leaving unemployment declines rapidly as the duration of unemployment increases. Unemployment hysteresis effects derive from this, since the LTU are not part of the effective labour supply and they play no role in reducing inflationary pressures. Hence where subsidies for the long-term unemployed cause a more even incidence of unemployment duration, this 'churning' or 'queue-shuffling' increases the effective labour supply which produces the normal market adjustment of lower wage pressure and a lower NAIRU. In contrast Calmfors and Forslund (1991), assessing Swedish experience, found that non-targeted wage subsidies weakened wage moderation, presumably since they lower the unemployment costs of displaced workers. Targeting the subsidy on a duration basis also creates an additional built-in-stabiliser for governments since unemployment duration tends to vary more than unemployment inflow over the cycle. Sloan (1993) argues that targeting the subsidies on

the LTU offsets employers' higher screening costs for such applicants and therefore can reduce statistical discrimination against these applicants. A social externalities rationale for targeting disadvantaged workers is provided by Phelps (1994). His argument utilises equity considerations and also cites benefit externalities together with the harmful community effects of LTU, especially those concerning crime and alienation.

In recent years there have been several attempts to assess the relative effectiveness of employment subsidies at the macro level. In principle, studies at this level allow the full effect of such schemes on labour market behaviour, including that of non-participants, to be incorporated into evaluations. Layard, Nickell and Jackman (1991) analysing cross-sectional data for OECD countries found that active labour market policies (ALMPs) had favourable effects on unemployment rates, though Forslund and Krueger (1994) reran the data for the 1990s and found that the ALMPs variable had lost its significance and changed its sign. Their explanation being the growth of unemployment in Scandinavia where ALMPs expenditure has been traditionally high. Time-series studies have concentrated upon Swedish experience, Calmfors and Skedinger (1995) concluding that the evidence for large favourable employment effects is weak, though training programmes appear to out-perform subsidies. Data limitations, particularly the diversity of subsidy schemes and their short shelf-life, also prevent firm conclusions being drawn from micro studies of the schemes outlined above. We should not be too concerned by our inability to reach firm conclusions about the effectiveness of subsidy schemes. We would expect poorly targeted subsidies to have small net employment effects and the macro consequences of 'churning' effects will be

difficult to identify in small scale schemes targeted on the LTU.

6. Assessment

Most discussion and evaluations of wage subsidies adopt a static framework, primarily analysing their substitution effects on employment. We prefer an approach which also stresses short and medium-term output effects and recognises the importance of policy objectives additional to that of achieving short-term reductions in the stock of unemployment. Given the current EU labour-market problems identified earlier and the lessons to be learnt from previous policy experience, we find both the Kaldor-Phelps and the Snower proposals attractive. The former tackles the issue of increasing wage and employment inequality whilst the latter also addresses the issue of long-term international competitiveness. A concern with the former is its impact upon productivity growth whilst the latter offers little for those LTU unable or unwilling, due to age for example, to enter employment which is training intensive.

We favour an amalgamation of the two approaches: a straight job-creation wage subsidy to promote more labour-intensive production in the non-tradable goods and services sector and a wage/training subsidy for the tradable sector. Figure 2 provides a taxonomy of this proposal. The proposal presupposes mass unemployment and initially limits subsidies to the long-term unemployed. Subsidising labour in the non-tradable sector will increase output in this sector as well as increasing the labour intensity of production. *Ceteris paribus*, as long as the additional employment has a net positive productivity this must be socially beneficial even in a static framework. The limited size of the subsidy payable to the employer together with the self-financing aspects of the BTP to

Figure 2: A Taxonomy of Proposed Wage Subsidies

	<i>Long-term unemployed seeking employment with training</i>	<i>Long-term unemployed seeking direct employment</i>
<i>Tradable goods and services sector</i>	Wage/training subsidy available	No subsidy available
	Permanent scheme with eligibility on a duration basis which declines as unemployment decreases	
<i>Non-tradable goods and services</i>	No subsidy available	Wage subsidy available
		Fixed-duration scheme, subsidy available to an individual on a long-term basis

the Treasury, may cause a concentration of employment creation in the public sector. Administering this component of the scheme through local government and/or local training councils may increase the sensitivity of the subsidy to the local influences which has been beneficial in other countries (Grubb, 1994).

Given mass unemployment, productivity growth should not be an issue in the non-tradable goods and services sector at the present time. However, in the tradable goods sector our previous arguments imply that replicating the same wage subsidy would be counter-productive in the medium-term. Straight wage subsidies produce both output and substitution effects, the latter would provide a competitive boost to the most labour-intensive plants and firms in any sector and impede the movement towards more technologically sophisticated production. These dynamic considerations, together with the training-market failures discussed earlier, dictate that in this sector

subsidies should only be available where significant training is provided. This requirement generates the additional advantage, discussed earlier, of reducing insider power since employer's costs of hiring entrants is reduced. Both theoretical and empirical arguments indicate that particularly generous funding should be available for these marginal job-creation subsidies for the private sector. Snower (1994b) has argued that the training market failures may cause sectors to be locked into a low-skill, bad-job stable equilibrium, and large subsidies may be required to shift the sector toward a high-skill, good-job equilibrium. In addition for the UK, empirical work suggests that factor prices influence the demand for labour largely through competitiveness (Barrell, Pain and Young, 1994).

In the long run if LTU disappears, we would argue for the retention of the wage/training subsidy but gradually increase eligibility by extending the scheme to those

entering unemployment with low duration-independent escape rates, that is the future LTU. Such targeting reflects the findings of the most recent empirical work on duration dependence. Whilst most panel data studies find negative duration dependence, the survey by Pedersen and Westergård-Nielsen (1993) concludes that no duration dependence is a common result in those studies which attempt to adjust for unobserved sample heterogeneity. At the same time no new subsidies would be provided for employment in the non-tradable sector. To the extent that this policy mix, together with the lower tax burden on the tradable goods sector made possible by BTP, was successful at creating more 'good' jobs in the tradable goods sector then the growing wage differentials between the sectors would encourage a further re-allocation towards the tradable goods sector. Ultimately wage differentials between the sectors may be restored without producing non-sustainable trade and/or chronic budgetary imbalances.

In some ways our proposal is a return to the crude Bacon and Eltis (1978) dichotomy. However, our argument does not require a tight labour market and relies upon a tradable/non-tradable divide rather than the more problematic, especially given the growth of market-testing and compulsory competitive tendering in the public sector, marketable/non-marketable distinction. Our proposals encourage firms in the tradable goods sector to adopt more skill-intensive methods of production, extending their flexible manufacturing practices and exploiting economies of scope. This process should increase the income elasticity of demand for exports whilst reducing the income elasticity of demand for imports and the balance of payments equilibrium growth rate should therefore increase. We therefore reject the argument of Glyn and Rowthorn

(1994) that a Snower type wage subsidy is bound to worsen the balance of payments. Their conclusion relied upon an assumption that aggregate domestic consumption expenditure would increase significantly in the case of a subsidy, this need not occur when the subsidy is financed from reduced unemployment benefits. Their conclusion that a wage subsidy is inferior to an expansion of public expenditure programmes as an anti-unemployment policy appears untenable when the favourable long-run output effects of the subsidy are included.

Whilst 'beggar thy neighbour' objections are still pertinent, the advantages of BTP schemes within most theoretical frameworks is that, for a given money supply, they lower the prices of traded goods and services without raising world interest rates. Hence in aggregate they must produce a positive net output effect in the global economy. Our review of schemes above suggests the more highly targeted the subsidy the greater the potential benefits, though increased targeting raises the administration and monitoring costs. Adnett and Dawson (1995) provide a fuller presentation of the proposed scheme and detailed suggestions for implementation in a UK context. Administration costs may be reduced if a public sector/private sector distinction is substituted for our favoured tradable/non-tradable divide. Whilst allowing the subsidy to be split between different employers would help to increase take-up in the present employment environment. Providing generous subsidies to firms only when they pay above some specified 'root' wage would help to ensure that take-up is not limited to the lowest-paying, most labour-intensive sectors of the economy. The latter is our main objection to the Juppé government's £1.8 billion employment initiative (CIE) which has the effect of reducing employer's labour costs by 40 per

cent for LTU hired at the minimum wage rates. The 'root' wage is an alternative to the imposition of a statutory minimum wage with its attendant potential for reducing further the employment prospects for the LTU.

7. Conclusions

Wage subsidies are an increasingly common feature of EU labour markets, reflecting both the extent of current employment problems and the increased willingness of economists and policy-makers to work outside of the simplest competitive frameworks. We have argued that a modified BTP may be a politically acceptable, yet effective, policy instrument in the current EU environment. Our analysis suggests that a BTP should be designed to affect the tradable sector differently from the non-tradable sector. In the former the subsidies should be designed to encourage producers to move into more sophisticated product ranges and into the strong-demand, skill-intensive and high-tech sectors of the global market. In the non-tradable sector employment growth should be the key objective with little concern for the consequences for gross unit labour costs, subject to an overall constraint that net costs to the exchequer should fall.

Endnotes

1. Staffordshire University Business School. John Whittaker and participants at seminars at Staffordshire University and RUCA, University of Antwerp provided comments on an earlier draft. This paper has been substantially rewritten following helpful comments from referees and the editor.

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