An Economists' Manifesto on Unemployment in the European Union *

FRANCO MODIGLIANI, JEAN-PAUL FITOUSSI, BENIAMINO MORO, DENNIS SNOWER, ROBERT SOLOW, ALFRED STEINHERR and PAOLO SYLOS LABINI

1. Foreword

This *Manifesto* challenges a pernicious orthodoxy that has gripped Europe's policy makers. It is that demand and supply side policies must have different aims, that a limited number of supply side policies are

□ Massachussetts Institute of Technology, Cambridge, Mass. (USA);
Observatoir Français de la Conjoncture Économique, Paris (France);
Università degli Studi di Cagliari, Cagliari (Italy);
Birkbeck College, London (Great Britain);
Massachussetts Institute of Technology, Cambridge, Mass. (USA);
European Investment Bank, Basle (Switzerland);
Università degli Studi di Roma "La Sapienza", Roma (Italy).

* Economists who want to express their broad support for the arguments and policy recommendations of the *Manifesto*, without necessarily agreeing with every detail, are welcome. Communications of support can be sent to any Author, and will be made public. The following is a first group of economists who expressed their agreement (sometime with some reserves on single proposals) with a preceding version of the *Manifesto* (published in Italian in *Sviluppo economico ed occupazione*, a cura di B. Moro, Franco Angeli, Milano, 1998) whose main arguments are here reported: Francisco Alburquerque Llorenz (Consejo Superior de Investigaciones Científicas, Madrid), Rosario de Andrés Gómez de Barreda (Universidad de Madrid), Mario Baldassarri (Università degli Studi di Roma "La Sapienza"), Giacomo Becattini (Università degli Studi di Firenze), José Benítez Rochel (Universidad de Málaga), Oliver Blanchard (MIT, Cambridge, Mass.), Alan Blinder (Princeton University), Ascensión Calatrava Andrés (Consejo Superior de Investigaciones Científicas, Madrid), Maria Luisa Ceprini (MIT, Cambridge, Mass.), Carlo D'Adda (Università degli Studi di Bologna), Rudiger Dornbusch (MIT, Cambridge, Mass.), Hans Helmut Kotz (Deutsche Girozentrale, Frankfurt a.M.), Giorgio La Malfa (Università degli Studi di Catania), Assar Lindbeck (Stockholm University, Stockholm), Siro Lombardini (Università degli Studi di Torino), Carlos Machado (Universidade do Minho), Antonio Marzano (Università degli Studi di Roma "La Sapienza"), Ana Melero Guilló (Universidad de Madrid),

to be devoted to fighting unemployment, and that demand management (and particularly monetary policy) is to be devoted solely to fighting inflation. The prevailing orthodoxy also claims that the choice of policy instruments for combating unemployment is a political decision, in which each instrument is evaluated on a case-by-case basis.

In what follows, we outline various practical proposals aimed at a prompt reduction of unemployment. We are confident that if the advice is given proper attention by governments and monetary authorities, unemployment can be reduced significantly in a matter of a few years.

We will divide the proposed actions into those bearing on the revival of aggregate demand (demand policies) and those addressed to the reform of the labour and product markets and the system of benefits for the unemployed (supply policies). But we stress from the very beginning that we regard our proposals as strictly complementary with one another. Each proposal, applied in isolation, may produce little or even perverse effects, while the simultaneous application can be counted upon to yield the desired outcome. This holds in particular with respect to the relation between demand and supply policies. The underlying idea is that it is much easier to encourage people to look for jobs if there are jobs to be found and it is much easier to encourage firms to offer more jobs if there are more people willing to accept them.

2. The unemployment problem

We share the view that at present time unemployment is the most serious and urgent problem facing the European Union (EU). Today (October 1998), the average rate of unemployment in these countries is 11% (19 million), with peaks of 15-20%, while in the 60s and early 70s it was almost universally well below 3% and nowhere over 5%. Such a huge rate of unemployment results in an immense waste of resources, through loss of output, that can be estimated at some 15% or more, and even larger loss of saving-investment potential. It is degrading and demeaning for the unemployed and with damaging long run consequences, especially for the young that represent, in most countries, the bulk of the unemployment. And it is also a source of dangerous social tensions.

We also share the view that the measures that have been proposed in numerous meetings of representatives of member governments at various levels, including the Amsterdam (June 1997) and Luxembourg (November 1997) meetings especially devoted to this problem, suggest that many of European leaders have not adequately confronted the nature of the problem. Consequently they have not succeeded in agreeing on politically feasible programs that have a chance of producing an appreciable decline in the current, high unemployment rate in the relevant near future.

Giangiacomo Nardozzi (Università degli Studi di Milano), Fiorella Padoa-Schioppa (Università degli Studi di Roma "La Sapienza"), Luigi Pasinetti (Università Cattolica del S. Cuore di Milano), George Perry (Brookings Institution, Washington), Manuel Rodríguez-Zúñiga (Consejo Superior de Investigaciones Científicas, Madrid), Alessandro Roncaglia (Università degli Studi di Roma "La Sapienza"), Gumersindo Ruiz Bravo de Mansilla (Universidad de Málaga), Antonio Ruiz Molina (Universidad de Málaga), Paul Anthony Samuelson (MIT, Cambridge, Mass.), Javier Sanz Cañada (Consejo Superior de Investigaciones Científicas, Madrid), Gustav Schachter (Northeastern University, Boston), James Tobin (Yale University, New Haven) and Elvira Urzainqui Miqueleiz (Universidad de Madrid). Jean-Paul Fitoussi has some reserves on the supply side policies.

3. False and misleading explanations for European unemployment

The widespread acceptance of the timid program agreed so far seems to reflect in part the view, by now common in Europe, that unemployment is a calamity due to causes beyond the capacity of governments to manage, except possibly by increasing profits and generally increasing income inequalities. And this conclusion has led to a convergence of both the right and the left on the view that the scourge must be bravely endured for fear that any remedy might make matters worse.

Many possible causes have been advanced to account for the high and persistent rate of unemployment in the EU. They vary somewhat along the political spectrum. On the right, it has been argued that EU unemployment is primarily the outcome of i) the absence of the needed skills (there are jobs but the unemployed are not qualified to fill them), ii) the large share of long-term unemployed who lack motivation to seek jobs, and iii) the crushing burden of taxes. All these arguments contain grains of truth, but it is easy to be misled by them.

The first argument is supported by the observation that the rise in unemployment has fallen disproportionately on the less skilled and qualified segments of the labour force. But American experience over the past few decades suggests that when unskilled workers are not consigned to an 'unemployment trap' through misguided welfare entitlements, then the demand for unskilled labour fluctuates with the availability of jobs. When available jobs shrink, workers with higher qualifications displace those less qualified, and when demand and job opportunities improve, the unemployment rate of the less qualified declines.

The share of long-term unemployment varies substantially among EU member states; but there is good reason to believe that a large share of long-term unemployed is more the effect than the cause of a high and persisting unemployment.

As for taxes, it is estimated that in 1997 total government levies amounted to about 43% of GDP in the EU versus 31.6% in the US. But these figures fail to distinguish between taxes that pay for government services and social security levies, that represent contributions toward pension benefits - i.e. saving - even if compulsory. If one leaves out social security contributions, the tax burden (direct plus indirect taxes) drops to 27% in Europe, versus some 23% in the US. The difference in the untaxed share of income - 73% in Europe versus 77% in US - is by no means dramatic and certainly cannot account for the fact that European unemployment is 8% higher than before the early 70s, while that of the US is not higher. If unemployment were so sensitive to small differences in taxation, why is it that Germany - with a tax burden similar to that of the US (23.3%) - has unemployment similar to the rest of the European countries (11%), while the UK - with a tax burden 6 percentage points larger than Germany (29.5%) - has much smaller unemployment (5.6%)?

It is of course true that in Europe social security levies take a much larger bite from income (16% of GDP versus 9% in US). Of course the average rate of contribution for those workers actually covered by social security in many countries is much higher than 16%, and the fiscal pressure is well over 40% for countries like Italy (44%) and France (46.8), where the replacement rate (the rate of unemployment benefits to wages) is very high. These high levies, it is said, increase unemployment both by sapping the incentive to work and by raising the cost of labour to employers. But these assertions are fundamentally flawed. Firstly, the higher European levies do not, as is generally supposed, reflect the need to cover the higher costs of a more wasteful and intrusive government. They are instead the result of an explicit social choice of saving (in compulsory form) a larger portion of income in the working years in order to receive a larger pension in retirement (and to retire earlier), combined with the inefficiency of the pay-as-you-go public pension system. Secondly, social security levies generally have little influence on real labor costs in the long run because they are born primarily by labor, and not by profit earners, whether they are formally collected from the employee nominal compensation or from the employer.[1] A possible exception may arise for workers on a minimum wage, if that wage is fixed in terms of real take home pay. In that case higher social security levies cannot be shifted to the worker and will instead result in a higher real cost and price and thus higher unemployment.

As for the assertion that high social security levies reduce the incentive to find a job by reducing the difference between unemployment compensation and take-home pay, the conclusion is obviously valid only if the government pays the social insurance contributions of unemployed workers, or if pensions are independent of the workers' contributions, which is certainly not the general practice.

On the left side of the political spectrum, European unemployment has been portrayed as the outcome of iv) a crisis of capitalism, v) an excessively rapid rate of technological progress, and vi) competition with low-wage countries. All of these explanations are called into question by a very simple consideration: if they were valid, they should produce the same high rate of unemployment in all other developed countries. But in fact the sharp rise in unemployment since the 80s has no parallel among other advanced industrial countries. In fact, the unemployment rate of every OECD country nowadays is be-

[1] Social security levies may be directly deducted from the take-home pay. But even if they are not, say, because they are levied on the employer, they will tend to be added to nominal labor cost and passed on into higher price - much like an *ad valorem* tax - thereby reducing the real take-home pay by the extent of the levy, at least to a first approximation.

low the EU average and only two such countries have unemployment rates that are even close.

One further and very different line of thought that has supported tolerance toward the *status quo* is the argument that the demand and supply side factors above are an inevitable part of European political and social policy and reforms would be intrinsically undesirable. The restrictive demand side policies are commonly viewed as necessary prelude for the further economic and political integration of Europe; and the restrictive supply side measures are frequently seen as required to retain economic equality and social cohesion. It is held that governments must choose between two disagreeable options: a 'flexible' labor market bedeviled by wide income disparities and an 'inflexible' labor market crippled by unemployment. The 'flexible' market, where people's wages reflect their productivity, is allegedly achieved by reducing job security, restricting unemployment benefits and welfare entitlements, eliminating minimum wages, bashing the unions, and opting out of the social chapter. The 'inflexible' market, where people's earnings reflect politicians' judgements about fairness and social cohesion, is supposedly achieved by the opposite policies. This generates the conviction that the ultimate choice, then, is between inequality and unemployment. In this light, the high level of European unemployment is sometimes portrayed as a price that must be paid for the achievement of other important long-term objectives.

These presumptions are reflected in much of the European Union's policy approach to unemployment. The Luxembourg communiqué and those issued on earlier occasions restrict their purview to a very limited timid set of supply side policies and do not even mention the possible role of demand management policy, and monetary policy in particular, in affecting unemployment. Furthermore, they stress that unemployment is a problem that can and must be solved within each country, without explicit co-ordination of policies between EU countries even though, in joining the euro system, the member countries renounce the possibility of independent demand management policy, monetary or fiscal, and come into close competition on supply side policies.

By contrast, we believe that the bulk of European unemployment serves no useful purpose whatsoever. On the contrary, it is overtly harmful to the achievement of the objectives that have been used to rationalize the problem. Since work is the major avenue whereby people are able to claw their way out of poverty and overcome economic disadvantage, high levels of unemployment – particularly long-term unemployment – are deleterious to social cohesion and economic integration.

We call for rejecting the powerful pernicious myth, that blinds policy makers to unemployment policies that could reduce unemployment without widening the gap between the rich and poor. Thus it is important to expose the myth and get on with the urgent business of fundamental policy reform. The trick is to recognize that much of the current employment policy is responsible for the disagreeable choice between unemployment and inequality.

It is thus extremely important to differentiate carefully between the genuinely promising policy proposals and those that are unpromising in the sense that they may reasonably be expected to turn out ineffective or counter-productive. Making this distinction is not easy because many of the policies that influence unemployment are highly complementary with one another. This means that potentially enlightened policy initiatives are often ineffective when implemented in isolation from one another. Employment-promoting supply side policies frequently enhance the effectiveness of employment-promoting demand side policies, and vice versa. Furthermore, counter-productive policies often emasculate the influence of enlightened policy measures. In the domain of unemployment policy, bad measures drive out the good, and good measures reinforce one another.

In the next Section we review several of the major 'conventional' policies which have been implemented or proposed and show that they belong to the 'unpromising' set and are, in the end, an important source of European unemployment.

4. Misguided policies as a cause of high unemployment

We hold the view that the European unemployment is, in important part, the result of policy errors. These errors involve both a mismanagement of aggregate demand (demand policies) and an unimaginative approach to the supply side of the economy. We are confident that these errors can be corrected promptly, putting an end to the unremitting longer-run growth of European unemployment.

4.1. *Errors in demand management*

The words aggregate demand policy have become familiar to economists ever since Keynes used it to provide an understanding of the Great Depression and the role played in that episode by central banks. Yet at present the concept has become taboo among many European central bankers and political leaders, even though there is plenty of evidence that, in recent years, it plays a significant role in accounting for the rising unemployment.

A first suggestive piece of evidence is provided by the observation made earlier that double digit unemployment is common only in Europe - or more specifically among the countries that are in (or are candidates for) the euro. In fact, the European countries not in the euro have substantially lower unemployment rates: in Norway the rate is 4%, in Switzerland 5.5% and in the UK 5.6%.

This observation has some powerful implications. It suggests that in order to gain insight into the constellation of causes responsible for EU unemployment, it is important to identify factors that are shared by most EU member states but are not in evidence in non-euro countries.

On the demand side one experience that the euro countries have shared in common in the last few years, and generally not shared with others, has been the very restrictive aggregate demand policies, both fiscal and monetary. They have been forced to pursue these policies as a result of their common endeavour to join the euro. The common fiscal policy was the result of the Maastricht parameters and it was very restrictive in the light of the huge unemployment and resulting depressed government revenues, and of the tight monetary policy. One by-product of this policy has been the slowdown of public sector infrastructure that is complementary with private sector investment. Similarly, monetary policy was made uniform by the fact that exchange rates were to be kept narrowly fixed while all restrictions on the free movement of capital were eliminated. Under these conditions, interest rates had to be the same for all the candidate countries and there was no room for the national banks to pursue an independent monetary policy. And the common monetary policy appears to have been also much too tight, especially in the light of the tightening of fiscal policy, resulting in a long period of excessively high real interest rates that have discouraged investment and swollen unemployment.

The relation between unemployment and the demand for labour provides further evidence. Since the beginning of the oil crisis, in 1973, the rate of growth of demand has fallen considerably below that of capacity output - the sum of productivity and labor force growth. In fact the growth of demand has been roughly the same as that of productivity. Thus demand could be satisfied without a significant increase in jobs and the growth in the labor force of around 2% went to swell the ranks of the unemployed. This process of jobs falling relatively to the labor force is confirmed by direct information on the available jobs, the sum of employment and vacancies. In most EU countries, the number of jobs offered in each year as a percentage of the country's labor force has tended to fall.[2]

We believe that one reason for the drastic European decline in the demand for labor relative to its available supply - and the resulting rise in unemployment - has been a decline in investment relative to full-capacity output. In this connection it is interesting to observe that the difference between the growth of unemployment since the early 70s in Europe (8.5%) versus the US (0%) occurs mostly in two episodes since 1982. Up to that year joblessness had increased sharply on both continents as consequence of a restrictive monetary policy and resulting fall in investment, which was unavoidable to halt an inflationary spiral, ignited by the two oil crises. But after 1982 the shortfall and unemployment continued to rise in Europe till 1986, whereas in the US both fell promptly and significantly. The second episode begins in 1992 and extends to the present. In both these episodes, the investment rose relative to full capacity in the US but remained stagnant at peak levels in Europe.

[2] For example in France in 1973 there were 101 jobs offered for every 100 persons in the labor force, but by 1993 the jobs available had shrunk to 89. As one would expect, unemployment moved inversely to job availability: as jobs kept shrinking well below the people seeking them, vacancies dwindled from 4% of the labor force in 1973 to a mere 1% in 1986; search time for an unemployed person grew longer and thus unemployment rose from 2.7 to 11.6%. There was only a short span of years, between 1986 and 1990, when demand rose temporarily somewhat faster than productivity, jobs increased from 90.7 to 92.7%, and unemployment promptly fell from 10.9 to 8.1%. A similar story may be told of other EU member states.

4.2. *Misguided supply policies*

The measures to combat unemployment that have been suggested do not, in our opinion, reflect the best options available from the potential portfolio of feasible policy choices. One important source of the European unemployment problem are the misguided conventional policies that have been put into place to support the unemployed and protect the employed from job loss. The following provide three important examples.

Minimum wage legislation

Minimum wages are widespread in Europe and are potentially an important source of unemployment. The institute of the minimum wage (MW) is inspired by a lofty ideal, that any one who wishes to work should be able to secure a minimum decent living standard. The trouble is that the translation of this principle into practice typically takes a form which ignores basic economic laws and thus ends up creating great injustices and doing more harm than good. The form it takes consists in essence in forbidding firms to hire anybody for less than an imposed (fair) minimum wage or, equivalently, making it a 'crime' for anyone to accept a job for less than that fair wage. Clearly this system will 'work' for those that can in fact secure a job at the minimum wage. But if the number of people that would be willing to work at that wage or less exceeds the number of jobs that the system can offer at that wage, then it is obvious that the excess supply (if any) is condemned to unemployment, with all its negative economic and social implications. In practice these unemployed will largely consist of young people with no experience and little human capital.

It must be acknowledged that despite numerous studies attempting to measure the influence of minimum wage legislation on unemployment, to date there is little consensus about the precise nature of the impact. Although empirical studies have shown that relatively modest increases in the minimum wage may not raise unemployment, there is widespread agreement that large minimum wage hikes – wage increases sufficient to eliminate the major income inequalities between mainstream employees and workers marginally attached to the labour market – would have such an effect.

One further negative impact of minimum wages comes from their interaction with high social security levies. In so far as the minimum wage aims at assuring a minimum real take-home pay, higher Social Security levies cannot be shifted to the employee: an increase in compulsory saving will be borne by the employer and raise the cost of the employee. This is one of the important factors that make a minimum wage so high in Europe, discouraging the employment of less skilled labour.

Job security legislation

Some commentators have maintained that job security legislation helps reduce unemployment. The underlying argument is that such legislation reduces both firing (by making it more costly for employers to dismiss their employees) and hiring (by discouraging employers from taking on new recruits who may have to be dismissed in the future). But at given real wages, the firing costs generated by job security legislation discourage firing more than they discourage hiring, since firms that fire must pay the firing costs now, whereas firms that hire may have to pay the firing costs at some point in the future.

However, this argument rests on tenuous foundations. In the first place, even though firms may initially find it economical to employ more people than would be optimal in the absence of constraint, they eventually will find it advantageous to shrink their labor force, at least through attrition and aging and also rely more on overtime. Second, and far more serious, the slowdown in the flow of hiring greatly reduces the chance of outsiders, and particularly new entrants in the labor force, to find a job and is a major cause for the high, in some cases almost unbelievably high, incidence of unemployment among young people. This high rate is particularly striking in countries where no unemployment benefits are provided for people that have never held a job. In addition, a rise in firing costs cannot be expected to leave real wages unchanged. On the contrary, the greater the firing costs, the greater will be the market power of the incumbent employees (insiders) and thus the higher the wages these workers can achieve. Taking further into account the fact that the high cost of firing will add to labor costs both directly and through redundancy, we can expect a lower demand for labor, at least in an open economy.

On the whole, job security legislation must be regarded as a major negative influence on unemployment, especially youth unemployment, even if it might have desirable effects in other directions. Consequently, the lower will be the demand for labor. For these various reasons, increasing job security is far more likely to eventually decrease jobs and employment rather than the reverse.

Work-sharing and early retirement

There can be no objection to people reducing their work week or retiring early if they are prepared to accept the corresponding reduction in weekly pay, but we hold that there is no justification for the government to provide incentives for people to work shorter hours or retire earlier.

The logic underlying work-sharing and early retirement is of course elementary. If there is a fixed amount of paid work to be done in the economy, and if this work falls very unequally across the population – with a majority of people enjoying full time employment while a minority is saddled with long periods of unemployment – then considerations of equity and social cohesion make it reasonable to seek policies that share the burden of unemployment more democratically. In short, if the pain and impoverishment of unemployment are inevitable, it may the best to spread the misery as evenly as possible.

The problem with this approach is that the underlying premise is false. We do not believe that the European unemployment problem is unavoidable. The amount of work to be done in the economy is not fixed. When the economy is in recession, an increase in production and employment – in response, for instance, to a rise in export demand or on private investment – will lead to a rise in purchasing power and thereby generate a further increase in production and employment. In this sense, unemployment is not inevitable. Policy makers who see it as such are being unduly defeatist; they should spend more thought on bringing unemployment down rather than on spreading it more thinly.

We therefore agree that those measures are not appropriate as the central pillar of a policy strategy to reduce unemployment. In fact, they pose some dangers of becoming counter-productive in the sense they might reduce the total number of hours worked in the economy even if they succeeded in increasing the number of people working. It has proved very difficult to implement them without raising non-wage labour costs (particularly costs of hiring and training) and thereby discouraging firms from creating more jobs. Furthermore, by diminishing the number of people competing for jobs, these measures may indirectly put upward pressure on wages and thereby on prices. Governments or monetary authorities may then feel called upon to dampen inflation through contractionary fiscal and monetary policies, thereby generating further unemployment.

The push for shorter work week as a device to reduce unemployment by work sharing has taken recently a dangerous turn when some of its sponsors, in an effort to gain popular support for the measure, have proposed that the reduction from 40 to 35 hours should be accompanied by an unchanged weekly pay. We regard this version as little more than demagogy. It would compound the difficulties already encountered in reducing individual hours while maintaining the hours worked by the firm, by imposing a rise in hourly wages by 5/35 or nearly 15%. The effect could not but be disruptive. The increase in labor costs could hardly be expected to come out of profits but could be expected, instead, to be passed along in higher output prices. This would result in a weekly real wage equivalent to 35 hours and/or in successful demands for higher nominal wages, initiating a wage-price spiral. But with fixed exchange rates or a single currency, the rising prices would also reduce the share of the country's foreign and domestic markets and prove a new source of unemployment. This effect might be mitigated if all countries undertook the measure simultaneously, but the inflationary spiral would be reinforced.

5. Proposed policies for a timely reduction of unemployment

In what follows, we set forth a number of practical proposals aimed at a prompt reduction of unemployment. We are quite confident that if the advice is given proper attention by governments and monetary authorities, unemployment can be reduced by 4 or 5 percentage points in a matter of a few years and without compromising the recent gain in subduing inflation.

Our proposals cover both demand and supply side policies. We wish to emphasize that these policies are not to be assessed on a case-by-case basis. Our recommended policy package is not to be viewed as a portfolio of independent measures, from which policy makers can pick and choose. Rather, as noted at the beginning of the *Manifesto*, we regard the policies as complementary to one another, with the demand side policies creating a need for the new jobs that the supply side policies make available.

The failure to exploit policy complementarities may be an important reason why so many of the partial, piecemeal labour market reforms implemented in EU member states have done little to reduce Europe's unemployment problem. In Spain, for example, a labor market reform has been introduced in 1984, whose main aim was to achieve a greater flexibility in labor contracts. Among other things, this reform introduced fixed-term labor contracts with low firing costs. As a result, fixed-term labor contracts have grown quickly and Spanish firms have used them to buffer fluctuations in demand by changing the number of fixed-term employees. But, at the same time, this policy reduced the risk of unemployment for workers with permanent contracts, which reinforced the bargaining strength of the insiders. Since wage bargaining agreements mainly reflect the interests of the latter, this reform has turned out to cause more rigidity rather than more flexibility of the wage rate. To mitigate this unwanted effect, Spain has recently reintroduced some restrictions on fixed term contracts and has reduced firing costs for all workers.

In France, several acts have been passed aimed at introducing a greater flexibility in the labor market and at preventing the negative effects of both minimum wages and the highest payroll taxes among OECD countries. Moreover, restrictions on part time work have been eased, and work-sharing has been encouraged. But nothing has been done in this country to reduce the stringency of job protection legislation and the bargaining power of insiders.

In Italy, a reform of the labor market was first passed in 1991, which allowed small- and medium-size firms to dismiss redundant workers, but only with the agreement of the unions. The so-called 'mobilità lunga' (long mobility) was also introduced, which consists in the possibility to put the unwanted workers in the social security system (thus aggravating its operating costs) before giving these workers the right to definitely retire. A second reform has been recently introduced in 1997, which permits firms to hire workers temporarily from appropriate employment agencies.[3]

Also in Sweden, some reforms have been approved in order to increase labor market flexibility. In this country, unemployment benefits are of comparatively short duration, but the replacement ratios are high. Thus, jobless people can move from unemployment benefits to training programs and back, while generous welfare state entitlements encourage leisure relative to employment. In general, the welfare benefits in this country are so generous to render the condition of inactivity, especially for medium-aged people, more appealing than employment.

The United Kingdom and the Netherlands are the only two European countries that have witnessed appreciable reductions in unemployment from their labor market reforms over the last two decades. These successes may well be due to the broad-based nature of their reforms, enabling them to exploit significant policy complementarities. The UK, for instance, introduced legislation restricting strikes and secondary picketing, decentralizing wage bargaining, liberalizing hiring and firing restrictions, reducing the duration of unemployment benefits and tightening the associated eligibility criteria. Moreover, minimum wages have been abolished (soon to be reintroduced by the current Labour government) and unemployment benefits have been reduced, and, at the same time, new procedures have been implemented in order to facilitate the search for a job for the unemployed people. These reforms, together with the decision to opt out from the European Monetary Union, at least in the initial stage, have spared this country the need to adopt restrictive aggregate demand policies and have greatly contributed to the fall in the UK unemployment rate from 10.5% in the 1993 (approximately equal to the EU average) to 5.6% in 1998. This result, moreover, has been achieved without substantially changing other welfare state entitlements, such as housing benefits, or by a thoroughgoing drive to improve education and training systems.

The experience of the UK and the Netherlands also highlights the dangers of leaving particular policy complementarities unexploi-

[3] However, in a typical display of Italian partisan economic obtuseness, it has been suggested that the people to be rented out on a part time basis, should be hired by the agency on a permanent basis!

ted. In both countries the tightening of the unemployment benefit system was not matched by a correspondingly fundamental reform of the sickness and incapacity benefit systems. Consequently budgetary pressures have shifted from unemployment benefits to sickness and incapacity benefits. Since the latter have a longer duration than unemployment benefits, the shift created more serious conditions of dependency from publicly-provided income support than unemployment insurance. Thus in the Netherlands, which has one of the most generous disability benefits systems among the OECD countries, the percentage of persons directly involved in social benefits reaches 17%.

In sum, European countries have not, on the whole, sought to reduce unemployment by implementing a coherent strategy of fundamental reforms across a broad range of complementary policies. In the main, these countries have adopted a number of *ad hoc* measures that attempt marginal corrections to the most egregious distortions stemming from existing labor market policies or regulations. We argue that, since only marginal, piecemeal changes have been implemented, existing restrictive institutions and regulations that are complementary to each other continue to interact, blocking the effectiveness of the recent reforms and prolonging unemployment.

Accordingly, our recommended policy strategy is *a*) to implement a broad spectrum of supply side policy reforms that give employers a greater incentive to create jobs in response to increases in demand and give employees a greater incentive to accept these jobs, and *b*) to implement demand side policies that enable the European economies to raise their growth rates of capital formation and productivity, and to use the productive potential that has been released through the supply side reforms.

5.1. *Aggregate demand policies*

We believe that the demand side strategy for reducing EU unemployment should involve policies that stimulate a broad revival of investment activity, taking care not to ignite inflationary pressures or increase the size of the national debt relative to national assets. The process of stimulating investment is, to a very considerable extent, self-reinforcing, because of a well-established mechanism, known as

the accelerator effect. As investment rises, increasing employment and output, the initially existing excess productive capacity will become more fully utilized and there will soon be a need for additional capacity, which will require new investment.

It is generally agreed that labor and capital are often complementary in the production process, so that an increase in the capital stock usually leads to a rise in labour productivity. Provided that the economy is kept out of recession – so that the danger is avoided that firms employ as little labor as possible to meet a given, deficient product demand – and provided that there are sufficient supply incentives in place to encourage employers and potential employees to exploit profitable job opportunities, increases in labor productivity will generally lead to increases in labor demand and consequent reductions in unemployment.

The endeavour to expand the rate of investment need not, and should not, be limited to private investment. The constraints on public investment are currently felt with particular stringency because of the large public-sector debt existing in many European countries, and because of the consequent limitations on fiscal deficit imposed by the Maastricht parameters, 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.

In order for an expansion of public investment to produce the same beneficial effects on unemployment as private investment, it is necessary that it should be financed neither by cutting other expenditure – except for transfer payments whenever it is possible – nor by raising taxes (which at present would be practically impossible anyway). This means that the additional investments must be financed, for most of the countries, in just the same way as private investments are typically financed, namely by raising the money in the capital markets in the form of debt or equity. Private-sector finance of public investment, along the lines currently being explored in some EU countries such as the UK, needs to be expanded as well.

In this context, it would be important to introduce a distinction, long overdue, between the current and the capital account deficit, and 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.

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 proper 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).

Of course, deficit financing of government expenditure, when there is no room for an expansion of employment, tends to crowd out private investment, and thus burden future generations by depriving them of the return on crowded out capital. But we hold that the program of government investment we advocate will not harm and may even improve the lot of future generations. In the first place, when there is an enormous reserve of unemployed resources, investment will increase income and thus saving, at least to the extent of financing the investment without any crowding out. In the second place, infrastructural investment increases the marginal product of both capital and labor in the private sector, which will have expansionary effects. Finally, we agree that debt financing of capital expenditures satisfying the above criteria, unlike that financing a current account deficit, would not be harmful to future generations, even if it displaced an equal amount of private investment, because its return would at least compensate for the return lost on private investment.

We propose to concentrate public investment on specific infrastructures capable of giving returns in the short run. To finance these investments we propose that the existing European Structural Funds should be more used than in the past. Such funds, already considerable (153 billions of ecus for the period 1994-99), should be enlarged and their regulations should be re-negotiated, especially with regard to the procedure to spend them, since in the future they could become the main financial instrument of the European strategy to cure unemployment and promote growth. Today these funds can be spent only if the state using them provides simultaneously an equal amount of funds. This regulation is wise, but an interval should be granted when there is a proper guarantee. Moreover, to avoid delays, a particular care should be devoted to the organization of the structures in charge of the projects.

In any case, some public support for job creation is perfectly justified. The European Structural Funds were created for that purpose. Although important, their grant nature leads to inefficient uses and quarrels between providers and recipients. Therefore, there is little hope for a substantial increase of these funds in the EU. We propose to augment the grant of the Structural Funds with loans at interest rates at or below market rates. Such loans could be provided by the European Investment Bank (EIB), which has the resources and the experience in project evaluation to ensure that these funds finance sound and job-creating investments. The EIB already received the mandate of the Amsterdam and Luxembourg meetings to attach top priority to job creation. We argue that this mandate should be scaled up. For such a programme, interest rates below market rates are important otherwise the potential to stimulate investment and job creation remains limited. In countries like Italy, in which it is particularly important to keep at a low level the public deficit, recently achieved after a long and costly effort, it would be advisable to partly finance the infrastructural investments by also using a share of the receipts obtained from the privatization of public enterprises.

However, the success of the operation requires a revision of the principle that has emerged from the meetings in Amsterdam and Luxembourg, namely that the solution of the unemployment problem is not a collective responsibility but a task to be tackled by each country on its own. This approach is mistaken and will make a prompt solution very unlike. It springs from the view that unemployment is mainly due only to the malfunctioning of the labor market. But while we all concur that labour relations greatly contribute to the problem, we also share the view that demand plays a major role, relying on the evidence presented above as well as other evidence and reasoning. But the agreements of the two recent summits actually hamper the exercise of demand policy, because, after assigning to the individual states the task of reducing unemployment, they deprive them of all the classical tools of demand management: i) monetary policy, because individual central banks have already little control over interest rates and will have, gradually, even less; ii) fiscal policy, because of the rigid constraint on fiscal deficit; and iii) exchange rate policy. And the European Union, besides being exonerated of any responsibility, has no tools either: the Bruxelles Commission has no resources to spend, and the European Central Bank (ECB) is to concern itself exclusively with price stability.

The solution we are advocating, by contrast, requires co-ordination of policies of EU member states. Indeed, if any country were to engage in a demand side expansion alone, then, as is well known, its effect on unemployment would be much smaller than under a co-ordinated policy approach, because much of its beneficial impact would be lost to it and would spill over to others, through higher imports. The resulting deterioration of the current account could be so severe as to make the expansion inadvisable. But when the expansion is simultaneous and symmetric, then the increased imports will be offset by an increase in exports resulting from the increased imports of the other countries, and this will both help the current account balance and restore the potency of the expansion of investment. In short, in a simultaneous expansion, countries would be helping each other.

The role of the European Central Bank

In addition to the supply side measures illustrated in Section 4.2 below, our proposed plan advocates a significant revival of aggregate demand and that revival in turn is expected to come from a strong and long lasting inversion of the persistently declining or stagnant trend of private investment activity. We expect that some of this inversion may come from the supply measures below; but most of it, especially in the early stages, must come from the long acknowledged, classical tool of investment control: monetary policy. But this policy is the prerogative of the central banks, which, hereafter, means essentially the new European Central Bank (ECB).

This has one very basic implication: if 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.

There are three major considerations that support this view of the proper role of the ECB on the path of return to high employment. In the first place, 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.

In summary, the perils of inflation as a result of a revival of investments are negligible at the present time. And that danger will be further reduced by applying several of the supply measures advocated below, which will increase the incentives to accept jobs as they become available. We submit therefore that, under present conditions, assigning the ECB the single task of fighting inflation should not be acceptable. It leaves it far too much unnecessary leeway, e.g. given that wages are rigid, it can satisfy that target by a prudential policy of raising interest rates *ad libitum*, reducing investment and raising unemployment further.

A second reason why the ECB should not make price stability its single, overriding focus is that, realistically, it has very limited control over the price level, at least in the short run. Indeed, its policy instruments – the money supply or interest rate policy – do not directly affect prices when there is slack in the labor market. Given large-scale unemployment, they can affect prices only indirectly by affecting the rate of economic activity, and hence the rate of unemployment (and utilization of capacity) and thereby the growth of wages and finally prices. But unemployment is not a very potent instrument to control inflation when there is already plenty of slack while it has a major impact on society's welfare.

The third and crucial reason for the central role of the ECB in the program of investment expansion is that, as control over monetary policy shifts from the states to the ECB, the latter becomes the only institution that has substantial power to influence investments. The other possible approach to stimulate investments could be through fiscal measures (subsidies, tax rebates, tax credits), but such measures cannot play a significant role at this time in view of the severe fiscal squeeze resulting from the Maastricht parameters.

One can think of various objections to this reinterpretation of the role and responsibilities of the ECB. One is that the Bank lacks the power to stimulate investment. This objection is especially popular among central bankers. But this argument is disingenuous. How can a central bank claim that it can control prices if it cannot control demand and how can it control demand if it has no control at all over investment? Another objection is that the euro needs to establish itself as a prestigious, credible currency in the world capital markets. To satisfy this need what is required is a policy that will be viewed as continuation of the tough policies of the Bundesbank, involving high interest rates that will attract capital and help to support high exchange rates, especially with respect to the dollar, seen as the major competing world currency. We believe that it would be a deadly mistake for the ECB to focus on a competitive struggle with the dollar, fought through the escalation of interest rates, and at the expense of an economic revival. The high value of the dollar is the result of the strength of the American economy achieved through a policy of full employment pursued with 'benign neglect' of the international 'pecking order'. The ECB must adopt the same attitude of independence aiming at fostering an economy as vigorous and prosperous as the American economy.

The awesome responsibility of the ECB for maintaining high growth in Europe have become even more serious with tragic events of the last few weeks in Asia, and Russia and the sharp set back in the equity markets. It is up to the ECB and to Europe with its still sound fundamentals to engage in a policy of supporting domestic investment and demand offsetting the expected decline in net exports.

5.2. *Supply side measures*

We do not believe that a widespread liberalization of the labor market in Europe, along the lines of that existing in the American or Japanese labor markets, is advisable, even if it were feasible. It is important to keep in mind that the present European welfare systems spring from different cultures and from different ways to interpret the solidarity and equality principles. However, we think that, in order to fight unemployment, it is necessary and feasible to introduce a substantially higher degree of flexibility in the European labor and product markets including, where necessary, a relaxation of job security legislation, a reduction in the coverage of collective bargaining agreements, and a reduction of barriers to entry of firms and of barriers to geographic mobility of labor. We believe that if such measures are combined with the reform strategy outlined below, both the efficiency and equity of European labour markets can be improved. The economic instruments now available in many European countries to pursue these efficiency and equity goals are insufficient. The portfolio of policy instruments needs to be expanded, along the lines suggested hereafter.

The labor market flexibility policies, unlike the macroeconomic management, cannot be uniformly adopted by all the European countries; on the contrary, they should be adapted to the different situations of each country and region. We begin by recalling that an important aspect of European unemployment is found in the regional differences that characterize this phenomenon. We believe that one important source of differential unemployment within countries is the uniformity of wages imposed by unions or custom in national negotiations, disregarding the glaring fact of important regional differences in productivity. We are in agreement that to remedy this problem requires recognizing the need for regional differentiation in labor cost per hour reflecting regional differences in productivity. But in order for these reforms to obtain a large social consensus, it is necessary that they be accompanied by measures that compensate for their negative effects on income distribution. In fact, it is evident that fundamental labor market reforms are very difficult to implement because usually, while they have readily identifiable distributional consequences for specific groups of people, it is not always easy to readily see their advantages for everybody. For this reason, it is likely that the most radical components of the reform packages will probably face strong opposition from the groups most affected by such reforms. Compensating the prospective losers is important to mitigate this difficulty. With respect to the realignment of labor in line with productivity one basic approach is not to put all the emphasis on reducing wages but on reducing cost to the firm through appropriate subsidies. Some suggestions for accomplishing this task efficiently are suggested below (see e.g. the paragraph on the benefit transfer program).

There is also evidence that the lower productivity and higher unemployment in some regions, like the South of France, Italy and Spain, reflects a paucity of entrepreneurs. We share the opinion that 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. For example, Italy has had some success with industrial districts. By industrial districts we mean here some horizontal aggregations of small- and medium-size firms, where each firm operates in an autonomous way from the others, but whose production is in fact co-ordinated with others in the district, with resulting external economies.

A successful example of regional development pushed on by the diffusion of industrial districts is the functional integration of small- and medium-size firms that occurred in many Italian regions like Toscana, Marche, Veneto and Emilia Romagna. But, for the regional development to further proceed by the implementation of this model, we need to introduce some reforms of the industrial districts, so as to reinforce them and make them more effective and dynamic. Such measures should aim primarily at creating advisory institutions in the field of bureaucratic, fiscal, financial and technological matters. As for the new technologies, it is fitting to emphasize the importance of the re-organization and the expansion of institutions for labor training and of the relations between firms and universities and other research institutions.

Another characteristic common to many underdeveloped regions is the rationing and high cost of credit, which affects new and small firms in general, reflecting both the cost of processing small loans, their risk, as well as the monopolistic power (and sometime the inefficiency) of the local banks. In these regions the spread between lending and borrowing rates has been huge and nearly prohibitive, discouraging small firms and new initiative. In some countries like Italy a great improvement in the availability and cost of loans has been obtained through the formation of cooperative of borrowers. The members of the cooperative, in exchange for the availability and lower cost of credit, must be willing to assume some personal responsibility to guarantee the repayment of the overall obligation assumed by the cooperative, something they are willing to do because of personal knowledge and trust of those who are admitted to the cooperative. In addition local governments (regional or subregional) typically have provided a rotating fund which also serves to increase the guarantee offered to the banks.

We advocate, where necessary, a broad supply side reform package that includes the following well-known elements:

– *job creation policies* and product market reform to reduce barriers to employment creation.

Examples of such policies include tax reform or relaxation of regulations restricting the entry of firms, restrictions on land use, regulations limiting product market competition, as well as measures to avoid penalizing flexible time schedules and part time work. Measures to encourage part time leasing of workers may help not only to provide currently unemployed workers with a stepping stone into the world of work, but also help firms restructure their organization of production and work in accordance with the new advances in information technology and flexible manufacturing.

The tight regulation of the atypical working contracts now existing in many European countries deserves special attention in formulating labor market reforms.

– *Restructuring of the minimum wage institution.* We have indicated that the minimum wage tends to be harmful because it is a potential source of unemployment. Yet we cannot advocate the simplistic solution of abolishing that institution altogether because we share the view that its purpose to ensure a decent minimum standard of living to a full time worker is a worthy one. The trouble with the present structure is that a 'decent' wage may prove to be higher than what would be required to induce employers to absorb the excess supply. If so, the only way to reconcile the 'fairness' principle with high employment is to create a wedge between the remuneration received and the cost to the employer.

In reality such a wedge already exists in most economies, but in the direction opposite to the desired one: that is, the cost to the employer is typically substantially higher than what the worker actually receives in his pay-envelope. In many European countries this so called wedge may be close to 50%: the pay envelope may be not much more than half the cost to the employer.

This has led to simplistic solutions to the problem of lowering the cost without reducing the income - namely to abolish the wedge, misleadingly regarded as 'fiscal levies' on the firm. But this solution ignores the fact that in reality the wedge is part of the remuneration of the worker, even if it is not in the form of cash. It consists in the first place of the income tax, which is part of workers' income, even if it is withheld from this income. The rest consists mostly of social security contributions, or compulsory saving (amounting in much of Europe around to one third part of income), of which some one third may be formally taken out of wage, while the other and major part is paid by the employer, but on behalf of the worker. On top of this the employer may pay some insurance for the worker. It is obvious that these amounts are part of the worker's remuneration, as they provide him with personal benefits, such as a pension or insurance against unfavorable events, even though they may be mandated. If the wedge, or part of it, were abolished, the worker would in effect receive a smaller remuneration. In addition, the social security system, being generally on a pay-as-you-go basis, would run into deficit. This could be avoided if the cost of the wedge were taken over by the government, as has been done some time on a limited scale. But this would be expensive and inconsistent at present with the need to satisfy the Maastricht criteria, unless more taxes were raised, hardly conceivable at present. What we seek then is a way to reduce the cost to the employer, while maintaining the take-home pay and minimizing the negative effects on the budget and the social security system.

We suggest that this might be achieved along the following lines.[4] Let the employer continue to pay the same take-home pay, and some fraction, say one third, of the social security contributions. Suppose, in addition, the government agreed to forego the income tax

[4] What follows is a broad description of the proposed approach, with the caveat that the details have to be elaborated taking into account the existing institutions.

levied on this income, say around 20%. Then labor cost per hour would be reduced by some 40-45%.

Let us next stipulate that this special kind of treatment would be reserved to those unemployed that are least employable, namely those who have never held a job and the long-term unemployed in the depressed areas.[5] We submit that in this case there would be no significant loss to the government because the recipients would likely have remained unemployed and paid no taxes anyway. For the same reason, the social security would not loose revenue but more likely gain, because of the payment of one third of the contribution. Would then any one bear any loss from our proposal? At first sight the answer may seem: the worker who has been deprived of the two thirds of the employers contribution toward his pension benefits. But on the close examination this answer does not hold. In the first place, if he remained unemployed, the contribution to his pension would be zero, compared with one third under our proposal. It remains true that he will have lost two thirds of the contribution compared with what he would have secured had he found a job at standard wage (which he could not). But that only means that his current compulsory saving is below standard. All this should be perfectly acceptable in a life cycle perspective where we expect people to save little, if any, when they are young and relatively poor. We should expect then to make up for the low saving by saving more when they can afford it better. We propose to use this lead by incorporating into our scheme the right of any one accepting our 'special' minimum wage (which is in any event not compulsory) to make up for say another third of this initially lost contribution. (The employer could be asked to match this contribution partly, as further inducement to a delayed contribution.)

The above is merely meant as an illustration of the appropriate strategy to deal with minimum wages: not abolishing them but finding appropriate acceptable ways of reducing the wedge.

- *An extension and generalization of fixed-term and part time jobs* could favor youngsters and women, whose possibility to work is often tied to these more flexible kinds of contracts. Usually, on the contrary, the existing laws favor only permanent or long-term labor contracts, which are much less flexible.

[5] Note that e.g. in Italy the first of this two groups alone represents about half of total unemployment.

– *Reform of job security legislation policies* to reduce the ratio of firing costs to average wages.

We have criticized earlier the policies that have pushed job protection, to the point where firing of workers was a nearly impossible task. Although the situation has generally improved, there seems little question that the present institutions in many European countries still contribute to the unemployment problem by discouraging firms from hiring permanent employees even in the presence of a rising demand. We therefore share the view that the reforms needed to reduce unemployment must include substantial reforms of the job security provisions.

We do not believe that it would be possible or advisable to push reforms as far as the American system, where job security provisions are largely absent. But there must be a marked liberalization of the ability of firms to eliminate surplus labor, and some with respect to dismissal of individual workers for cause. This is particularly important in order to deal with youth unemployment, which is a serious problem in many European countries.

However we recommend that these reforms be postponed to a more suitable time. To carry them out now, when the demand is greatly depressed and there is plenty of unemployment, probably a good deal of redundant labor in many firms and few vacancies would have simply the effect of condemning many workers to join the rank of the unemployed, initially reducing instead of increasing employment. It would therefore meet with an understandably bitter opposition of union and workers who might well succeed in maintaining the *status quo*. In our view, therefore, the reforms should be postponed until, and made conditional upon, the realization of more favorable labor market conditions, which should hopefully not take very long if our program is pursued. But it would seem feasible and desirable to spell out promptly the conditions for proceeding with the reforms, e.g. when unemployment first reaches 7%. Furthermore, the content of these reforms should be agreed upon promptly. This two-stage approach should make the reforms far more palatable to labor while at the same time encouraging employers to assume more labour as the demand expands in the expectation that, if eventually the new employee assumed should prove redundant, they would be able to scale down their labor force.

– *Search promoting policies* to reduce labor market search costs, such as job counselling, information provision to unemployed workers and firms with vacancies. The UK experience with its Restart Programme and its counselling initiatives associated with the Welfare to Work policy indicates that such search promoting policies have an important role to play in enhancing the effectiveness of other employment creation measures, such as employment vouchers and training initiatives. These latter measures are likely to have a strong influence only if the currently unemployed workers are aware of them and help to make use of them as part of explicitly formulated strategies of gaining long-term employment in accordance with their idiosyncratic abilities.

– *Policies to stimulate worker mobility*, such as policies to increase the portability of housing subsidies, as well as the portability of health insurance and pensions between firms; and

– *unemployment benefit reforms*. Unemployment benefit systems should be reformed in such a way as to give unemployed people appropriate incentives to seek work when jobs are available for them and to support them when such jobs are absent. Accordingly, the size of unemployment benefits could be made to depend on the ratio of vacancies to unemployment. The greater the number of vacancies relative to unemployed (in specified skill categories), the lower the unemployment benefits would be (within these categories). This proposal would promote efficiency, since it would give the unemployed a greater incentive to search, the greater is the firms' demand for their services. It would also help fulfil governments' equity objectives, since unemployed people are in greatest need of support when they are unable to find work.

This policy would generate a favourable complementarity between demand side and supply side policies. A government stimulus to aggregate demand (and thereby vacancies) could then be financed, partially or wholly, through the associated drop in unemployment benefit payments.

The political economy of unemployment benefit design could be influenced through the device of charging the cost of unemployment compensation to the public in the form of a separate tax. At present, the cost of unemployment, both its social cost and the cash cost of the benefit systems is not well known, because, as has been frequently noted, it typically affects but a small fraction of the population, and the cash cost is not the very visible. This has the consequence that, on the one hand, the public does not put enough pressure on the government and the central bank to correct the situation, and on the other hand it makes voters frequently inclined to favor programs that grant excessive unemployment benefits through mechanisms that are economically wasteful. The above segregation would improve voters' information on this issue and permit them to make better informed policy choices.

Finally, we should like to stress that while the enforcement of specific micro-supply policies is primarily a matter for the individual member governments, all the member states share a common interest in the design of the unemployment policies and in making sure that these policies are forcefully pursued everywhere. This conclusion rests on the consideration that, because of the rising degree of factor mobility within the EU, as well as EU regulations concerning open market access and cross-border competition, the appropriate level of subsidiarity in unemployment policy making does not lie exclusively at the level of the EU member states. In addition, each member state has a very real and tangible interest in the reduction of unemployment in other countries as it contributes to reduce its own. Therefore the European Commission needs to take the lead in providing a legal and institutional framework within which necessary labor market reforms can take place and in making sure that the reforms are promptly carried through.

In addition, we believe that EU governments should also consider some more innovative supply side policy proposals that are designed to reform the incentives that employers and employees face. Currently EU governments spend massive sums of money on unemployment support, further education and training. We believe that the question that should be asked is whether these funds could be redirected to create more incentives for employers to generate jobs and workers to become employed. The following are some illustrative policy measures that take this tack.

Conditional negative income taxes

This measure may be seen as an alternative to supporting jobless people through unemployment benefits. The conditions attached to the

proposed negative income tax would be analogous to those attached to current unemployment benefits. For instance if, under the current unemployment benefit system, people must provide evidence of serious job search in order to qualify for unemployment benefits, then they must also be required to provide such evidence under the proposed conditional negative income tax system; if unemployment benefits decline with unemployment duration under the current benefit system, then so too must the negative income taxes.

The Earned Income Tax Credit (EITC) in US belongs to this family of initiatives. The socially desirable relation between the magnitude of the negative income tax and the individual level of income has yet to be analyzed rigorously. The EITC is hump-shaped (so that the magnitude of the negative income tax rises with income at low income levels and then falls toward zero at higher income levels), whereas many of the proposed negative income tax schemes involve a strictly inverse relation between the size of the tax and the income level.

The broad argument in favor of a switch from unemployment benefits to negative income taxes is that this policy could meet the equity and efficiency objectives of current unemployment benefit systems more effectively than the unemployment benefit systems themselves. Although conditional negative income taxes would generate the same type of policy inefficiencies as unemployment benefits, the former would tend to do so to a lesser degree than the latter. For example, negative income taxes may be expected to discourage job search, but by less than unemployment benefits, for when a worker finds a job, he loses all his unemployment benefits, but only a fraction of his negative income taxes.

It is worth noting that a major criticism of the traditional negative income tax schemes – namely, that they make people's material well-being less dependent on employment and thereby discourage employment – obviously does not apply to conditional negative income taxes, since these taxes are conditional on the same things as current unemployment benefits.

Furthermore, conditional negative income taxes also tend to be more effective than unemployment benefits in overcoming labor market inefficiencies generated by credit constraints (e.g. people being unable to take enough time to find an appropriate job match or unable to acquire the appropriate amount of training on account of credit constraints), since the presence of these constraints is more closely associated with low incomes than with unemployment.

The benefit transfer program (BTP)

The aim of the Benefit Transfer Program is simply to redirect the funds that the government currently spends on the unemployed – in the form of unemployment benefits, temporary layoff pay, redundancy subsidies, poverty allowances, and more – so as to give firms an incentive to employ these people. The BTP gives the long-term unemployed people the opportunity to redirect some of the benefits to which he is entitled to a voucher that can be turned over to a firm that will hire him.

The magnitude of the vouchers is to be set by the government, and depends on the magnitude of individuals' unemployment benefits (the higher the benefits, the higher the vouchers) and unemployment duration (the longer the unemployment spells, the higher the vouchers). The size of the vouchers is set so as to be financed from the unemployment benefits and other welfare entitlements foregone when people move from unemployment into jobs. Once a person is hired, the voucher gradually declines as the duration of employment proceeds. The vouchers could be given either to the prospective employers or employees. When unemployed people find jobs, they give up their unemployment benefits in exchange for the wage they earn.

The vouchers come in two varieties: 'recruitment vouchers' and 'training vouchers'. The former are granted solely on the condition that a previously long-term unemployed person is recruited; the latter are conditional on the employer being able to prove that the voucher is spent entirely on training the new recruit at nationally accredited training schemes. The recruitment and training vouchers both are related in the same way to the duration of a person's previous unemployment and the duration of that person's subsequent employment, but the level of the training voucher (other things equal) is higher than that of the recruitment voucher.

Since the BTP is voluntary, it extends the range of choices open to the unemployed and their potential employers. The unemployed will join only if it is to their advantage, i.e. if the wages they would be offered are higher than their unemployment benefits. At the same time, employers will join only if they find it profitable. Once again, many could well do so, since the vouchers could reduce their labor costs. In short, employees may wind up receiving substantially more than their unemployment support, and many employers may find themselves paying substantially less than the prevailing wages. The BTP has the unique capability of making most participants in the labor market better off: the unemployed who earns more, the employer who secures a lower cost, and the government that reduces its expenses incurred for the unemployed. This 'free lunch' is possible since the BTP induces people who were previously unemployed to become productive, and the proceeds of the output they generate may be divided among the economic agents above.

The BTP has been implemented in various forms in the UK, the Netherlands and several other OECD countries. Empirical studies of the program indicate that there are three major obstacles to its effectiveness: i) displacement of current employees by the targeted groups of workers, ii) dead-weight (paying vouchers to unemployed people who would have found jobs anyway), and iii) substitution (the employment of the targeted group rather than unemployed workers outside the targeted group). The first obstacle can be mitigated by confining the vouchers to firms that increase their total employment relative to their industry average.[6]

The second and third obstacles can be reduced by targeting the employment vouchers at the long-term unemployed (since they have a relatively low probability of finding jobs anyway and are often imperfect substitutes for the short-term unemployed). However, these measures can only reduce, but never completely eliminate displacement, dead-weight and substitution. Nevertheless, evaluations of the program in the UK and the Netherlands have shown that, when the program is appropriately designed, it is able to create significant additional employment without putting upward pressure on wages. Moreover, even if the vouchers lead some firms to substitute their current employees for subsidized workers to retain the subsidized workers only so long as their vouchers last, the program will still succeed in substituting short-term for long-term unemployment. This would

[6] The condition must be formulated relative to the industry average, for otherwise the scheme would be less effective in economic downturns – when the need for employment creation is greatest – than in upturns.

still lead to a fall in aggregate unemployment, since the short-term unemployed have higher chances of employment than the long-term unemployed.

Beyond that, the BTP is not inflationary, since it reduces firms' labor costs and since the long-term unemployed have no noticeable effect on wage inflation. If designed properly, it costs the government nothing, since the money for the employment vouchers would have been spent on unemployment support anyway.

By offering higher vouchers for training, the Program could become the basis for an effective national training initiative. Clearly, firms will spend the vouchers on training only if they intend to retain their recruits after the subsidies have run out. Thus the training for the unemployed would automatically come with the prospect of long-term employment. This is something that the existing government training schemes do not offer. Many existing schemes also run the risk of being ill-suited to people's diverse potential job opportunities, whereas under the BTP firms would naturally provide the training most appropriate to the available jobs. And whereas the existing training schemes are costly to run, the BTP is free.

Finally, the BTP could play a vital role in tackling regional unemployment problems. Regions of high unemployment would become areas containing a high proportion of workers with training vouchers, thereby providing an incentive for companies to move there and provide the appropriate training.

Auctioning off unemployment benefits and employment vouchers

Existing unemployment benefit systems could be radically reformed to improve the incentives for job creation and job search without exacerbating disparities in incomes. Auctioning employment vouchers and auctioning unemployment benefits may be useful in this regard.

Regarding the former proposal, the government could auction employment vouchers to the firms. Firms would qualify for a number of vouchers equal to a) the number of previously unemployed people they intend to hire minus b) the number of employees they fire (or separate from).[7] Firms' entitlement would also be withdrawn if they

[7] This difference may be adjusted for average changes in employment within that sector. Specifically, if sectoral employment is shrinking (expanding), then firms

used the vouchers to displace current employees. To make this provision credible, employees who believe they have been displaced would have the right of complaint, to be investigated by an independent body. If the complaint is found to have been justified, the firm in question would be fined.[8]

To prevent the short-term unemployed driving the long-term unemployed out of the market, there would be separate options for workers belonging to broad groups with different unemployment durations. Another possibility is for the government to auction employment vouchers to unemployed people.

The aim of the supply side proposals here presented, then, is to transform unemployment benefits and other social security grants in incentives to firms to create more jobs and to workers to accept them.

6. Conclusion

In sum, we believe that the EU unemployment problem needs to be attacked on two fronts: through a broad spectrum of supply side policies and the demand management policy. The expansion of 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.

receive a number of vouchers greater (less) than the difference between the number of unemployed people hired and the number of employees fired. The reason for this adjustment is to avoid the possibility that the effectiveness of the voucher policy may diminish as the sector falls into a recession.

[8] This anti-displacement provision has been successfully tried in Australia.