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## How Can Europe Solve Its Unemployment Problem?

by Horst Siebert

### CONTENTS

- In continental Europe, the unemployment rate has risen continuously from a low level of below 3 percent in the early 1970s to more than 10 percent in the late 1990s. If those who are in governmental employment schemes and in early retirement are included, the unemployment rate runs as high as 20 percent in quite a few European countries, including France and Spain.
- The basic rule for a stable employment situation in an economy is: nominal wages should stay in line with labor productivity growth plus the increase in producer prices. In a situation of high unemployment, however, when the unemployed are to be integrated into the labor market, the productivity rule has to be modified: the increase in real wages should stay below the productivity growth rate until a satisfactory level of employment has been obtained.
- The most elegant approach to creating more employment is to improve labor productivity. If an economy succeeds in raising labor productivity, there is more scope for real wage increases or for more employment. We should, however, not overestimate the potential of an economy to increase labor productivity. If we want to integrate the unemployed, average labor productivity in the economy is likely to decrease. We should be realistic enough as to expect trends in Europe to be similar to those in the United States, where labor productivity per hour has increased by less than 1 percent per year since 1980.
- The task for Europe is to change the institutional setup of labor relations, to move wage formation closer to the market process, and to allow greater wage differentiation. It is unlikely that the "social partners", i.e., the trade unions and employers' associations, will be able to change the rule system sufficiently. Therefore, it is necessary to change the legal rules, especially those in favor of the unemployed, for instance, by introducing a legal right for each individual to enter the labor market at a wage of his or her choice.
- If continental Europe wants to reduce unemployment, it will have to change the impact of the welfare state. With respect to the level of benefits provided by unemployment and health insurance, a distinction should be made between large risks and small risks for the individual. Such a distinction between large and small risks would allow the costs of the social security system to be reduced, thus lowering the tax on labor. Insurance against large risks would be mandatory, small risk coverage would be optional. With respect to financing the welfare state, more choice should be given to the individual as concerns the insurance coverage that he/she desires.
- One serious issue concerning social welfare payments is determining the extent to which the level of social welfare benefits should be scaled down for those who are able to work in order to increase the incentive to work and the intensity of the search for work. A related issue is whether unemployment benefits should be reduced in their level or in the length of time they are paid in order to intensify the job search and reduce the reservation wage.
- Shifting the employment issue to the EU level would take attention away from the need to decentralize wage formation, i.e., to negotiate wages at the level of firms. It would be an incentive not to undertake the necessary steps to solve national unemployment problems and it would shift the financial burden to those countries that are successful in reducing unemployment. It would elevate the national labor market cartels to the EU level and it would blur the lines of responsibility. National governments would shift their responsibility to the EU level. This would be an extremely dangerous development for European integration because the European cause would become the scapegoat of failed national policies.

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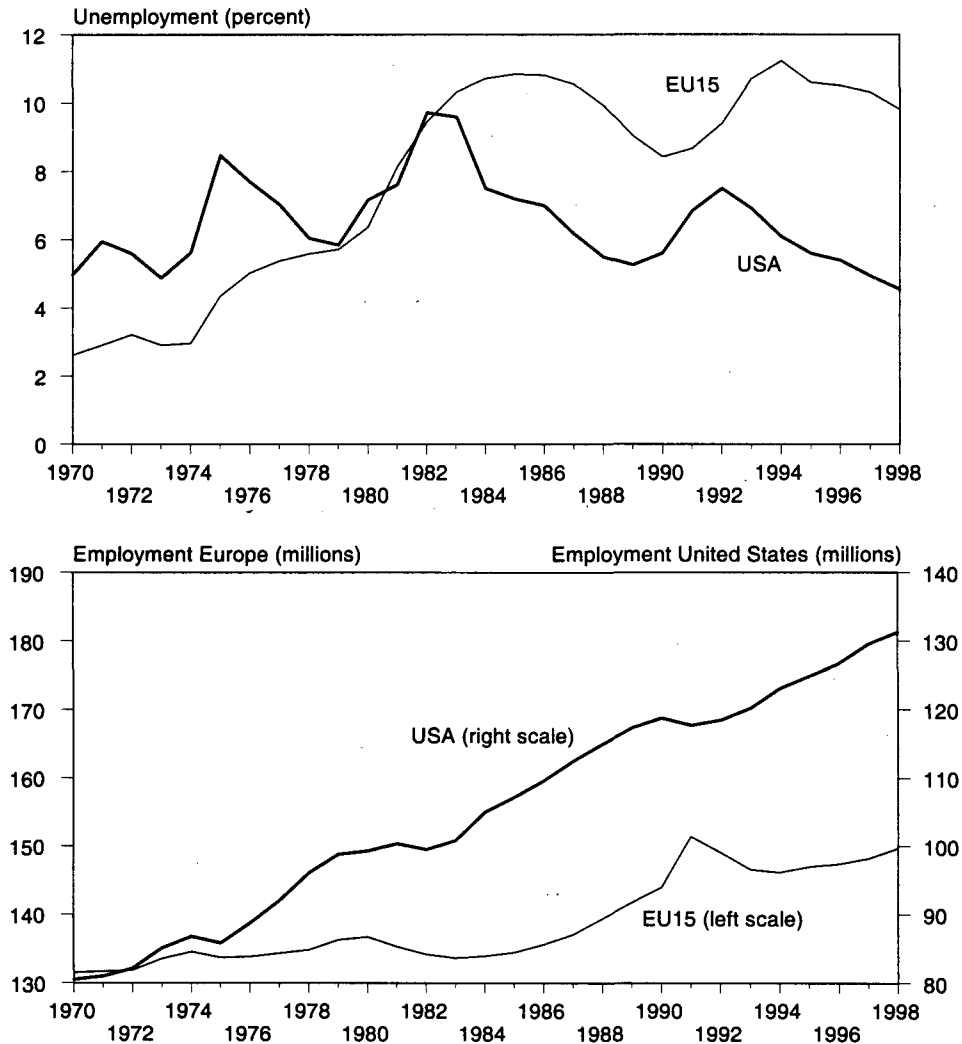
# 1. Increasing Unemployment in Continental Europe

1. Unemployment is the number one policy problem in continental Europe. The unemployment rate in the European Union has risen continuously from a low level of below 3 percent in the early 1970s to more than 10 percent in the late 1990s, and this stepwise increase in the unemployment rate is dominated by the development in the countries on the continent (Figure 1). In most European countries, there was a ratchet effect after each of the last three recessions, with unemployment moving upward in each recession

and not fading away in the years of higher growth; for example, in West Germany unemployment increased by roughly one million each time. If those who are in governmental employment schemes and in early retirement are included, the unemployment rate runs as high as 20 percent in quite a few European countries, including France and Spain (Siebert 1999c). Quite in contrast to this development, the unemployment rate has not increased systematically in the United States over the last 30 years; now it is even at a lower level than in 1970.

Job creation has been weak in Europe, especially in the major continental countries Germany, France and Italy. In the 1980s, employ-

Figure 1: Unemployment Rates and Employment in the European Union and the United States



Source: OECD (1998).

ment increased at a rate of 0.3, 0.2 and 0.0 percent per year in Germany, France and Italy, respectively (Table 1 in the Appendix). In the 1990s, the average rates per year were -0.9, 0.1 and -0.5 percent. The United States did much better with rates of 1.9 and 1.1 percent per year. The United States added 53 million jobs to its 79 million work force of 1970 by 1998; Europe augmented its 131.5 million labor force by only 18 million. Investment (private nonresidential fixed capital formation) was also weak in the major European countries in the 1990s, stagnating in France and Italy and rising only slowly in Germany in spite of the unification stimulus. In contrast, the United States had a high rate of 5.6 percent. It is quite clear that the poor performance in Europe cannot be permitted to continue. What can be done?

## 2. The Fundamental Rule

2. Employment and unemployment are determined by a complex set of factors which interact in the economic system. It is therefore difficult to develop a simple strategy with which to reduce unemployment. You cannot turn only one screw in order to solve the problem. In contrast, we have to turn many screws, and the economic machine has to be partially rebuilt to allow an equilibrium in the labor market with a satisfactory level of employment. What are the essential elements of an approach that would reduce unemployment?

The basic rule for a stable employment situation in an economy is: real wages should not increase more than the rate of labor productivity growth. This means: nominal wages should stay in line with labor productivity growth plus the increase in producer prices.<sup>1</sup> Then employment will remain constant. Note that the rule refers to producer prices, which are relevant for the decision of the firms to hire workers, and not to consumer prices, which are relevant for the real income of workers.

<sup>1</sup> Note that, in an open economy, producer prices may not increase as much as consumer prices because of the intensity of international competition. Therefore, the scope of firms in the export sector to pass on wage increases is limited.

3. In a situation of high unemployment, however, when the unemployed are to be integrated into the labor market, the productivity rule has to be modified. Keeping real wage increases in line with productivity growth will only stabilize employment and perpetuate unemployment. It will not create new jobs. To integrate a large number of the unemployed into the labor market, the wage increase should stay below the productivity growth rate until a satisfactory level of employment has been obtained. Stated another way: an increase in labor productivity brought about by laying off people cannot be the measuring rod for determining wage increases in wage bargaining. Care must be taken to use employment-neutral productivity growth as a baseline in wage negotiations.

4. In any case, the productivity rule has become more difficult to obey with the rate of productivity growth declining in major continental European countries during the last 40 years from 5 percent in the 1960s and 4 percent in the 1970s to 2 percent in the 1980s and 1990s. For instance, in Germany the rate declined from 5.5 percent in the 1960s and 4.1 percent in the 1970s to 2.6 percent since 1980 (Siebert 1998a).<sup>2</sup> If the figure for the statistically measured productivity increase relating to the last 20 years were corrected for the rising level of unemployment, it would be definitely lower.

## 3. Stimulating Aggregate Demand?

5. Demand siders see a potential approach to creating more employment in stimulating aggregate demand. In the context of the basic rule, the idea is to have more scope for firms to pass on cost increases and to utilize capacity better; statistically, this implies higher measured labor productivity. There are two major arguments against this approach.

<sup>2</sup> For Italy the figures are 6.8 (1960s), 4.0 (1970s), 2.6 (1980s), and 1.9 (1990s), for Sweden 4.9, 2.4, 1.2 and 1.9, for France 3.7 (1970s), 2.9 and 1.5, for the Netherlands 4.4, 2.4 and 1.5 (OECD 1998: Table 5.8).

First, there are opportunity costs of financing an expansion of aggregate demand (Siebert 1999b). Of course, the opportunity costs are nil if the export demand of a country increases because it is financed abroad. For the other components of aggregate demand, however, the story is a different one.

With respect to monetary policy, not too many, except occasionally Paul Krugman, really seriously suggest that we should accept a higher inflation rate in order to enjoy short-run gains in employment. Unfortunately, the long-run opportunity costs of such an approach consist in the loss of a stable money. If market participants anticipate the higher inflation rate perfectly, there will be no impact on the real economy, i.e., the Phillips curve will be vertical.<sup>3</sup>

A more delicate matter is whether the central banks use all the scope they have to expand the money supply. We should remind ourselves, however, that the increase in the money supply shows up in the price level with a time lag, for instance, in West Germany after 10 quarters, so that a low current inflation rate is not a sufficient signal to expand the money supply. Moreover, the money supply should be expanded such that the growth of the production potential is financed. Going beyond this (and making some allowance for a tolerable rise in the price level and for a change in the velocity of money) raises the risk that monetary policy could become unsteady and restless. This implies uncertainty for market participants and volatility of monetary variables, including the interest rate and the exchange rate. This, in turn, feeds into the real sphere of the economy. The opportunity costs of this approach are high and may be detrimental in the long run. Even if the consumer price index remains relatively stable, this is not a sufficient indicator that monetary policy does not cause disruptions. Money expansion may start an asset price inflation, with a new pattern of the business cycle in which the boom is stopped when the bubble bursts. The correction of the bubble causes severe economic hardship, as the Japanese experience shows (Siebert 1999d).

Increasing government spending, as suggested by some, is likely to turn out not to be a stabilizer for the economy. The main reason for this is that the political process has not been capable of bringing the budget into balance over the business cycle. On the contrary, expenditures have risen over time, including welfare state entitlements, with a negative impact on the demand for labor. Moreover, in most European countries, the interest burden in public budgets is extremely high, so that policy has lost its maneuvering space.

Second, even if there were no opportunity costs of stimulating aggregate demand, additional demand would not necessarily carry over to employment. One reason for this is that an increase in domestic income is partly being used for imports and savings and does not fully translate into effective domestic consumer demand. The other reason is that there is no one-to-one relationship between an increase in GDP and an increase in employment. Taking the case of Germany, a growth rate threshold of 2 percent has to be surpassed before employment starts to pick up. A growth rate of one percent over the threshold value, i.e., a growth rate of 3 percent, adds 0.5 percent to employment, by far not enough to solve the unemployment problem.

#### 4. Improving Labor Productivity

6. The most elegant approach to creating more employment is to improve labor productivity. If an economy succeeds in raising labor productivity, there is more scope for real wage increases or for more employment. So how can we raise labor productivity?

##### *Cutting Costs*

A cost-cutting strategy is the immediate response of firms when profits are squeezed, and the manufacturing sector has used this line in the United States (in the 1980s) and in Europe (in the 1990s). Cutting costs by shedding labor raises labor productivity, but it is not a promising policy approach to solve the unemployment problem in an economy. It causes firms to establish their competitiveness by making explicit that jobs are not sustainable.

<sup>3</sup> In an open economy, an increase in the money supply cannot expand the scope of firms to shift price hikes because they then will lose competitiveness.

### *Innovation*

A more promising approach is the innovation of new products, of superior production processes and of a more efficient organization. But how can an economy obtain a higher rate of innovation? Quite clearly, the government itself cannot produce new technological knowledge. Public administrators and political cabinets do not have the relevant information to know which product will do well on the market. Thus, any explicit technology policy, strategic industrial policy, or strategic trade policy will be dashed against the rocks of the Hayekian argument of the presumption of information (Hayek 1968). Moreover, the government would tend to socialize the costs of a technology policy failure, thus creating a systematic moral hazard for the future. Rent seeking would be induced. The line to stimulate innovation must therefore be to define a reliable framework for the private sector in which innovations flourish. This should not be done through preferential treatment of innovation per se, as this is likely to cause distortions. Instead, an investment-friendly tax system is required. In addition, the role of the government is to develop an outstanding institutional environment for basic research (which is to be financed by government) and for the transfer of new knowledge to firms.

### *The Role of Investment in Equipment*

Investment in physical capital is the most important vehicle, besides human capital formation, by which new technological knowledge is implemented. A high rate of investment leads to a high rate of economic growth, whereas the nearly stagnating real capital formation in the continental European countries in the 1990s contributed to their poor employment performance. The example of the United States demonstrates that, as a result of double-digit rates of increase in investment in equipment since 1995, the production potential has become surprisingly elastic, high growth rates have been achieved, and labor has been absorbed into the production process. The recommendation for economic policy in Europe, therefore, is to establish conditions such that firms want to invest. Here, taxation is of crucial importance.

The major task of continental European countries, therefore, is to come up with tax reforms that will stimulate investment. Equity-oriented tax reforms will not be helpful.

Higher real economic growth and the more dynamic investment climate it engenders tend to have a positive impact on employment, but it would be a strategic error to assume that economic growth alone will do away with unemployment, as already explained before. If one does not want to be dependent on the growth rate surpassing quite a high threshold value for employment to pick up, the task must be to increase the employment intensity of growth and also to reduce the employment threshold of growth. This can only be done by changing the institutional setup of wage formation and labor relations.

### *Locational Competition*

Governments that want to improve labor productivity find themselves under a new severe restraint. They compete for mobile capital and mobile technological knowledge. With capital being mobile and firms being capable of optimizing their location as well as tailoring their structure, governments have to realize that capital and technological knowledge may emigrate or may not come to a country if economic policy is inappropriate. Less capital, however, implies a lower labor productivity or a smaller increase in labor productivity. This implies a lower potential for wages and for employment.

A national government which does not understand and respect the mechanism of locational competition is likely to miss its employment target and its goal to improve the well-being of its citizens.

### *Deregulation of Product and Capital Markets*

Since the demand for labor is a derived demand (being derived from the demand for products), favorable conditions on the product markets are always welcome. Improved international competitiveness will yield a higher labor productivity; deregulating goods markets may strengthen the demand for labor. A related argument points to the necessity to deregulate the capital market so that firms, especially new firms, can obtain

easy access to new capital. At the end of the day, however, the labor market is the decisive issue for employment. Improving the competitiveness of firms in the product markets and easing the access to capital does not guarantee a strong demand for labor: firms can also become more competitive by increasing their capital intensity and by taking advantage of labor-saving technical progress.

### *Human Capital Formation*

Labor productivity can be influenced by human capital formation. It is realistic to start from the premise that labor productivity is likely to be spread unevenly among the work force. The frequency distribution may be concentrated near the mean (Figure 2a), or it may even be skewed towards low productivity. Unfortunately, we do not have sufficient information on the density function of the skill distribution in the individual European economies. Comparative data are available on literacy (OECD 1994, 1997) and on qualifications in specific areas as a result of school teaching (such as in mathematics and in

natural sciences in the TIMSS study, see Max-Planck-Institut für Bildungsforschung et al. 1997). Another, more general category of information is input going into productivity, such as the years of schooling (Barro and Lee 1996), and the impact of human capital formation on the rates of return on education (Hall and Jones 1999; Gundlach et al. 1998).

Human capital formation can be viewed as improving labor productivity generally and changing the density function, possibly leading to a more equal distribution of labor productivity among the members of the work force. Thus, it is hypothesized by Nickell (1997) that European countries have a more equal distribution of labor productivities among the work force than the United States and that their work force looks more like Figure 2b than 2a.

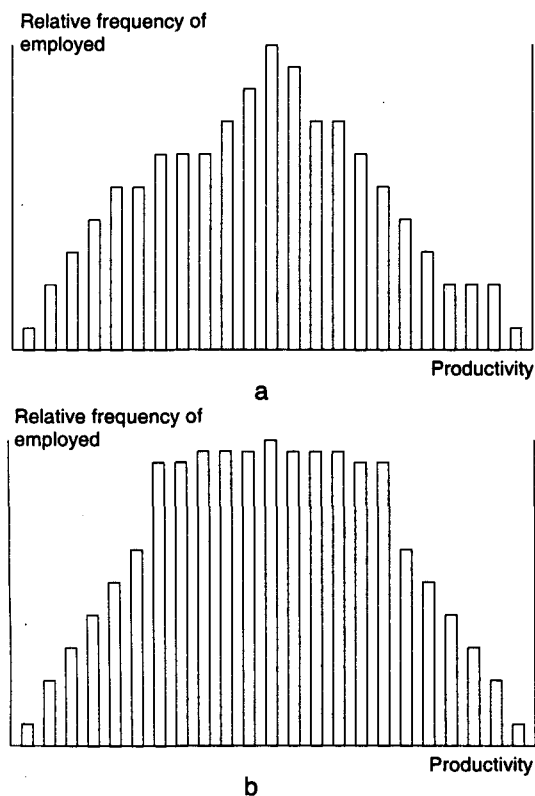
### *The University System and Basic Research*

Empirical evidence suggests that the institutional setup ("social infrastructure", according to Hall and Jones 1999), under which individuals accumulate skills and firms accumulate capital and produce output, is a major determinant of productivity per capita. An important line of attack to improve human capital is the organization of the educational system and basic research. Here, there is anecdotal evidence that some countries in Europe, among them Germany, no longer have an adequate university system. Equity orientation that led to the expansion of the welfare state has prevented organizing the university system according to the competition principle, and social aspects and administrative and planning approaches have a dominant impact on the university system. Basic research is exposed to labor market regulations and other bureaucratic rules that prevent flexibility and initiative. This means that, if European countries want to stimulate innovation, they have to say good-bye to their administrative approach to the university system.

### *The Apprenticeship System and Training on the Job*

The apprenticeship system, or the dual system of learning on the job together with formal schooling for young people, which is in place in some European countries, seems to be an asset

Figure 2: Density Function of Labor Productivities





for human capital formation which allows young people to be integrated into the labor market and their productivity to be enhanced. However, this system should be modernized, for instance, by introducing new types of occupation more quickly and introducing other improvements.

#### *Working Time Flexibility*

Labor productivity can be increased by organizing labor more flexibly, especially by arranging working time in a more flexible way. In many European countries, working time has been regulated too rigidly. Such regulation does not allow potential productivity increases to be exploited. Working time should be flexible over the year to allow firms to cope with seasonal shifts in demand; working time should also vary over the ups and downs in the demand for firms' products and over the business cycle. More flexibility is possible by having a larger band between the individual's minimum and maximum working time per day (and per week, as well as per month), by separating the working time for individuals from the operational time of firms, and by introducing more innovative part-time work arrangements. It is my impression that noticeable progress has been made in firms in introducing more working time flexibility and that labor productivity has been enhanced considerably, for instance, in Germany.

#### *The Solution Potential of the Innovation Approach*

To sum up for the strategy of innovation, we should not overestimate the potential of an economy to increase labor productivity. If we want to integrate the unemployed, average labor productivity in the economy is likely to decrease. We should be realistic enough to expect trends in Europe to be similar to those in the United States, where labor productivity per hour has increased by less than 1 percent per year since 1980.<sup>4</sup>

## **5. Changing the Institutional Setup of Labor Relations**

7. Postulating a basic rule to keep wage increases below the productivity growth rate as long as unemployment is high does not guarantee that this condition will be satisfied in reality. The task for Europe then is to change the institutional setup of labor relations so that the rule is met more or less automatically. This means moving wage formation closer to the market process.

The institutional system that societies have developed for the labor area is an intricate system of norms, incentives, and behavior that has an impact on the demand for labor, the supply of labor, and wage formation. This impact is similarly complex to the rules for using an ecological system. As in an ecological system, interventions at one spot eventually show up elsewhere; the impact of a measure taken today becomes fully apparent only after many years, sometimes only in a decade. It is therefore necessary to analyze the long-term impact of such a rule system on the demand for labor and on the supply of labor. In Europe, it is quite apparent that the institutional arrangements do not generate a full employment equilibrium. They produce equilibria for the economy which are characterized by a high level of unemployment.

8. An important aspect of getting wage formation closer to the market process is decentralization. This implies that wage changes should be a vehicle with which to bring about decentralized full employment equilibria in the various regions, contributing to a balance between the demand for labor of sectors and firms and the supply of labor. This equilibrium must also relate to the qualifications required by firms and offered by workers. Institutionally, it can only be obtained if wage formation on the economy level and on the sector level is given up. Wage negotiations should not be binding in the following interpretation: either they only define a lower floor for the rate of increase of wages from which firms can deviate upward (wage drift), or they define a general frame of reference in which it is left to the decentralized level to find the appropriate wages. This requires finding an institutional mechanism by

<sup>4</sup> In the United States, the rate of increase of labor productivity per hour was 0.8 in the 1980s and 0.9 in 1990–1996 (OECD 1998: Table 5.8).

which wages are set in the firms. The basic mechanism is the market mechanism. In a way, the analogy with the provision of bread is a good one. Bread is such a fundamental product that we want to make sure that everyone has enough of it to eat. But this target is not satisfied by rules and regulations, the market does it. In a similar way, the market will supply enough jobs.

9. To leave it to the "social partners", i.e., to trade unions and employers' associations, to find and implement the necessary institutional changes of decentralization, implies following a corporativistic approach in which the social partners are granted the privilege to bring about the needed change in the rule system. Actually, they have the legal right to set the wages (in some countries with a constitutional guarantee of that privilege), but they are not made responsible for the quantities that eventually result in the labor market. In such an approach, as practiced in the Rhine model, which relies on consensus, one of the social partners can block a change in the rules. We therefore need an institutional control, for instance, a stipulation that links wage agreements to the level of unemployment. Thus, a wage increase in a region above the rate of productivity growth should be suspended if regional unemployment surpasses a specified threshold. Without any such constraints, the consensus approach in an alliance for work is likely to lead nowhere. Possibly, the Agreement of Wassenaar was successful because in the Dutch institutional setup the government has the threat potential to execute a wage stop.

10. It is unlikely that the "social partners" have the capability to change the rule system sufficiently. In my evaluation, it is therefore necessary to change the legal rules. Besides protecting the power of the social partners or the wage cartel, the institutional framework benefits those who have a job, the incumbents or the insiders. The rules do not sufficiently take into account the interests of those who are unemployed, the new entrants or the outsiders. Insiders are protected, whereas outsiders cannot enter the labor market freely. Free entry, therefore, is a necessary and very essential condition in reforming European labor markets. Labor

market rules have to be changed in favor of those who are unemployed.

My proposal is that a legal right be introduced for each individual to enter at a wage of his or her choice.<sup>5</sup> Giving individuals the right to enter the labor market at their chosen wage would be a powerful mechanism to bring about a full employment equilibrium by finding the equilibrium wage rate and the equilibrium wage structure. The approach proposed here is to change the rules of the wage cartel, to give more importance to the fringe of the cartel, and to punch some holes into the walls that protect the cartel.<sup>6</sup>

Along with this proposal, wages agreed by wage negotiations should not be declared mandatory by the government. Declaring wages mandatory reduces wage flexibility and destroys the role of wages as a mechanism for bringing about a good employment situation.

It is feared that, with such an institutional setup, wages would fall all the way to the bottom of the wage scale because there would be no trade union to defend at least a lower floor of the wage level. This fear is unfounded because as soon as wages fell below labor productivity, demand for labor would increase. Firms would compete for workers as soon as labor productivity rose above the wage level. Thus, the lower floor of the wage level is determined by labor productivity. As it is in the self-interest of the baker to produce bread and not a result of his benevolence, it is in the self-interest of profit-maximizing firms to hire labor as soon as wages are lower than labor productivity.

## 6. Differentiating Wages

11. Keeping wage increases below productivity growth as long as unemployment is high is one element of a strategy for more employment. An additional element is the necessity to have more

<sup>5</sup> I doubt that the social partners will be able to stipulate that wage agreements explicitly allow outsiders to enter at entrant's rates. Therefore, a law is required.

<sup>6</sup> On specific proposals of necessary legal change in Germany, compare Siebert (1998a).

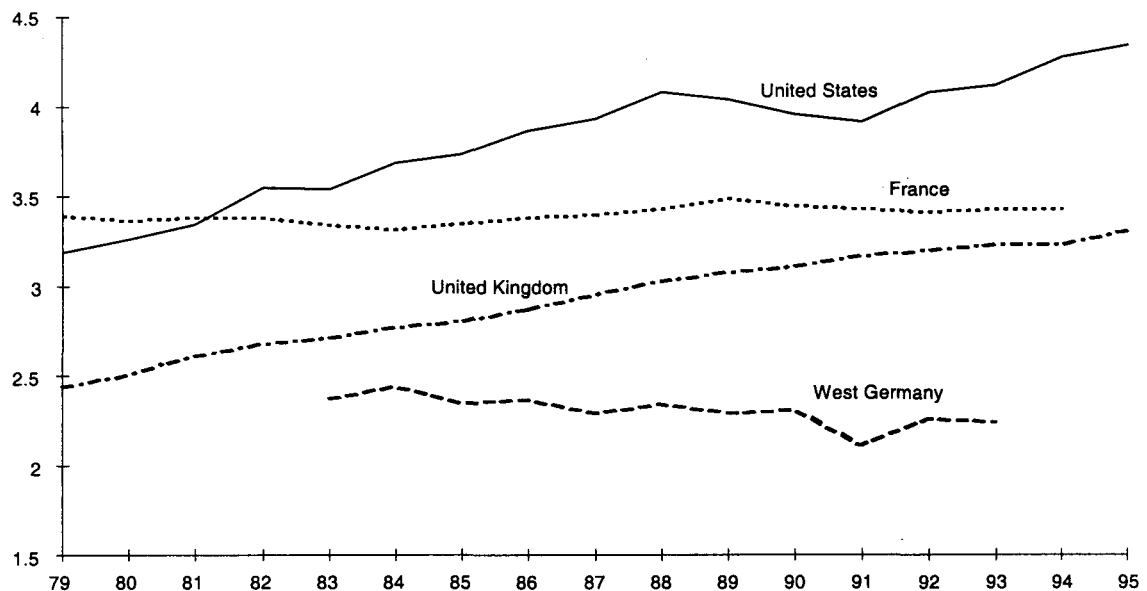
wage differentiation. There are three reasons for wage differentiation. First, labor productivity is not uniform over the millions of firms and over the millions of workers in an economy. Each country has a productivity ladder with higher, middle and lower levels of productivity. This requires wages to be differentiated according to sectors, regions, firms, and workers' qualifications. Second, relative demand moves to the disadvantage of the less qualified. This is a common phenomenon in the industrialized countries, in North America as well as in Europe (Siebert 1999a). For instance, in Germany the number of persons with higher qualifications increased by 6.2 million in the period 1976–1995, whereas the number of less qualified fell by 4.2 million (Siebert 1998a: Table 10). Thus, the terms of trade clearly moved to the disadvantage of the less qualified (Schimmelpfennig 1999). Third, structural change makes human capital partly obsolete (Paqué 1999). Whereas in the 1950s and the 1960s a worker who lost his job in a branch of industry could move to another (similar) branch of industry, the industrial worker who is laid off today has to

find a job in another sector, such as services including information technology, which requires a completely different human capital.

12. A potential way to get around a greater wage differentiation is homogenous human capital. Improving qualifications may be viewed as the corresponding approach with which to achieve this, but qualifications cannot be expected to improve productivity to a fully homogenous level, as is pointed out above. Moreover, human capital formation takes time.

13. Whereas the United States is characterized by a highly differentiated wage structure and more differentiation over time, continental Europe, including France and Germany, is not prepared to accept such a differentiation (Figure 3). Normative equity considerations imply that wages for low-paid jobs are rising overproportionately. This reduces the demand for labor in the lower productivity segment of the labor market. Similarly, regional wage structures, such as those found in Germany, do not reflect differences in regional unemployment, thus distorting the labor market and increasing unemployment.

Figure 3: Earnings Dispersion in Selected Countries<sup>a</sup>



<sup>a</sup>Ratio of upper earnings limits of the ninth decile (D9) to the first decile (D1) of male employees when employees are ranked in order of their earnings from lowest to highest.

Source: Siebert (1998a) according to data from OECD (1996: Table 3.1).

14. Starting from the premise that wage differentiation is not acceptable politically, quite a few now take refuge in proposing wage subsidies that are supposed to bridge the gap between a desired higher wage level and the given lower productivity in the lower segment of the labor market. Wage subsidies can come in many forms, as a subsidy to a firm if it employs an unemployed person (possibly only a long-term unemployed person), as a general subsidy to firms per worker in the low-productivity segment, as a payment to workers themselves if they are in low-paid jobs, or as a voucher per unemployed worker which turns into a subsidy for the firm if the worker is employed. I have serious objections to wage subsidies. First, a high fiscal burden is incurred in the long run. For instance, one form of the wage subsidy, letting people who are in social welfare retain 50 percent of their wages earned on the market in order to provide an incentive to get out of the unemployment trap, would pertain to a large part of the work force, for instance 10 million workers in Germany, roughly one-third of the labor force (Gern 1999). Second, the sums needed have to be raised by taxes which have detrimental effects elsewhere in the economy. Tax revenues will have to come from labor income either as direct payroll taxes or indirectly as value added taxes. Third, trade unions may take the subsidy for granted and behave strategically by raising wages in order to obtain a higher subsidy. Fourth, the subsidy is a political variable that is likely to rise in the political process. Thus, wage subsidies will lead more and more away from the necessary decentralized market-oriented approach. The solution, therefore, should be that European countries accept the necessary wage differentiation.

15. This analysis suggests that countries should discontinue minimum wage policies. Minimum wages are one cause of unemployment, as soon as they are binding. This is especially true for specific groups of workers. Thus, minimum wage legislation in France is one reason for the high youth unemployment. In addition, minimum wages that are not an effective restraint nationally may nevertheless be binding regionally.

## 7. Reforming the Welfare State

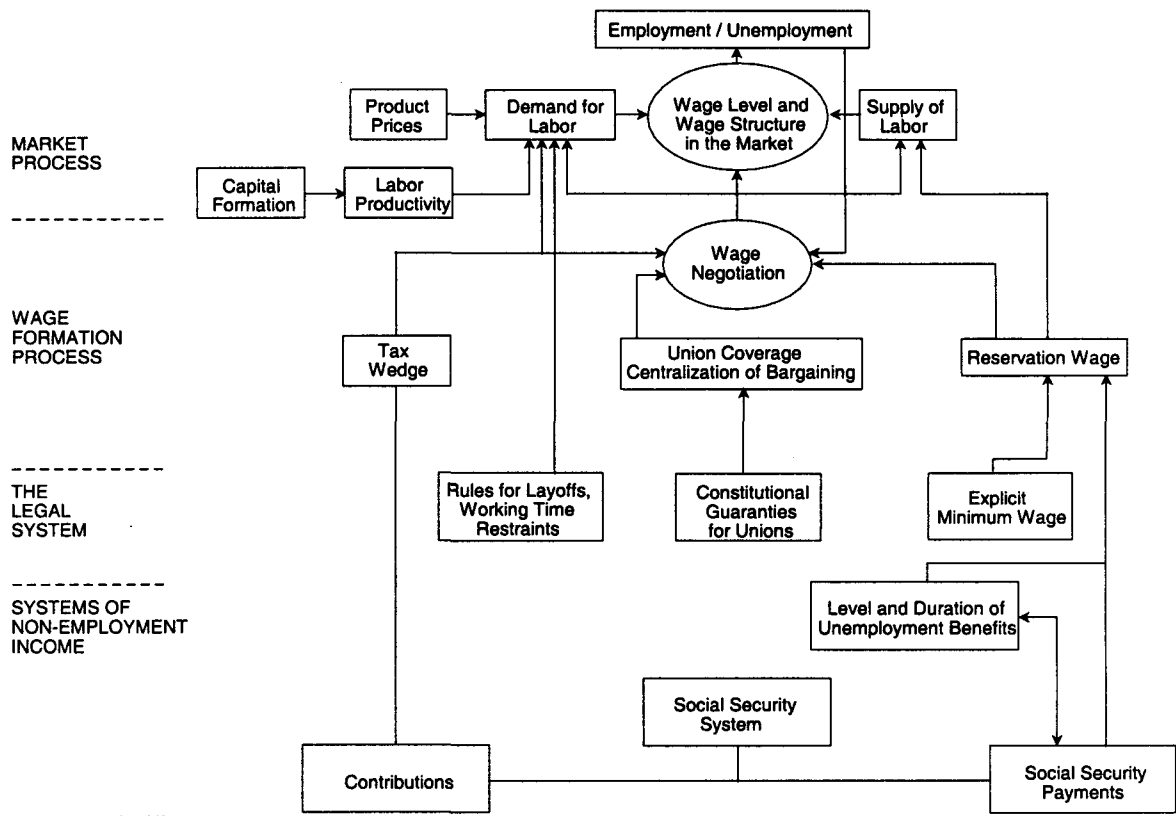
16. The reason why Europe is not prepared to accept stronger wage differentiation is its equity orientation and the expansion of the welfare state that followed from this orientation. Quite clearly, the welfare state has a severe impact on employment and unemployment in a complex web of interdependencies (Figure 4). There are four reasons. First, in most countries the social security systems are financed by a tax on labor. This reduces the demand for labor. Second, payroll taxes create a tax wedge between the gross wage (producer's wage) and the net wage (consumer's wage). It is an artificial distortion that is to the disadvantage of labor. High income taxes aggravate the problem further by lowering the net wage for workers. This makes a moderate wage policy less acceptable for the trade unions and is an incentive for workers to move to the shadow economy. Third, the social security system and the income level provided by it define a reservation wage which influences wage bargaining behavior and sets a floor for the wage structure, even if no explicit legal minimum wage is established. As the welfare system has developed, the wage floor has gradually increased, reducing the demand for labor at the lower levels of the productivity ladder. Fourth, the reservation wage influences labor supply behavior and people's willingness to move out of the "social security trap."

17. If continental Europe wants to reduce unemployment, it will have to change the impact of the welfare state. Reforming the welfare state has several aspects. One is the level of entitlements that is provided by the social security systems. The other is the mode of financing the social security systems.

### *Differentiating between Large Risks and Small Risks*

18. With respect to the level of benefits provided by the social security systems, for instance, unemployment and health insurance, a distinction should be made between what are large risks and what are small risks for the individual. Social security systems should protect the indi-

Figure 4: Institutional Arrangements of the Labor Market and the Welfare State



vidual against large risks, but the individual should bear small risks himself. For instance, the loss of income in the first three or five days of unemployment can be considered to be a small risk which can be covered by the individual's ability to pay, for instance, by his or her own savings. Such a distinction between large and small risks would allow the costs of the social security system to be reduced, thus lowering the tax on labor. Insurance against large risks would be mandatory; small risk coverage would be optional.

This concept should also be applied to old age pension systems in which the individual can provide for extra coverage beyond the mandatory requirement by paying into a capital funded system ("cappuccino" approach). Thus, with respect to financing, more choice should be given to the individual on the extent of insurance coverage that the individual desires. Letting the individual decide on the extent of social insurance coverage (in relation to the

premia to be paid) allows bringing about insurance coverage at lower costs, implying a higher labor income.

#### *Scaling Down the Social Welfare Benefits for Those Who Are Able to Work*

19. Looking at the two different layers of income floors provided by the social security system (Siebert 1997), namely, welfare and unemployment benefits, the serious issue for social welfare payments is the extent to which the level of social welfare benefits should be scaled down for those who are able to work in order to increase the incentive to work and the intensity of their search for work. A potential accompanying approach is to offer a job to those who are in social welfare programs, and to reduce support if the job is declined. This approach seems to be possible in countries where, in the spirit of the principle of subsidiarity, social welfare is organized on the municipal and county level.

### *Reducing the Duration of Unemployment Benefits*

20. A related question is whether the level of the second layer of the income floor, unemployment benefits, should be reduced or whether the duration of the benefits should be shortened in order to intensify job search and reduce the reservation wage. Whereas the United States and the United Kingdom have shortened the duration of the benefit to six months, insurance coverage in continental countries lasts up to 33 months in France and 32 months in Germany (with one type of unemployment benefits there being given indefinitely). European countries should discuss shortening the time that benefits are paid for or scaling down the level of benefits over the period of time the recipient is unemployed.

### *The Principle of Equivalence in Social Security Systems*

21. Except for social welfare programs, the principle of equivalence should be adhered to in all the social security systems. This means that there should be a relation between benefits received and contributions paid by the individual. This also implies that tax financing of social security systems should be avoided. This principle is of special relevance for old age insurance. Admittedly, the implementation of this principle runs into the problem that the income floor defined by the social welfare system, if pushed high over time, prevents an equivalence-based social security system because benefits can be received without having made contributions.<sup>7</sup>

### *Uncoupling the Financing of Social Security from the Work Contract*

22. With respect to the financing of social security entitlements, a far-reaching proposal is to uncouple financing from the work contract. The individual would purchase an insurance service from his income, which also includes his capital income. Such an approach would be attractive for a number of reasons: it takes into account

that capital income (including income from savings) has become more important recently in households' income. Moreover, the reality of work relationships has changed considerably, so that the traditional full-time worker, who has a lifelong job, preferably in the same firm, which was the frame of reference for the traditional social security systems, is no longer the standard case.

## **8. Approaches on a European Level?**

23. Quite a few European governments, for instance, the French government, see a possible approach to more employment in becoming active on the European level. The catchwords are "European employment policy" or "European employment pact", which are intended to stimulate a positive association for the voter. Looking more closely, the terms are interpreted differently and can mean different things.

One approach that has been discussed is stimulating aggregate demand and coordinating demand management. Some have in mind (mis-) using the European Central Bank to finance an excessive expansion of demand. I have already discussed the opportunity costs of this approach. With monetary policy being elevated to the European level, coordination now relates to national fiscal policy and the optimal policy mix between common monetary policy and national fiscal policy. Admittedly, in macroeconomic models with a nonvertical Phillips curve, theoretical arguments can be made for coordinated demand management by a group of countries like those in Western Europe. But it is quite likely that coordination will fail. One reason for this is that governments have different policy concepts. Another is the impossibility of reaching agreements between sovereign governments because they have different interest positions. Yet another is that time lags of the incidence of fiscal policy instruments differ between countries. Experience with international arrangements, such as the Plaza Agreement (1985) and the Louvre Accord (1987), supports this position. Besides, if explicit demand management

<sup>7</sup> Witness the inability to reduce the net rate of pensions in Germany from 70 to 64 percent of the net wage because pensions would then be in the neighborhood of social welfare benefits.

has basically been a failure on the national level, why try it on the European level?

A second approach is active employment policy at the European level, such as EU employment programs. This is a highly questionable and misleading approach because it could open up a source of finance for those countries that are unwilling or unable to do the required reforms in their labor markets at home. This would be an incentive not to undertake the necessary steps to solve national unemployment problems. Financing the EU programs would be a burden for those countries that are successful in their labor markets.

A third approach is that influential groups intend to Europeanize wage formation. Such an approach clearly goes the wrong direction when decentralization of wage formation is required and when it is necessary to take wage formation closer to the market. It would elevate the national labor market cartels to the European level. Anyone who thinks about approaches on the European level must take into account that labor productivities are quite divergent among European countries ranging from 95 percent of the west German level in France and 90 percent in Austria to 60 percent in Spain and 35 percent in Portugal (Siebert 1998b). A Europeanization of wage policy would clearly worsen the unemployment problem.

A disastrous development would be a minimum wage for the European Union as proposed by the French Finance Minister Strauss-Kahn.<sup>8</sup> Such a minimum wage would clearly aggravate the level of unemployment.

Shifting the employment issue to the European level would take attention away from the necessity to decentralize wage formation, i.e., to negotiate wages at the level of firms. It would blur the lines of responsibility. National governments would shift their responsibility to the European level. This would be an extremely dangerous development for European integration because the European cause would become the scapegoat of failed national policies.

The European employment approach can only be an exchange of ideas on best practices

of different countries, a benchmarking with international experience, and an attempt to reach a consensus on the assignment problems where the responsibility for employment rests with the national governments.

## 9. Conclusion

24. At the beginning of a new century, continental European countries face a choice: either they continue their labor market approach of the last thirty years or they manage to revise their approach to the unemployment problem. The old approach will not reduce unemployment.

Taking a look at Japan in the late 1990s, it seems that Japan has lost its capacity to solve problems, and one can have the impression that institutional constraints have become so powerful that the country is not strong enough to initiate the necessary changes. Sometimes, I begin to have the impression that continental Europe is in a similar state of losing its political capacity to solve problems.

Politicians have to explain to the voter that the economic conditions in the world and in Europe are different now and that a new approach is needed. Politicians must go for a change in their approach to the unemployment problem. If they do not, they will fail.

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<sup>8</sup> Compare *Süddeutsche Zeitung*, April 17/18, 1999.

## Appendix

Table 1: Employment, Unemployment Rates<sup>a</sup> and Capital Formation<sup>b</sup> in Major OECD Countries

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998 <sup>c</sup>	1980-1989	1989-1998
<i>Germany</i>																					
Employment	1.6	-0.1	-1.2	-1.4	0.2	0.7	1.4	0.7	0.8	1.5	3.0	28.2	-1.8	-1.7	-0.7	-0.4	-1.3	-1.3	0.0	0.3	-0.9 <sup>f</sup>
Unemployment rate <sup>d</sup>	2.6	4.0	5.7	6.9	7.1	7.2	6.5	6.3	6.2	5.6	4.8	4.2	4.5	7.9	8.4	8.2	8.9	10.0	9.8	5.8	7.4
Real capital formation	3.0	-3.9	-4.7	4.5	-0.4	5.0	4.3	3.8	5.6	7.4	10.1	25.8	0.0	-10.2	0.6	0.7	-0.5	2.1	5.0	2.3	2.2
<i>France</i>																					
Employment	0.1	-0.5	0.4	-0.2	-0.9	-0.1	0.5	0.4	1.0	1.5	0.8	0.0	-0.6	-1.2	0.1	0.8	0.1	0.4	1.2	0.2	0.1
Unemployment rate	5.8	7.0	7.7	8.1	9.7	10.1	10.2	10.4	9.8	9.3	9.0	9.5	10.4	11.7	12.3	11.7	12.4	12.4	11.9	8.8	11.3
Real capital formation	4.2	-2.5	0.0	-4.1	-2.1	4.4	6.6	6.0	9.6	8.6	4.7	0.4	-0.4	-8.2	1.5	3.5	2.0	0.3	6.8	2.8	0.2
<i>Italy</i>																					
Employment	1.3	-0.6	-0.4	0.1	0.3	0.3	0.4	-0.3	0.5	-0.1	1.2	0.7	-0.9	-2.5	-1.7	-0.6	0.4	0.0	0.2	0.0	-0.5
Unemployment rate	5.6	6.2	6.8	7.7	8.1	8.4	9.2	9.9	10.0	10.0	9.1	8.8	9.0	10.3	11.4	11.9	12.0	12.1	12.3	8.2	10.8
Real capital formation	9.7	-8.4	-7.6	-5.4	6.4	0.9	4.9	8.5	12.4	5.9	5.3	-0.1	-1.2	-18.5	5.1	13.8	0.7	1.7	2.5	1.7	0.1
<i>United Kingdom</i>																					
Employment	-1.0	-3.4	-1.9	-0.2	2.2	1.1	0.3	2.5	4.0	2.7	0.4	-3.0	-2.1	-0.4	1.0	1.2	1.1	1.7	0.5	0.8	0.0
Unemployment rate	6.2	9.7	11.1	11.1	11.1	11.5	11.5	10.6	8.7	7.3	7.1	8.8	10.1	10.5	9.6	8.7	8.2	7.0	6.2	9.9	8.5
Real capital formation	-4.2	-4.2	7.6	-0.4	11.1	9.2	-3.2	12.0	16.7	12.9	1.0	-7.9	-2.9	-2.9	3.7	7.7	8.8	8.8	9.3	6.6	2.6
<i>United States</i>																					
Employment <sup>e</sup>	0.5	1.1	-0.9	1.3	4.1	2.0	2.3	2.6	2.3	2.0	1.3	-0.9	0.7	1.5	2.3	1.5	1.4	2.2	1.3	1.9	1.1
Unemployment rate	7.2	7.6	9.7	9.6	7.5	7.2	7.0	6.2	5.5	5.3	5.6	6.8	7.5	6.9	6.1	5.6	5.4	4.9	4.6	7.3	5.9
Real capital formation	-2.4	5.3	-4.4	-1.7	17.3	6.2	-3.5	-1.1	4.4	4.0	-0.6	-6.4	1.9	7.6	8.0	9.6	9.3	10.7	10.9	2.8	5.6
<sup>a</sup> Standardized. — <sup>b</sup> Real gross private nonresidential fixed capital formation. — <sup>c</sup> Estimates. — <sup>d</sup> Prior to 1993, data refers to West Germany. — <sup>e</sup> Break in series as of January 1994. — <sup>f</sup> 1991-1998.																					

Source: OECD (1998).



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