To illustrate CEP's impact on public policy and debate, **John Van Reenen** introduces and presents the first in a series of 'big ideas', surveying the significant research findings that have emerged from the Centre over the past three decades.

What has economics done for me lately? I am often asked about the purpose of the Centre for Economic Performance (CEP). What impact have we had? How can we justify our funding?

The CEP makes a difference in a variety of ways. We evaluate public policies to see if they have any benefits and, if so, to whom those benefits accrue and whether they outweigh any costs. The literacy hour in primary schools, the Job Seeker's Allowance for the unemployed, R&D tax credits and many other policies have been subjected to our rigorous and objective assessment. Our findings can be used by governments and others to assess what worked in the past and what needs to be changed in the future.

Of course, many of these findings go unattributed once they enter the national bloodstream. Ideas, once accepted, are often bastards. How many people know that the decline in social mobility between the generations born in 1958 and 1970, mentioned repeatedly by politicians and commentators, was first discovered by CEP researchers?

CEP researchers do not hide away from public debate. In 2007 alone, CEP research appeared in the print, online or broadcast media on more than 380 occasions. It is by taking public communication seriously that our research can be disseminated to a wider audience.

Our researchers are also formally involved in policy-making in a number of different areas, serving on bodies such as the Low Pay Commission, the Monetary Policy Committee, the Migration Advisory Service and pay review bodies, and advising business and non-governmental organisations such as trade unions.

But this perhaps misses out what is most important: the long-term impact of the CEP. Starting in this issue of *CentrePiece*, we have decided to give a flavour of how our ideas have influenced the world. As Keynes said in *The General Theory*, 'Madmen in authority, who hear voices in the air, are distilling their frenzy from some academic scribbler of a few years back.' Whatever your opinion of their mental state, there is no question that policy-makers have been significantly influenced by CEP research.

Obviously our ideas are not developed in a vacuum: we have many interactions with the wider research and policy community, above all with others in the economics faculty at the London School of Economics (LSE). We are fortunate to be part of the department that is the highest-ranked in the world outside the United States.

We have learned that it takes time for academic ideas to percolate into public consciousness. Our findings and their policy implications are not accepted immediately – or sometimes at all. Many are disproved by events or further investigation, but even the ones that prove to be right take time to be supported and put into practice. This means, of course, that many of the new ideas that we have been generating in recent years may not have an effect for many years to come.

Our first 'big ideas' overview looks at unemployment and welfare to work. Future commentaries will include the causes of rising wage inequality and policies to combat this inequality such as education, the minimum wage and unions; declining social mobility; productivity and competition; innovation policies; economic geography; and happiness and mental health.

Unemployment and welfare to work

Unemployment and welfare to work have been one of the most high profile areas in which the combination of theory and careful empirical analysis at CEP led to policy developments. In turn, the recommendations that were adopted were evaluated and this allowed us to enhance our theoretical understanding of these issues.

In the aftermath of the Great Depression and World War II, the Keynesian consensus was that unemployment was essentially a problem

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of demand. Governments needed to get the level of aggregate demand right to maintain full employment through a mixture of monetary and, above all, fiscal policies. LSE economists like John Hicks and Bill Phillips (of the famous Phillips curve) were at the heart of this consensus.

The appearance of 'stagflation' – growing inflation and unemployment – in the 1970s shattered this happy state of affairs. Out of the crisis, Thatcherism drew on Milton Friedman's work to emphasise the failure of demand management and the need for governments to allow the market to let unemployment find its 'natural' level (the NAIRU or 'non-accelerating inflation rate of unemployment'). Printing money to boost demand led only to accelerating inflation.

In 1990, as the Thatcher era was drawing to a close, CEP was born. A major strand of our work (building on the former Centre for Labour Economics) agreed that there was a NAIRU as Friedman argued. But rather than being something immutable and fixed in stone, microeconomic supply-side policies could be used to lower the NAIRU and thereby reduce unemployment. Simply cutting unemployment benefits was not the only way of achieving lower unemployment.

The framework for this view was published in the classic textbook *Unemployment: Macroeconomic Performance and the Labour Market* by Richard Layard (CEP's founder director), Stephen Nickell and Richard Jackman (first edition 1992). Reviewing the 2005 edition in the *Journal of Economic Literature*, MIT's Olivier Blanchard wrote:

> *'The book was and remains an impressive achievement. The way to read it however is not so much as a treatise than as a manual of battlefield surgery. Its purpose is clear: How to understand, and then how to reduce, unemployment in Europe, by taking inventory of the knowledge at hand.'*

First, there had to be intellectual foundations. This meant moving away from the textbook model of perfect competition in the labour market and considering a more subtle and realistic picture of how people worked. Together with Dale Mortensen, Chris Pissarides (director of CEP's macroeconomics programme from 1999 to 2007) developed job search theory, now regarded as the foundation for modern unemployment theory.

The basic idea is that it takes time for an employee to find a job and for an employer to find an employee – so this means that there will be an equilibrium level of vacancies and unemployed as individuals get 'matched' with jobs. Layard et al showed how many other models of imperfect competition (bargaining, efficiency wages, etc.) had some similar implications.

Second, these theories had to be confronted with data both to test the models and to put numbers on the strength of the relationships. Huge effort was invested in building up cross-national macro and micro datasets that could be used to perform statistically rigorous analysis.

The next step was the implications for policy. The basic message was that supply-side policies to improve the matching process between jobless workers and vacancies were crucial. This implied an agenda of 'welfare to work', something that has been taken up by governments around the world, particularly in the UK since 1997.

An example of this is the New Deal for Young People, first suggested by Richard Layard and introduced by Gordon Brown in 1998 (and later extended to other groups on welfare, including single mothers and disabled people). The philosophy of the reform was that long-term unemployment was a huge waste of resources as the jobless lost skills and motivation and were no longer effectively competing in the labour market and dampening wage inflation.

To combat this problem, a combination of 'carrot' and 'stick' was needed. The carrot was to give the unemployed help with job search through intensive information and mentoring at job centres. Those who still struggled to find work would be supported in subsidised work and training programmes. The stick was that those who refused work or other options would lose their benefits. Elements of a sanctions approach had been tried before the Labour government but without the support package, they had only limited success.

The story does not end there. A vital part of policy is rigorous evaluation of whether it works or not. I was deeply involved in the first evaluation of the New Deal, which required us to develop new techniques and combine new datasets. We found that the programme did appear to have major benefits, raising the job finding rate by about 20%, and I argued that on the whole these benefits outweighed the costs. Subsequent work has tended to support this conclusion.

The evaluations raised many questions: what should be the balance between the carrot and the stick? How effective is the training option? Why does the New Deal effect seem stronger when it was first introduced than later? Why is the aggregate effect not larger, and is the youth labour market now running into trouble? These questions feed back into further developments of the theory and other policies.

The overall lesson is that careful economic research has real effects on policy and the world.

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John Van Reenen is director of CEP.