Is Unemployment Here to Stay ?

Fraser Hosford
Junior Sophister

European-wide recession has pushed unemployment and trade union activities to the forefront of both the political and economic agenda. Fraser Hosford reviews the concept of unemployment as portrayed by standard neo-classical theory.

"The patrimony of a poor man lies in the strength and dexterity of his hands; and to hinder him from employing this ... is a plain violation of this most sacred property"

- Adam Smith, The Wealth of Nations

Introduction

High unemployment is now a common feature of society in many Western European countries. The dramatic rise in unemployment in the 1980s and 1990s, and its subsequent persistence, has led to a certain fatalism about these levels of joblessness. However, there are solutions available, and perpetually high unemployment need not be the fate of a modern economy. In this paper, the three main ways in which European governments can, and should, attack unemployment are outlined. Primarily, Europe needs to reverse the continual rise in its natural rate of unemployment by reforming its labour markets. Secondly, European tax levels need to be reduced, and this requires control of its escalating public expenditure. Finally, the declining international competitiveness of European industry and commerce needs to be reversed. European industry has been consistently losing world market share to both the US and Japan.

According to standard classical macroeconomic theory, all unemployment is voluntary. As the real wage adjusts in the long run, the labour market will clear at the equilibrium rate, where everyone who wants a job will get one. Therefore, if governments refrain from intervention, market forces will ensure the desired outcome. The rate of unemployment will be the natural rate, or the non-accelerating inflation rate of unemployment. This is the single rate of unemployment consistent with a stable rate of inflation in the long run. The present unemployment rate of 5.8% in the US is deemed by many to be the country's natural rate, in Europe the figure is higher, estimated to be around 8%. This level of unemployment, which is described as frictional unemployment, is necessary to ensure the efficient functioning of the economy, and to subdue inflationary pressures. However, during the 1960s the natural rate and the actual unemployment rate in Europe were thought to be about only 3%. The increases in this natural rate since the 1960s indicates that it may be possible to bring the rate back to these low levels. Thus, the primary focus of this essay are the causes and remedies of this high natural rate, and the sclerotic nature of European labour markets in general.

The Social Security Trap

The social security trap is generally promoted as a major cause of high unemployment in modern, industrialised societies. High levels of unemployment benefit reduce the opportunity cost of unemployment, thereby reducing the incentive for individuals to find employment. Some people refuse to accept low paid jobs, as the pay may only be marginally above the unemployment benefits, a phenomenon known as a high replacement ratio. Many argue that the lower NAIRU (Non-Accelerating Inflation Rate of Unemployment) in the US is due to the lower level of benefits available there, which in any case stop after six months. In their sophisticated econometric research into unemployment, the British economists Layard, Nickell and Jackman said that "the unconditional payment of benefits for an indefinite period is clearly a major cause of high European unemployment." [1] No one wishes to point a finger at those who are jobless by choice, but for many people safety nets have undeniably become hammocks. Chancellor Kohl said that "about a third of those on welfare rejected jobs offered to them", and noted that construction sites around Germany are filled with foreign workers, while Germans sit idle.[2] Burda also finds a strong positive relationship between the generosity of the benefit system and long term unemployment rates across countries.

A greater emphasis, therefore, must be placed on active labour market policies. While dampening the disincentive problem that is inherent with social security, this approach will assist the unemployed in effective job search, increasing the rate at which they are successfully matched with available job vacancies.. The OECD, who are advocates of such an approach, concede that some of these policies have been ineffectual. They propose enhanced co-ordination between the different functions of benefit administration and these active strategies as a solution.[3] This would facilitate the monitoring, and support, of the job search activities of those receiving benefits. It would reduce the risk that staff dealing with placement activities and benefit administration would aid different clienteles. Those placing the unemployed can lose touch with the long term unemployed in particular, and those on benefit administration have no incentive to reduce the level of benefits paid out. There is also the possibility of encouraging competition from the private sector in job search activities and counselling. However, a number of difficulties arise with this, most notably whether the government provide subsidies for start-up costs, how to define and monitor successful

[1]Layard, P.R.G., Nickell, S. and Jackman, R.
[2]Branegan, J. (1996)
[3]Employment Outlook (1995)

outcomes, and how to set fees so as to maximise incentives without generating large rents.[4]

With high and persistent unemployment, emphasis should be placed on active labour market policies to increase the numbers taking on part-time work. Periods of training and short term jobs are needed to maintain the skills of the unemployed, to boost their motivation, thus hopefully preventing the drift into long term unemployment. Training is essential in the labour market question. David Soskice has identified four key areas.[5]

- Close links need to be developed between schools, the system of vocational training, and companies. This is to enable young people to see clearly the route from education to stable employment, via training.
- Training needs to lead to marketable skills, not just company specific skills. This also provides a signal to the right sort of inward investment.
- There is a need for some EU-wide system for standardising and approving qualifications.
- Local labour markets need good systems for retraining those who have been made unemployed.

However, while the aforementioned social welfare system is undoubtedly an inhibiting factor, it cannot account for levels of unemployment of 11% and 12% by itself. The European welfare state did not suddenly become more generous in the 1970s, and as such cannot be the sole reason for the rise in unemployment. It does, however, help to explain the persistence of high unemployment long after the transitory disturbances have disappeared.[6] Yet, Charles Bean of the LSE concedes that "we really don't know enough about the causes of Europe's high unemployment to know exactly how to cure it".[7] Despite this, numerous efforts and studies have taken place which can lead us in the right direction.

Minimum Wage Theories

Minimum wages have always been propounded as damaging policies by economists, yet the social concerns of politicians, and some say naivety of the electorate, have resulted in their continued existence. If a worker can only offer productivity worth £3 to you as an employer, but the minimum wage states he must be paid is £4, would you employ him? Despite the obvious logic, new approaches suggest that a minimum wage may even create employment. The most popular one is the notion of monopsony in the labour market, where

[4]OECD Employment Outlook (1995)
[5]Soskice, D. (1995)
[6]Bean, C. et al. (1995)
[7]Branegan, J. (1996)

employers have monopoly power as buyers of labour.[8] Theoretically it can boost employment, but the usefulness of the idea for policy is very limited. To act on it without running the risk of losing jobs, the government would have to fine tune the minimum wage continuously, according to the type of worker, area by area, industry by industry, and even firm by firm. From a practical point of view, the idea is unworkable. The figures speak for themselves, one in six workers in the US are paid less than the French minimum wage.[9] Those who would lose their job as a result of a minimum wage are the very ones it would aim to benefit, the less productive, unskilled and uneducated workers. Furthermore, a law against offering one's labour services under a set wage is a direct attack on one's economic freedom. The OECD believes one of the most vital strategies would be to lower minimum wages so the young and the unskilled could price themselves into jobs. This would also hope to encourage greater wage flexibility among companies, industries and even different regions of a country.[10] However, implementation of such strategies can be very problematic, for example, a 1994 French government proposal for a lower youth minimum wage was withdrawn due to a wave of student protests.

Insider-Outsider Model

The Insider-Outsider model is commonly cited to explain situations of less than full employment. The basic assertion of this model is that wages are set by bargaining between employees and employers. Unemployed outsiders play no role in the setting of wages. It is the employees, or unions acting on behalf of employees, known as insiders, who determine wages, whilst securing their own employment. Economists have always been wary of the power of trade unions, who may protect the wages of their members, at the expense of those who would work for lower pay. Within a corporatist system, where the bargaining process takes place at a national level, institutions are unable to pass on their wage increases to others, because each represents a large element of the total workforce. The experience of Germany, in particular, seems to show that this system has worked well, as unions are forced to acknowledge the impact of pay rises on unemployment.

The Corporatist System

However, the efficiency of the labour market may be impaired by the placing of uniform wage agreements on different sectors of the economy. In a corporatist system, wage differentials may be imposed in a rigid manner, irrespective of changes in economic activity, and this can affect unemployment. It can lead to a situation where workers' wages will not equal their marginal product - an

[8]"The Economist", Sept. 10th 1994
[9]"The Economist", Nov. 19th 1994
[10]Branegan, J. (1996)

inefficient allocation of labour. Then there will be no incentive on a worker's part to move to firms where they will be more productive. Workers may be let go in a situation where productivity increases by less than the average, as firms will be paying too much for them. There is no guarantee, however, that firms whose productivity has been growing at a faster rate than its wage bills, will take on more workers.

The German model is stumbling at present, and many blame its overly rigid corporatist wage bargaining system. The trade unions who are famed for their responsibility, were the reason for its early successes. However, new firms are not signing up to industry-wide agreements, because they want the freedom to tailor wage deals to their own conditions. It is sustainable for large firms, who can afford settlement by demanding huge price cuts from their subcontractors, however, these subcontractors cannot afford them because they are forced to pay the same industry wide wage deal. The Mittelstand (minor contractor) is thus picking up the bill for social solidarity, and as international competition intensifies it can no longer afford to pay. Furthermore, neighbours such as Poland, Hungary and the Czech Republic have wages at 10% of the German level, therefore increasing the probability that firms will simply relocate production in order to lower costs.[11] This contrasts gravely with America where small- and medium-sized enterprises have been the driving force behind the employment boom.

Institutional Factors

An alternative would be the UK style system, where the power of trade unions was severely diminished in the 1980s. Many believe the labour market reforms that have taken place in the UK were necessary, and do not see the option of a corporatist system as unworkable in the UK. The results are likely to be similar to those achieved in Ireland, where social partnership consists of strong public sector trade unions, within the Irish Congress of Trade Unions demanding wage increases way above the rate of inflation, while the interests of the private sector have been largely ignored. Certainly the failure of unemployment figures to fall during the recent boom questions the system. Many economists have been warning against the power of trade unions, but it seems that these warnings are not being heeded. The public services pay bill has increased by more than 6 % annually since 1987 as a result of the Programme for National Recovery and Programme for Economic and Social Progress increases and special pay awards. If the public sector had been persuaded to accept a 2.5% annual increases in the period 1987-92, sufficient to compensate for inflation, a saving of six hundred million would have been made. This money could have generated up to thirty thousand extra jobs in the public sector, or have been used through tax cuts to stimulate employment in the private sector. Either way, as McAleese has shown,

[11] Hutton, W. (1995)

"many thousands of jobs have been priced out of existence because of public sector unions' success in obtaining high increases in remuneration".

Employment protection is also blamed for Europe's rigid labour markets. The rise in unemployment over the 1970s and 1980s arose mainly through a reduction in outflows from the unemployment pool and, hence, an increase in the average length of an individual's unemployment spell. In this context, Bertolila and Bertola argue that the high levels of unemployment are due to low job creation, rather than excessive job destruction. Employment security provisions, introduced in a number of cases, under pressure from trade unions, have increased the effective hiring and firing costs for labour. Furthermore, the oil shocks of the 1970s substantially increased the degree of uncertainty faced by firms. The result of both increased uncertainty and high hiring costs is to make firms hesitant to increase employment, even in relatively prosperous times, owing to the high costs involved in subsequently shedding labour in a down-turn.[12]

It has been argued that lack of protection and deregulated markets will result in less loyalty on the behalf of firms and employees, and a subsequent lack of training. The paramount importance of training is widely recognised as a necessary response to technological progress and increased international trade. The idea of life time employment has all but disappeared in the UK, and some see that as a reason for not following their example. However, the now more common short term contracts are only continued if performance is satisfactory, and in longer contracts, also, reward is increasingly on the basis of performance - surely foundations for healthy productivity? Also, as the question of life time employability has emerged, workers realise that they may well lose their jobs if the company can no longer make effective use of them. The best companies have already understood this, if they are to retain their own right to flexibility, they also need to make their workers as flexible as possible.[13] They will be rewarded with less anxious employees, and higher quality ones, as the best people queue to work for firms that offer not the illusion of security, but an opportunity to stay employable.

Product Market Barriers

The McKinsey Global Institute report that product market barriers maybe even more important than labour market rigidities in explaining Europe's high unemployment.[14] New job creation offsets job losses in an efficiently working economy, but government interference, in the labour, capital or product markets, will block the expansion of jobs in new industries and products. In the retailing

[12]Blackaby, D.H. & Bladen-Hovell, R. (1992)
[13]"The Economist" March 19th 1995
[14]The Economist," Nov. 19th 1994

sector, for example, zoning regulations, restrictions on opening hours and other anti competitive practices have been shown to have stunted the growth of the sector across Europe. In France, retailing employment has shrunk whereas in the US it has been a huge job creator. 'Loi Royer' gives local politicians and shop owners power to block the opening of new large stores. Germany and Italy also have strict zoning regulations. In many European countries limits on the number of cable TV channels and restrictions on TV advertising have inhibited job growth. Reforming the labour market will create mainly low skilled low paid jobs. However, if this is accompanied by deregulating product markets, more high skilled jobs will be created.

Thus, it is my contention that changes should be made in the above areas. They are, undoubtedly, restraining employment creation. The measures will vary widely, as they must be suitable for different countries, with different social and economic structures. However, I believe measures must be taken. It may not, for example, be advisable for Germany to abandon its wage bargaining system - rather changes to enhance flexibility may be sufficient. The best climate for reform is when an expanding economy is experiencing a high rate of structural change. This can be shown, to some extent through the large scale introduction of temporary job contracts in Spain in the 1980s.[15]

Policies to Increase Labour Demand

Policies to increase labour demand, if implemented simultaneously with the aforementioned policies, should free up labour markets and subsequently reduce the 'NAIRU', which will increase wages and employment.

In Europe, public sector expenditure ratios average at almost 50 %, in contrast to the 30-35% of Japan and the US. If public sector expenditure is cut, the tax ratios could also be reduced. These tax reductions would then create conditions where companies would employ more labour, because it would be cheaper relative to capital, and because companies would be expanding faster. The supply of labour would rise at the same time, as the lower taxation would eventually decrease the replacement ratios in European countries. With more private sector output and less unemployment to finance, tax rates could be further reduced, to produce a virtuous circle for as long as these developments can be sustained.[16] Therefore, the reduction of public sector expenditure needs to become a major objective of economic policy for European governments.

It is a myth to believe that public sector expenditure ratios are already at an irreducible minimum. To take the example of Britain in 1976, real public sector

---

[15]Brittan, S. (1995)
[16]Eltis, W. (1995

expenditure was cut by 8% in two years. This, by a Labour government, is a larger figure than that achieved by any of the Conservative governments which followed. The fiscal tightening which took place in Ireland in the second half of the 1980s reduced the public sector expenditure ratio by a staggering 10% - from 53% of GDP in 1986, to a sustained 41-43% throughout the 1990s. What Europe now needs is a similar will to cut public sector expenditure now when the circumstances are not so pressing. In these examples, the ratios of taxation in GDP were not subsequently reduced because public sector expenditure was slashed to reduce budget deficits and control the growth of public debt. However, if governments with tolerable budgets and public debt, were to cut public sector expenditure as if they were in crisis, it is possible that they could at the same time reduce taxation and recreate the conditions for faster growth in employment and output.[17] Then a virtuous circle would be possible as the potential for further tax cuts would exist.

Lower European taxation would also enhance the competitiveness of European firms. It would increase their investment potential, and their ability to finance research and development. Furthermore, foreign investment into Europe would significantly increase. The efficiency of the labour market, as previously discussed, is also a major determinant of a country's international competitiveness, which needs to be improved in Europe to raise living standards, growth and employment.

With the advent of EMU, the possibility of changing the exchange rate is removed. Monetary policy will be dictated by the supranational European Central bank, based in Germany, and fiscal policy is also likely to be restricted. Therefore, the need to take structural measures to improve a country's international competitiveness will become stronger. Microeconomic policy measures should become more prominent, with the above ideas for training necessary for the increased labour mobility needed in a single currency area, being just one example.

Conclusion

While the causes and measures I have outlined are by no means conclusive, and some of the issues are quite contentious, I do believe the logic is clear. Furthermore the US, famed for its flexible labour markets, has a unemployment rate near to 5 %, and the UK , having made similar attempts, has a rate of 6.7 %. Richard Jackman of the LSE credits the reforms with helping to lower the unemployment rate by two to three percentage points. He also argues that the drop would have been more impressive if it weren't for the poor education

[17] Ibid.

system.[18] To conclude, I believe the main problem as regards any solution to this problem, is the deep rooted fear of the creation of a two speed society, as has happened in the US. There, the dispersion of income has increased dramatically, with many blaming the deregulated system. A look at the socio-economic background and educational attainment of the less well off, would certainly be a helpful insight into this problem, again emphasising the need for quality training for all. A study by the Centre for Economic Policy Research concluded that a fall in aggregate European unemployment to 6.4%, resulting in a distribution of income similar to that of the US, would benefit only 44% of the labour force, making it politically very difficult to achieve.[19] David O'Sullivan, a top aide to Commissioner Padraig Flynn, has said that "we agree there has to be radical change, but we don't want an American style free for all that destroys the social safety net."[20]

Bibliography

The Economist, (Sept 10th, 1994) "The Minimum-Wage Debate" *The Economist.*

The Economist, (Nov 19th, 1994) "How Regulation Kills New Jobs" *The Economist.*

The Economist, (March 19th, 1995) "After Lifetime Employability" *The Economist.*

Bean, C. et al. (1995) *Unemployment: Choices for Europe* Centre for Economic Policy Research.

Blackaby, D.H. & Bladen-Hovell, R. (1992) *Unemployment and Labour Market Flexibility in Western Europe.* University College of Swansea, Swansea.

Branegan, J. (February 26th 1996) "Why a Good Job is hard to find?" *Time Magazine.*

Brittan, S. (April 20th 1995) "Political Economy of Job Creation." *Financial Times.*

Carlin, W.J. & Soskice, D.W. (1990) *Macroeconomics and the Wage Bargain.* Oxford University Press, Oxford.

Eltis, W. (1995) *European Competitiveness and Employment Generation.* European Policy Forum, London

Hutton, W. (March 13th, 1995) "Britain Falls Short of the Mark." *The Guardian.*

---

[18] Branegan, J. (1996)
[19] Bean, C. et al. (1995)
[20] Branegan, J. (1996)

Layard, P.R.G., Nickell, S. & Jackman, R. (1991) *Unemployment: Macroeconomic Performance and the Labour Market* Oxford University Press.

Mankiw, N.G. (1993) *Macroeconomics* New York, Worth.

Smith, A. (1776) *An Inquiry into the Nature and Causes of The Wealth of Nations* G. Bell & Sons, London.

Soskice, D.W. (February 1995) *Labour Markets in the EC in the 1990s* Employment and Industrial Relations International.

OECD (1995) *Employment Outlook* OECD Publications Paris.