The economists' "Manifesto" on unemployment in the EU seven years later: which suggestions still hold?

BENIAMINO MORO

1. Supply side measures

When we wrote the "Manifesto",[1] in 1998, the EU unemployment rate was about 10%, the employment rate (15-64 years) 61%. Since then labour market performance has gradually improved, even during the years of stagnation 2002-03. The total employment growth rate was 0.5% on average, and the European Commission forecasts a further 1% improvement for 2005. The total employment rate reached 64.5% in 2004.

Not so good was performance on the rate of unemployment, which sagged to a minimum value of 7.4% in 2001 but since began to rise again, reaching 9% in 2004. On the whole, we can safely say that the situation of the European labour market has improved, but not spectacularly. In any case, unemployment still remains the most serious and urgent problem facing the EU, exactly as the situation described in the 1998 "Manifesto".

According to Franco Modigliani, the "Manifesto" was written to suggest to European policy makers the best policies to fight unemployment. Not only the co-authors, but also all 46 eminent economists (some of them Nobel Prize-winners) who expressed their support for the ideas of the "Manifesto" agree that unemployment must be attacked on two fronts: through a broad spectrum of supply side poli-

☐ Università degli Studi di Cagliari, Dipartimento di Economia, Cagliari (Italy); e-mail: moro@unica.it.

[1] Modigliani *et al*. (1998).

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TABLE 1

EMPLOYMENT RATES (15-64 YEARS) IN UE-15

Member countries	1991	1998	2001	2004	2005*
Belgium	55.8	57.4	59.9	60.0	60.4
Denmark	74.2	75.1	76.2	75.4	75.9
Germany	67.7	63.9	65.8	64.6	65.2
Greece	53.4	55.5	55.4	58.5	58.6
Spain	50.4	51.2	57.7	60.6	61.7
France	60.4	60.2	62.8	63.0	63.4
Ireland	51.4	60.6	65.7	68.2	69.3
Italy	53.0	52.0	54.8	56.2	56.6
Luxembourg	60.8	60.5	63.1	66.1	67.7
Netherlands	62.7	70.2	74.1	72.4	72.8
Austria	68.0	67.9	68.5	69.6	70.1
Portugal	67.5	66.9	68.7	68.2	68.3
Finland	70.3	64.6	68.1	67.8	68.1
Sweden	79.5	70.3	74.0	73.1	73.4
United Kingdom	69.4	70.5	71.7	72.8	73.2
European Union 15	61.0	61.4	64.1	64.5	65.3

* Forecasts.
Sources: European Commission, *Employment in Europe 2003*, September 2003, for data until 2001; European Commission, *Economic Forecasts. Autumn 2004*, for 2004 data and forecasts for 2005.

TABLE 2

UNEMPLOYMENT RATES IN UE-15

Member countries	1991	1998	2001	2004	2005*
Belgium	6.4	9.3	6.7	8.2	8.1
Denmark	7.9	4.9	4.3	5.8	5.3
Germany	6.0	9.1	7.8	9.7	10.0
Greece	7.1	10.9	10.4	8.5	9.0
Spain	13.2	15.2	10.6	11.1	10.8
France	9.1	11.4	8.5	9.6	9.5
Ireland	14.7	7.5	3.9	4.4	4.4
Italy	8.5	11.7	9.4	8.3	8.1
Luxembourg	1.6	2.7	2.1	4.3	4.6
Netherlands	5.5	3.8	2.4	4.6	5.0
Austria	4.0	4.5	3.6	4.2	3.9
Portugal	4.2	5.1	4.1	6.3	6.2
Finland	6.6	11.4	9.1	8.8	8.6
Sweden	3.1	8.2	4.9	6.3	5.8
United Kingdom	8.6	6.2	5.0	4.9	4.9
European Union 15	10.0	9.4	7.4	8.9	8.9

* Forecasts.
Sources: European Commission, *Employment in Europe 2003*, September 2003, for data until 2001; European Commission, *Economic Forecasts. Autumn 2004*, for 2004 data and forecasts for 2005.

cies and demand management policy. Expansion of the aggregate demand is necessary to increase both investment and employment.

> "However, unless supply side measures are also taken, demand expansion can result in more inflation instead of more employment, because of the mismatch between the demand and supply of labor. What is important to stress is that both demand and supply side policies must be adopted together by all European countries, in order both to avoid beggar-my-neighbor problems, and, at the same time, to catch all the possible complementary effects of these policies" ("Manifesto", p. 361).

By 7 years after we published the "Manifesto", some of the policies suggested therein had been adopted in various European countries, some had not. Specifically, many of the supply side suggestions were followed by European governments. In Italy, two reforms were approved by the Parliament: the first was the 'Treu act', passed in 1997, which began to produce positive effects in 1998, and more recently we saw the 'Biagi act' come into force.[2] Both reforms extended the possibilities open to all to find a job.

Thanks to these reforms, the Italian unemployment rate was reduced from 11.7% in 1998 to 8.3% in 2004, moving from above to below the European average. They have also been criticized by some for an excess of flexibility in certain cases, increasing the precarious component of employment, but on the whole the two reforms seem to be working well. They have significantly increased the number of temporary and part-time contracts, about half of which can eventually, according to the Italian Statistical Institute (ISTAT), be transformed into indeterminate and full time contracts. In the last 4 years, the proportion of part-time workers grew from 7 to 12% of total employment, with a maximum of 16% in the private services sector. The same dynamics has characterized the evolution of temporary contracts, which are preferred by women and people under thirty.

The spread of these atypical labour contracts has played an important role in the dynamics of Italian employment, but no less important is the growth of regular labour contracts, for permanent and full time jobs. The last two years have in fact seen an increase in both kinds of contracts. In any case, the latest data show the employment

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[2] Usai (2003) contains a brief overview of the new flexible contracts introduced by the Biagi reform.

growth rate falling while, at the same time, the reduction in the unemployment rate to some extent reflects the discouragement of some workers, who give up looking for jobs.

Therefore, on the whole, the more flexible labour market policies promoted in Italy by the Treu and Biagi reforms clearly move in the right direction suggested by the "Manifesto". The entrepreneurs are satisfied with them, and hope these reforms will help economic growth. Greater flexibility and liberalization of labour contracts also brought the elasticity of employment *vis-à-vis* GDP in Italy to the highest values shown over the last three decades.

In some other European countries, too, the "Manifesto" suggestions regarding a more flexible and liberalized labour market prompted the approval of acts similar to the Treu and Biagi reforms. For instance, one of the most widespread atypical labour contracts in Europe is the lease contract, which reaches 1.5% of total European employment, with peaks of 4% in the Netherlands and Luxembourg, while reaching 2.7% in France and 2.1% in the UK. Temporary contracts are also common in Spain, but much less so in Germany (Eurofound 2005).

In France, the reduction of the working week from 40 to 35 hours, introduced in 1997 with the Aubry reform, which in the "Manifesto" we regarded as little more than demagogy, has since been superseded and deprived of a real content. This reinforces the widely held opinion that reforms moving in the opposite direction to greater liberalization of the labour market simply do not work. Anyway, as a consequence of this reform, France became the industrialized country with the shortest working week, amounting to 35.7 hours, against 37-38 in Germany, the UK, the Netherlands and Denmark, and 39-40 in most of the other European countries, including Italy, while the US and Japan exceed 40 hours.

Today a new bill under discussion at the National Assembly, which "reforms the Aubry reform", introduces the possibility to increase overtime (from 180 to 220 hours) and negotiate leisure time. The new bill gives the opportunity to sign contracts with time extended beyond 35 hours on a sector basis. The magic word used is "souplir", which means softening the effects of the Aubry reform while saving the spirit of the shortened work week.[3]

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[3] The new act, which was approved in March, provides that each worker has a balance sheet of the worked hours which can be saved, where those hours cut by the

Another new proposal for more flexibility discussed in France is the possibility, in cases of dismissal, to substitute indemnities ruled by judges with a predetermined 'firing cost' for the firm.

In Germany a set of radical reforms known as the "Hartz acts" have been approved over the last four years. They are very similar to the Italian Biagi reform, and aim to make the employment services supplied by the job agencies more efficient. These acts allow for new forms of contracts like the American 'staff leasing', the 'job on call' and the so-called 'mini-jobs' (Ichino 2005).

The fourth Hartz act, adopted in the early days of this year, regulates unemployment benefits, setting them at two thirds of the last wage and making them conditional on real job hunting by the unemployed. Nonetheless, after the first year benefits dramatically decrease to about 800 € a month. This act also changes the methodology of unemployment calculation, so as to include among the unemployed people on public relief. The new method abruptly brought Germany's unemployment rate to 12% last January (Valentino 2005).

While the issue is still under debate in France, Germany simply produced another Hartz act to favour agreement between employers and employees on a predetermined firing cost, instead of looking to an indemnity fixed by the judge. The benefit fixed by law corresponds to half a month's wage for each year of employment, which is less than the corresponding benefit set in the Mediterranean countries. In Spain, e.g., the benefit is a month's wage for each year of employment; in France one year's wages regardless of the duration of employment, while in Italy it ranges from 1 to 2.5 year's wages, with an upper limit of four years' income.

Assessment of the effects of these reforms is variegated, despite the fact that the reforms have been approved by rightist governments, as in France, Italy and Spain until last year, or leftist ones, as in Germany and the UK. In either case approval of these labour reforms usually sees strong contrast among the political parties, no less than between the social parts (entrepreneurs and trade unions). Here, however, I can conclude with two comments. First, these reforms regarded

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Aubry reform appear as 'credits', as well as the holidays and the compensatory time. The worker can choose to be paid for these credits, or he can transform them into days off, without time limits. Furthermore, the extension of overtime from 180 to 220 hours a year is confirmed, and further flexibility in the application of the 35 hours has been introduced for those firms with fewer than 20 employees.

a marginal flexibility problem of the labour market: that of temporary and part-time contracts, while leaving unchanged the protection rules of the 'typical contract', which regulates subordinate and time indeterminate work (Blanchard and Tirole 2005).

On the other hand, there is fairly general agreement that these reforms constitute the right way to promote greater flexibility in the labour market, in the sense advocated by the "Manifesto". European firms are usually satisfied with these reforms; and the liberalization of temporary and part-time contracts has, as pointed out above, enhanced the elasticity of employment *vis-à-vis* GDP (ISTAT 2004).

2. Demand management policies

Unlike the supply side policies proposed, the "Manifesto" suggestions regarding demand management policies serving to increase investment have to a large extent been ignored by European governments. The poor results in European GDP growth largely depend on the failure of these policies: to take only the period 2002-04, the cumulative growth rate in the euro area was 3.5%, against 9.2% in the US.

This marked difference in the GDP growth rates of the two areas is to a large extent due to the difference in demand management control. In this respect, events in the two areas took a paradoxical turn. In the USA, traditionally a liberal country opting for the individualist and minimalist state, where many economists share the view that rational expectations make economic policy ineffective also in the short run, a conservative government chose to adopt the most orthodox Keynesian policies of demand management, namely an expansionary fiscal policy that drove the public actual balance from a surplus of 1.3% of GDP in 2000 to a deficit of 5% in 2004. At the same time, after 11 September the Federal Reserve also chose to adopt an expansionary monetary policy, keeping the term structure of interest rates for the bonds issued in dollars permanently below the corresponding term structure for euro bonds. This was the result of keeping the federal funds rate constantly and for a long period of time at half (1%) the main refinancing facility rate of the ECB (2%). Only in the second half of 2004, as we know, did the Fed gradually raise the federal funds rate to 2.25%, making the term structure of dollar interest rates again

similar to that of the euro market. The expectations for this year indicate a federal funds rate of 2.75% for next March, and 3.50% for the end of the year (UBM 2004).

On the contrary, in Europe, where both conservative and progressive governments by and large share the view of an interventionist state, and where Keynesian theories are still very popular in the universities, demand management policies proved very restrictive. This was due to the Stability and Growth Pact that regulates the fiscal policy and the actual balances of each European member state, and to the behaviour of the ECB as regards monetary policy.

The "Manifesto" had already warned of the serious risks of recession entailed in literal application of the Maastricht parameters and in formal interpretation of the Pact,

> "together with the unfortunate circumstance that, in computing the deficit, all expenditures, whether on current account or for investment, are treated identically. Under these conditions, governments have frequently found it expedient to cut investments, even if highly desirable, rather than cut the budget for public employment (e.g. by reducing the number of employees). Given the prospective difficulties many EU member states face in satisfying the Maastricht criteria, this under-investment is likely to continue" ("Manifesto", p. 343).

This is exactly what happened in the major continental countries, especially in Germany and France, which have been in excess of the 3% deficit/GDP rule since 2002. Revision of the Pact is therefore expected to be approved with the next European summits.[4]

In this respect, the "Manifesto" showed great foresight, as can be seen with the situation today, and the solution indicated therein remains sound (let us remember that the 3% deficit rule cannot be changed, without revision of the Maastricht treaty). The solution cannot be found simply by applying the *golden rule* that excludes all investments from the deficit calculation, which is the rule long proposed by the UK; rather, as proposed by the "Manifesto" (p. 344), the solution can easily be found in the distinction,

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[4] Giudice and Montanino (2003) contains a good exposition of the history of the Pact, with its origins inside the EMU, as well as its advantages and problems together with the revision proposals. It also contains a large bibliography on the theme.

> "long overdue, between the current and the capital account deficit [... It is necessary] to redefine the budget deficit, for the purpose of the Maastricht agreement and the later stability pact, as consisting of the current account deficit only. The Current Account Budget should include all current expenditures and receipts (expenditures that benefit those present and receipts collected from them) and it is appropriate to require that this budget be balanced, as this places the cost of current expenditure on the current beneficiaries.
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> The amount of public capital expenditures, on the other hand, should be primarily limited by the requirement that each project should have a return over its life at least as competitive as market returns (with due adjustment for taxes). However the difference, if any, between the cash receipts and the annual cost of providing the services, including the interest cost, and the depreciation, would be charged to the Current Account as a current expense (if negative) or treated as a current income (if positive)".

Unlike from the mere *golden rule*, then, which excludes all public investments from the deficit, the "Manifesto" proposal includes in the deficit calculation depreciation of and the interest on the invested capital.

With this interpretation the 3% deficit rule should not penalize investment, whether in specific infrastructures capable of giving returns also in the short run, as proposed by Italy, or in defense equipment and research & development, as proposed by the French government. Furthermore and more importantly, this interpretation would give the Pact an anti-cyclical role. Therefore, it is to be hoped that the next Ecofin meeting scheduled for March 8 and the following European Council scheduled for March 22-23 will revise the Pact according to these suggestions. In any case, this is not to exclude further revision proposals from the agenda of these meetings, among which the following, suggested by the European Commission: 1) the need to consolidate the public finances of member countries in the upturns of the cycle; 2) the expediency to limit the use of lump sum taxes; 3) the possibility to take greater care of the public debt and the quality of public finances, including the effects of structural reforms.

In this respect, in fact, there is broad agreement among Germany, France, and Italy that revision of the Pact should stimulate, and not restrain, structural reforms, such as social security, labour market reform, and reforms in education, health and administrative decentralization. But there is the risk in all these countries that the combi-

nation of tight monetary and fiscal policies might choke off economic growth, reinforcing appreciation of the euro and making the European goods lose competitiveness in the international markets. In others words, the risk is that tight demand management policies can thwart the efforts made to improve innovation and approve such structural reforms. Furthermore, in revision of the Pact Germany insists on taking account of (in the sense of excluding) expenditure to solve problems of solidarity such as those posed by the reunification of the country and the contributions paid to the European balance (Schröder 2005).

Taking account of all these opinions, the last Commission meeting on February 2, 2005, decided to link reform of the Stability Pact to the Lisbon Agenda, which states that all member countries are committed to reaching an employment rate of 70% by 2010. In fact, the Commission proposes to apply the Pact in a more flexible way to those countries that approved structural reforms, such as social security reforms, or are committed to promoting investment programs in research and infrastructures.

As indeed is firmly required by the ECB, all proposals for revision of the Pact must be simple, transparent, not contradictory and easily applicable, and must reserve the same treatment to each member country. It is essential for these characteristics of the proposed reform to be respected because of the need for the Pact to continue defending ECB monetary policy in achieving price stability over the medium run. In this respect, let me quote Stark (2005):

> "the myth of Ulysses fascinated by the sirens' song has been recalled. But in the present situation we can't see politicians agreeing, like Ulysses, to be fastened to the mainmast. So, once the Pact was reformed, they would not be able to resist the alluring song of increasing public deficits, believing they could sustain economic growth".

It is, then, necessary that in revising the Pact a just balance be found between the expediency of a more expansionary fiscal policy and safeguarding the credibility of the common currency in the financial markets.[5]

[5] Revision of the Pact was approved at the European Council meeting held in Bruxelles on March, 22-23. The innovations introduced with the New Pact can be summarized as follows. First of all, a greater flexibility on the deficit parameter has been introduced, in the sense that those countries with an excessive deficit have a

3. Monetary policy and the ECB's role

Furthermore, it is important to stress that the change in fiscal policy must also be matched by change in the conduct of the monetary policy by the ECB. In this respect, let me quote the "Manifesto" (pp. 346-47):

> "[I]f Europe really intends to achieve a rapid reduction in unemployment, it is necessary to give a broader and more constructive interpretation to the statutes that define the role of the ECB than that which is currently widely accepted. According to that interpretation, the Bank has but one target (one single front on which to do battle), namely preventing inflation. We urge a fundamental broadening of that interpretation – analogous to that of the US Federal Reserve – to include, on an equal footing, another target: keeping unemployment under control. And we are confident that it can do so without renouncing or sacrificing its commitment against inflation".

This interpretation of the role of the ECB is supported by Article 105 of the Treaty and more recently by the new European Constitution.[6] Both provide that the primary objective of the Bank is price stability, but they also require that, once price stability is guaranteed, the European System of Central Banks (ESCB) must favour the pursuit of the general aims of the Community, including promotion of sustainable and balanced growth for all economic activities, and a high level of employment and social cohesion.

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longer time to come back below the 3% ratio. It has been agreed that a temporary ratio of 3.5% will be tolerated provided that some corrective opportunity measures have been adopted by the involved country. Secondly, those countries that passed structural reforms, such as the social security reform, can have a longer time to come back below the 3% parameter. Among the relevant factors to take into account to judge a deficit excessive, it is important to stress the role of public investment in R&D, as well as the contribution of member countries to enhancing international solidarity. The New Pact does not contain room for the golden rule, so the infrastructure investment cannot be excluded from calculation of the deficit, as solicited by Italy. However, a note included in the minutes of the meeting would allow for inclusion in the calculation of the deficit only the rate of depreciation of public infrastructure investment, just as the "Manifesto" had interpreted the Pact. Finally, nothing has changed in the treatment of the public debt, which must only converge towards the rate of 60% of GNP. In any case, the convergence must be sufficiently swift towards the ratio objective.

[6] *European Constitution*, Part II, art. 29 and Part III, art. 74.

If we take into account the point made above, that the elasticity of employment *vis-à-vis* GDP growth has recently reached the highest values of the last three decades, we conclude that this is a very favourable moment for an expansionary monetary policy to increase aggregate demand through support for investment and exportations, and eventually produce a truly positive effect on employment. In order to increase exportations, it is necessary to further enlarge the differential in the term structure of interest rates between Europe and the USA, so as to counter appreciation of the euro/dollar exchange rate efficaciously.

Unfortunately, the ECB does not seem to be inclined to follow a more expansionary monetary policy, even if the European growth rate is very low and the dollar further devaluates in the currency markets. All this weakens the economic situation of the Old Continent, although there is no risk of inflation in the short-medium run. President Trichet recently declared that in the present situation only two options are still open for 2005: the main refinancing facility rate can only stay constant, or increase, but it cannot decrease. In fact, mid-year expectations are for an increase of 0.5%, up to 2.5% (UBM 2004).

This behaviour of the Bank, which has been referred to as the "ECB anti-growth-bias" (Hein, Schulten and Truger 2004), poses some problems of evaluation and the effectiveness of monetary policy; it will be useful to discuss them briefly. In October 1998 the Governing Council of the ECB announced the main elements of its stability-oriented monetary policy. After 4 years and a half of practical experience, and searching debate reported in many of the Bank's publications, on 8 May 2003 the Governing Council announced the outcome of its evaluation of the ECB's monetary policy strategy. The outcome of the Governing Council's evaluation confirmed the main elements of the strategy originally announced in 1998, namely that price stability is defined as a year-on-year increase in the Harmonized Index of Consumer Prices (HICP) for the euro area of below 2%, and that price stability is to be maintained over the medium term. This means that in the pursuit of price stability the ECB aims to maintain the inflation rate below, but close to, 2% over the medium term (ECB 2003, p. 79).

The upper bound was set at 2% in order to incorporate a safety margin to guard against the risk of deflation. Furthermore, the reference to the medium term means that the ECB recognizes that monetary policy cannot, and therefore should not, attempt to fine-tune

price developments to short horizons. Rather, policy must take a forward-looking approach, and can only maintain price stability over longer periods of time. Therefore, the reference to the medium term allows the ECB to respond in an appropriate but at the same time flexible way to different external shocks, in order to reduce the volatility of output and employment.

The Governing Council made it clear that also in the future monetary policy decisions will be based on an overall analysis of the risks that can attempt to price stability. This analysis is based on two analytical perspectives, referred to as the "two pillars". The first is "economic analysis", signaling the risks of inflation in the short-medium run, the second "monetary analysis", linking inflation to the quantity of money in the medium-long run, when the classical theorems of money neutrality and the quantity theory remain valid.[7]

In particular, the economic analysis includes, for example: developments in overall output, aggregate demand and its components, fiscal policy, the formation and cost of capital, labour market conditions, a broad range of price and cost indicators, developments in the exchange rate, the global economy and the balance of payments for the euro area, financial markets and the balance sheet positions of the euro area sectors. All these factors help to assess the dynamics of real activity and the likely developments of prices over shorter horizons (ECB 2003, p. 88).

The monetary analysis, by contrast, applies comprehensive assessment of the liquidity situation based on information from the components and counterparts of M3, and in particular loans to the private sector. A detailed analysis of the larger monetary aggregate M3 is useful to understand the inflation movements in the long run. The more recent studies have in fact confirmed the main conclusions of the quantity theory of money: first, it has been found that long-term variations in inflation are closely associated with long-term movements in money; second, in the long run, money growth only affects prices and not output growth; third, in the medium to long term, a stable relationship exists between nominal money balances and prices (ECB 2004).

[7] The mix of economic and monetary indicators bundled together is often defined as "illuminated monetary targeting" (Graziani 2004, pp. 51-52).

In any case, to support an inflation targeting of 2%,[8] the ECB recognizes that a number of considerations suggest the desirability of maintaining a moderate positive rate of inflation. Three main arguments are generally considered: the risks of deflation (de Cecco 1999) and the zero lower bound for nominal interest rates, the possibility of an upward measurement bias in measured inflation and the presence of downward nominal rigidities in prices and wages.

Taking account of this theoretical framework, the ECB has recently confirmed its December 2004 forecasts of inflation for the euro area: for 2005 the range is 1.5-2.5% and the average expected value is 2%, slightly decreasing to 1.5-2.2% in 2006. The calculation takes account of an exchange rate $/€ of 1.29, and the price of oil of 44.4 $ in 2005, and 40.8 $ in 2006. These inflation forecasts are in line with the IMF's (1.9% in 2005), the European Commission's (1.9% in 2005, and 1.7% in 2006) and the Consensus Forecasts', which expect 1.6% for March and 1.8% for August of this year.

My comments on these inflation forecasts are the same as the "Manifesto"'s (p. 347), that is:

> "making price stability the overriding target at this time is much like using all your military budget to fight the last war, an enemy that is no longer there. Inflation has been a most serious problem because of, and during, the two oil crises and their aftermath (including German reunification). But since 1991 inflation has been falling steadily for the group as a whole, and within each country, with hardly any exception. It is now around 2%, clearly a small number especially when taking into account the unquestionable upward bias of all inflation indices".

As we have seen, this ECB behaviour bears out the impression of an 'anti-growth-bias'. In fact, the inflation rate target of 2% is too small for the whole EU currency area, which is too heterogeneous within, and where inflation and economic growth are markedly different from one country to another. The really big risk for Europe, and particularly for Germany, France and Italy, is that the sum of tight monetary and fiscal policies might trigger a perverse spiral of

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[8] Two models of inflation targeting are Mankiw and Reis (2003) for the choice of the optimal price index by the central bank, and Surico (2003) for the best inflation targeting policy of the ECB.

deflation, currency revaluation, economic slump and new unemployment growth.

4. Fiscal policy for regional development

I would like to mention a last point we referred to in the "Manifesto", which I think is very important for the ultimate solution of the European unemployment problem. This point is given by the differentials in regional economic growth and employment rates inside each European country. In the "Manifesto" (p. 350) we wrote that there is

> "evidence that the lower productivity and higher unemployment in some regions, like the South of France, Italy and Spain, reflects a paucity of entrepreneurs".

Statistically, we see that in all member countries there are underdeveloped regions where the unemployment rate is considerably higher than the European average. Apart from the Italian Mezzogiorno, where the unemployment rate is 17%, in Belgium the region of Brussels has an unemployment rate of 16%; in Germany, the regions of Berlin and Brandenburg have a rate of 18%, while the Mecklenburg-Vorpommern and the region of Sachsen-Anhalt have 20%; in Spain, Andalusia has a rate of 19% and Extremadura of 17%; in France, apart from the oversees territories with 27%, also the region of Nord-Pas-de-Calais has 13%. These rates much contrast with the corresponding unemployment rates of the most developed regions, which range between 2 and 3% (Eurostat 2004).

As we wrote in the "Manifesto" (p. 350),

> "in these less developed regions, more active policies are needed in order to encourage new firms and help small- and medium-size firms, whose growth can be accelerated by some appropriate measures".

Furthermore, we agreed that another "possible approach to stimulate investments could be through fiscal measures (subsides, tax rebates, tax credits)" (*ibid.*, p. 348). This suggestion took account of the fact that among the many motives for finding investment attractive, the most important is the fiscal incentive. Labour cost, sound functioning of the

labour market and the presence of efficient infrastructures in the region then follow in order of importance.

Recently, some countries like Ireland and Spain have attracted a large part of Foreign Direct Investments (FDI) coming into Europe with shrewd application of fiscal policy. Ireland, in particular, succeeded in attracting around 25% of these FDI, which saw the Irish GDP rise from 67% of the European average in 1985 to 123% in 2003 in the space of about 15 years. At the same time, the Irish rate of unemployment decreased from 17% to 4%.

Why should we not, then, profit from the Irish experience, taking it as a standard model for the other still under-developed European regions, starting with the Italian Mezzogiorno? The useful suggestion is that fiscal policy can be used in these regions to increase the internal rate of return of capital, net of tax. To do so, it would be sufficient to differentiate tax rates on profits among regions inside the same member country, and require that in the less developed ones a lower rate be levied. Another technical instrument that can be used to improve investment is the mechanism of tax credits. In this case, a tax credit is granted to those firms that make new investments and create new employment in the less developed regions, instead of the traditional financial support commonly given in these cases, like lump sum contributions to investment and/or favoured interest rate credits. Unlike the latter incentives, tax credits work automatically in a short span of time, and they presuppose the existence of a fiscal capacity for the firm, or in other words tax debts that the firm can offset with such credits instead of paying.

This tax credits mechanism was introduced in Italy by law (Act 388/2000) to favour those firms that make new investments in the less developed regions of the South. It was very well received by entrepreneurs, but was abruptly suspended because of the insufficient resources advanced by the government to ensure its regular working. However, taking this into experience account I suggest it is possible to solve both the following problems: the tax credit problem together with that of a regional differentiated fiscal policy aimed at increasing economic growth in the Italian Mezzogiorno.

The solution to both problems consists in transforming the tax credit into a tax rate rebate on the profits of those firms that make new investments in the Mezzogiorno. In other papers I have demonstrated that a tax credit as originally formulated by Italian law is ex-

actly equivalent to a tax rebate of 20 percentage points in corporate income tax rate, which lasts for 20 years (Moro 2002 and 2003).

The main advantages of this corporate income tax rebate can be summarized as follows:

1) the firms that make new investments in the Mezzogiorno would be sure that the tax rebate would stay valid for 20 years; this would be a very big incentive to attract new investment inside the region, as suggested by the Irish experience;

2) the corporate income tax rate in the Mezzogiorno would be reduced from 33% to 13%, which is a level very close to the Irish rate (12.5%). As a result, the Italian Mezzogiorno could compete from a fiscal point of view with Ireland in attracting FDI;

3) the tax proceeds for the government would not decrease, as the tax rebate would refer only to new investments, letting old activities pay the same tax as before;

4) it is also possible that tax proceeds increase, in that much more FDI could be attracted inside the less developed region than before.

5. Conclusions

In conclusion, I think the "Manifesto" still offers many suggestions for appropriate policies to tackle unemployment in Europe and favour economic growth in the less developed European regions. Franco Modigliani taught us many things, and in the first place how to put in practice the theoretical arguments to contrast unemployment, which is the worst evil still afflicting Europe. His teaching warns us that not all that might have been done has been done: we have seen some positive steps forward, but much more remains to be done.

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