Panel 2

The Labour Market and the Job Miracle

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Flexibility, Job Creation and Economic Performance

Introduction

Many European economies lack robustness and vitality. They are losing ground in the international economic race. Unemployment is high and employment growth is low. Their competitive position in world trade is weak in areas of high technology, such as computers, communication technology, and biotechnology.

Europe's poor economic performance is a symptom of two interrelated factors. First, incentives for investment in skill (human capital) and venture capital are weak as a consequence of current European levels of regulation, taxation and bureaucratization. Second, most European economies are unable to respond rapidly to change. The new economy of the twenty-first century is characterized by variability and the need for flexible responses. This variability creates opportunity, but only for those able to respond quickly and with efficiency. The new economy creates a demand for highly skilled labor and venture capital to respond to its new opportunities. The social system in Europe impedes rapid responses and hence thwarts Europe from making use of the opportunities created by the new economy.

To understand the problems that beset the European economy and the possible solutions to these problems, it is important to understand the causes of these problems more clearly and to distinguish the short-run from the long-run problems. It is the incentives in place that have long-run consequences that are the most worrisome because they affect the way Europe will perform in the next generation. Large growth rates produce high wealth levels for future generations while small growth rates produce low wealth levels. Europeans should be worried about these rates, although most political discussions focus only on short-run income levels.

One immediate problem facing much of Europe is high unemployment and slow job growth. European unemployment has increased to extraordinarily high levels over the past 20 years. Something has changed and that something is common to many countries in Europe. Understanding that common factor, or set of factors, is the topic of a lot of recent research in economics.

There is a substantial body of microeconomic empirical evidence pointing to the fact that incentives matter and that firms, individuals, and entire nations respond to them. Disincentives imposed on firms such as minimum wages, union-imposed wage floors, or entry regulations have substantial effects on employment and wage growth when the minimums are binding. Studies from France, Latin America and the United Kingdom, where minimum wages are often a substantial fraction of average wages, have shown substantial disemployment effects of wage floors. Yet in the public discussion of employment creation these disemployment effects are minimized or ignored entirely, and advocates of minimum wages appeal to deeply flawed empirical studies to support their position.

Incentives motivate economic life. It is important to understand how the modern welfare state affects these incentives in order to understand why welfare states perform the way they do.

When the American economy is compared to most European economies, it is not hard to reach the conclusion that it is something about incentives in the regulatory welfare state that gives rise to the differential performance of these two types of

economies. This paper is about those incentives, how they affect economic performance, and how incentives might be changed to improve that performance. I consider the economic consequences of these incentives in both the short and the long run. Elections are won on short-term performance, so politicians and policy makers focus on short-run problems. As a detached scholar of regulation and economic growth, I want to direct attention to long-run issues. Nations prosper or founder on their long-run economic performance.

This paper makes four main points and presents empirical evidence to back them up.

1. The incentives in European welfare states distort resource allocation and impair efficiency

The consensus estimate of the welfare cost of taxation and regulation – what economists call deadweight burden – is 40% for each euro raised by taxation and regulation, and some would place the cost far higher. These costs arise from the distortions in economic activity induced by the fiscal system. Much more than the direct cost of taxation is involved.

Centralized bargaining and regulation of business entry, banking practices, and employment all contribute to the burden. The levels of these disincentives are higher in Europe than in America, and this contributes to higher unemployment, lower employment growth, and a lower level of effort in society. Such disincentive effects are much discussed in academic circles but they rarely make their way into popular discussions of policy issues. One of the worst examples of a bad policy in the current European system is the Italian system of Cassa Integrazione. It does not provide universal insurance for all workers like a properly functioning unemployment insurance might do. It only protects workers in larger firms that qualify. It is not a wage subsidy so it does not promote work or employment. It has the effect of protecting a few insiders in large protected firms at the expense of revenues collected from workers at all firms. In addition to being unfair, it props up inefficient firms and plants of firms and reduces productivity.

The benefit of the welfare state is alleged to be the social insurance it provides. According to this argument, the efficiency cost of taxation and regulation is to be set against the benefit of greater equity and security (Agell, 1999). A closer look at how the system works in many other European countries shows that it produces security and even wage gains for protected insiders at the cost of inequity, job loss, and income losses for outsiders who are only partially protected by the "social insurance". Far from promoting universal social justice at the price of efficiency, it provides security for some, at the cost of exclusion and wage loss for others.

2. The World Economy has become more variable and less predictive

The inefficiency and distortions created by the modern welfare state cannot explain the growth in European unemployment over the past 20 years. The edifice of the welfare state was in place 30 years ago, and arguably the incentives then were less favorable to employment than they are now (Ljungquist and Sargent, 1998, 2002; Blanchard and Wolfers, 2000). A vast empirical literature over the past 25 years has documented the distortions created by the welfare state. Many European governments reduced the worst of those incentive features in response to the findings from this literature but typically only by modest amounts. However, the reforms in Europe only partly close the incentive gap with America.

What is it, then, that accounts for the rise in European unemployment? This is the second major topic of this paper. A growing body of evidence points to the fact that the world economy is more variable and less predictable today than it was 30 years ago when the modern European welfare state with its high levels of taxation and regulation was established. This variability is associated with the entry of many countries into world trade; with the creation of new financial markets and markets for goods; and with the explosion in technology, especially in computers, information technology, and biotechnology. This variability is associated with the onset of skill-biased technical change proceeding at an uneven and unpredictable pace that is still transforming the workplace and making traditional methods of production and management obsolete. Many empirical studies have shown that skill-biased technology is at work in advanced countries as well as Third World economies. These developments contribute to enormous increases in productivity in many industries and create new trading opportunities. At the same time, they lead to more variability

and unpredictability in economic life. This variability is a source of wealth for those who can adapt to it.

The manifestations of the new variability are legion: rising wage inequality in markets favoring skilled workers in freely functioning labor markets, large scale increases in merger activity, and in patenting that occurred in the early 1980s at the time wage inequality began to increase and growth in volatility in trade and in some financial markets. The world has become more open and more fluid and at the same time many traditional methods and organizations have become obsolete.

We live in an era of creative destruction. The new order grows out of the old by destroying the old ways of producing goods and trading. This is an era of greater risk and greater return. The modern welfare state even at its newly "reformed" level is maladapted to this new world economy because it discourages risk taking and efficient adaptation by providing "social insurance" like employment protection laws to preserve the status quo at precisely the time when many old economic practices are no longer productive. This explains why so many of the piecemeal reforms implemented in many European welfare states have apparently failed and have been associated with rising unemployment. These reforms would have promoted employment and reduced unemployment in a former era. In this modern era of change they do not go nearly far enough to make the reformed economies flexible enough to respond to the new and changing world economy. The world has been changing too fast for European politicians and policy makers to keep up, and Europe will now have to run to keep in place.

An economic order that was well adapted to the more stable and predictable economic environment of the 1950s and 1960s has become dysfunctional in the late twentieth and early twenty-first centuries. The problem of unemployment in Europe is not solely due to the high cost of labor, although that is a problem (Bertola, 2000). It is also due to the inability of the many European economies to adapt to change and to exploit the opportunities and challenges of the new economy. The opportunity cost of security and preservation of the status quo – whether it is the status quo technology, the status quo trading partner, or the status quo job – has risen greatly in recent times.

3. Uniformity in the prices of traded goods dictates labor market outcomes

The opening up of world trade and the increased competitiveness that flows from it means that now, more than ever before, uniformity in the prices of traded goods dictates labor market outcomes. Benefits given to workers are costs to firms and must be paid for in terms of lower wages or less employment. Something has to give in costs because market prices are set internationally and, increasingly, capital markets are uniform around the world. Thus nonwage mandates to workers nominally paid by firms must be borne by the workers themselves. Higher wages achieved by unions or by minimum wage statutes must lead to substitution against labor – fewer jobs – if firms are to remain competitive.

4. Diversity, heterogeneity of opportunities, and value of local knowledge

These are the hallmark features of the new economy. One feature of the dynamics of the new order is that many idiosyncratic opportunities arise as potential trading partners and potential production partners seek each other out.

The old economics focused on stable technologies where broad aggregates such as capital and labor were assumed to be homogeneous. The economics of the modern era focuses on models of matching and sorting of heterogeneous individuals into trading and production units in the face of uncertainty about the suitability of any particular trading or production arrangement. This is a new model of the economy that features the unique and the relation specific. It is a model of marriage that emphasizes the value of partners that know each other in making the decisions to produce or trade and the value of divorce when circumstances change.

It is a model of the gains to trade among idiosyncratic individuals. The new model emphasizes the value of local knowledge and the benefit of exploiting local knowledge about particular possibilities and circumstances that are not widely known. The new economy emphasizes that one person's gain is not another person's loss and that economic efficiency is enhanced by allowing those equipped with local knowledge to act on it.

A striking example of the benefit of acting on local knowledge is the reform of British unionism. When

the locus of bargaining was shifted from the national and industry level to the firm level, the face of British unionism changed for the better (Pencavel, 2000). Firms and workers in Britain are now allowed to respond to the local opportunities and conditions that characterize their particular situation and can more freely adapt to those conditions than they could when national wage setting arrangements were in place. National or industry bargaining diverted the attention of workers away from the economic realities of their own productive situation and toward the redistributive possibilities that flow from the application of uniform rules across diverse industrial or national units. Not only does the implementation of local bargaining exploit local information and hence promote productivity but it also inhibits the application of monopoly and rent seeking that occurs when bargaining units become more expansive. Unionism per se is not a cause of inefficiency. Rather it is monopoly unionism using its power to redistribute resources and divert productive activity that leads to great harm.

In the case of Italy, national wage setting norms applied to the Mezzogiorno are a cause of low employment in that region. There are strong parallels between the German experience with its East and the Italian experience with its South (see Sinn and Westermann, 2001). In both cases, national policies applied across all regions retard the development of the relatively underdeveloped region. Rather than let wages adapt to local economic realities, and promote growth, current union policy stifles development of the South of Italy and the East of Germany. A policy of uniformity suppresses the possibility of exploiting regional diversity for the benefit of all.

In summary, this paper establishes that the European economy labors under the burden of heavy regulation and weak incentives. The European welfare state has succeeded in raising the wages and benefits of protected insiders but at the cost of low employment growth, low productivity growth in the manufacturing sector, and higher cost of unit labor. These factors threaten the long-term competitive position of Europe in world trade and inhibit European states from investing in the technologies of the future.

In analyzing European employment problems, I stress the importance of distinguishing long-run from short-run problems and long-run from short-run solutions. European unemployment is a structural problem. A substantial portion of European unemployment is a symptom of the deeper problem that incentives to innovate, to acquire skills, and to take risks have been thwarted by the welfare state and regulation. The costs of preserving the status quo have increased in the new world economy that is characterized by many new opportunities in technology and trade. The winners in world trade in the next generation will be those countries that can respond flexibly with educated work forces.

In pursuit of social justice – which in actuality is a defense of a protected enclave of workers and firms – Europe has muted incentives to invest in ideas, skills, and new technology. These muted incentives portend a second-rate European economy of the future.

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EFFICIENCY AND EQUALITY IN THE LABOUR MARKET

Unemployment in the United States stood at 6.8 percent in 1991, and dropped to a post-war low of 4.0 percent in 2000.[1] At the same time leading European economies struggled to keep their unemployment rates below 10 percent. The average unemployment rate in the European Union was 8.1 percent in 1991, increased to 10.6 percent in 1996, and fell back to 8.1 percent in 2000. In the United States only 6 percent of total unemployment in the year 2000 consisted of people who had been unemployed for at least a year. In Germany, Belgium and Italy long-term unemployment was more than 50 percent of the total. Finally, between 1991–2000 the US economy created 17.5 million additional jobs (an increase of 15 percent), while the European Union only created 12.4 million additional jobs (an increase of 8 percent).

The marked contrast between the performance of US and European labour markets is often attributed to the lack of flexibility in European labour markets. Today many economists agree that generous social insurance, employment protection, minimum wages and centralized wage determination create much wastage, in the form of unemployment, and compressed wage structures that distort people's incentives to look for new jobs and invest in human capital. As a corollary, it is often argued that far-reaching labour market deregulation is the only way to create a job miracle in European labour markets.

In this paper I will not argue that this is all wrong. I believe that some European institutions create inefficiencies, with small or no compensating gains in terms of equity/income security. I also believe that the US welfare reforms of the 1990s offer useful lessons for European policy-makers. But my main message is that Europeans should not throw out the baby with the bathwater. There is in fact both a cost and a benefit side to labour market institutions. Although it seems likely that certain institutions create unemployment, others may in fact serve quite useful purposes. Reforms failing to distinguish between good and bad rigidities will do more harm than good.

A basic objection to the view that adverse European institutions are the key factor behind the US-European divergence in labour market performance is that most European countries had in fact lower, or much lower, unemployment rates than the United States in the 1960s and early 1970s. As noted by many economists, most of today's institutions are in fact the same we had in the early 1960s. This makes it unlikely that adverse institutions can be the only factor behind the more recent developments. It appears likely that macroeconomic events, and their interactions with institutions, play important roles as well. Moreover, it has also been noted that there is large diversity within Europe. Though persistent unemployment is a serious issue in Germany, Italy and Spain, several of the smaller European countries have for long had unemployment rates on par with, or even below, the United States. This includes Denmark, Norway, the Netherlands and Austria, countries with extensive welfare states, encompassing institutions of collective bargaining, and – with the exception of Denmark – strict job protection. At the same time, it is noteworthy that the United Kingdom, which deregulated its labour markets in the 1980s, did not fare significantly better than the average European economy during the 1990s.[2]

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email: JA@ne.su.se
[1] The facts in this paragraph are taken from the OECD Employment Outlook (2002).

[2] In the 1996–2000 period the (OECD-standardized) average unemployment rates in the countries discussed in this paragraph were as follows: Austria 4.2 percent, Denmark 5.1 percent, Germany 8.9 percent, Italy 11.3 percent, Netherlands 4.1 percent, Norway 3.9 percent, Spain 18.2 percent, the United Kingdom 6.5 percent and the United States 4.6 percent. Source: OECD Employment Outlook.

Labour market institutions in second-best environments

Every student of economics knows that an efficient resource allocation will emerge if all agents in the labour market are price takers, and if there is a complete set of markets. The resulting allocation need not be an equitable one, but it will maximize the size of the pie (i.e. the sum of all producer and consumer surpluses). Viewed against the yardstick of such an idealized competitive environment, European-style labour market institutions are bound to create efficiency losses. Unions and minimum wages that push up the wages of low-skilled workers will reduce output and create unskilled unemployment. Taxation and generous social insurance will provide workers with an incentive to replace work in the high-productive market sector with less productive leisure and activities in the underground economy.

Viewed against the yardstick of an economy with pre-existing market failures, matters need not be so bleak. It is a standard result in welfare economics that because of externalities, public goods, increasing returns and asymmetric information there is – at least in theory – a case for government intervention. These market failures may also explain why labour market institutions that e.g. compress wages can improve efficiency. A classic example is that of the employment and welfare effects of minimum wages. When the minimum wage is introduced in a perfectly competitive economy it is bound to reduce efficiency. But when it is introduced in a labour market where the firm has all the market power, the firm is provided with the incentive to increase employment towards the first-best level.

Recent literature has explored the implications of labour market models that incorporate the standard market failures of welfare economics. A main theme of these papers is that many of the labour market institutions that have quite detrimental effects in perfectly competitive environments may have a beneficial impact in models with pre-existing market failures. This is not the time to review this literature, which covers a lot of ground. Instead, I will briefly discuss under what conditions institutional wage compression – a hallmark of European labour markets – can in fact be motivated for reasons of economic efficiency.

Missing insurance markets. As observed by John Hicks (1946, p. 189), uncertainty and expectations might well be the joys of life. But for risk-averse individuals uncertainty should be a cause of concern. For most individuals human capital is by far the most important asset. Yet, the private insurance market will not accommodate people's demand for protection against a variety of risks that originate in the labour market. In particular, for reasons of asymmetric information, and because of the problems of enforcing long-run insurance contracts involving human capital, the insurance industry will not provide protection against long-term career risk.

It is a standard result that missing insurance markets suggest an important role for government redistribution policy. By reducing the variance of disposable income, a system of redistributive taxes and transfers may improve welfare by providing an insurance effect in addition to the conventional incentive and equity effects. Several authors have even suggested that missing insurance markets explain why the modern tax-financed welfare state fulfils an important efficiency purpose, which goes beyond conventional justifications in terms of fairness and equality; cf. Atkinson (1991, 1999), Barr (1998) and Sandmo (1991, 1998). Though the welfare state imposes tax wedges that are detrimental to economic efficiency, voters are willing to pay this cost because they receive compensating insurance benefits.

But income redistribution via the welfare state is not the only way of purchasing insurance against the uncertainties of the future. Insurance can also be provided through labour market institutions (egalitarian unions, minimum wage legislation and unemployment insurance) that narrow the earnings distribution. As discussed by Agell and Lommerud (1992), under general assumptions the insurance benefits from a "small" compression of the wage distribution will outweigh any efficiency losses imposed on the economy. It is important to note that in this analysis egalitarian unions do create unemployment among their unskilled members, but in spite of this the expected utility of the average worker will be higher than in a *laissez-faire* economy with no unemployment. In this analysis unemployment is simply the cost associated with a second-best insurance contract.

As pointed out by Sinn (1995), the social insurance approach to the institutions of the welfare state has an intriguing implication. It is a common belief that

the high taxes of the welfare state are necessarily bad for investment and entrepreneurship. But Sinn shows that properly designed welfare institutions may in fact encourage people to undertake risky activities. Sinn extends the model of social insurance via the tax system to the case where individuals can invest in risky activities, and he shows that the insurance provided via redistributive taxes and benefits may lead to increased investment in risky activities. In the words of Sinn "… under the protection of the welfare state more can be dared".

The idea that properly designed social insurance may encourage risk taking and productive investment is in fact an old one. In defending social insurance against the supporters of *laissez-faire*, Cassel (1900) wrote approvingly of a social policy aimed at protecting the working class. He argued that social policy was a powerful instrument to promote economic progress, and to induce people to accept change. He even went so far so as to state that "… the main point in defence of this policy must rest in the acknowledgement that the productivity of labour increases in parallel with the social position of the working class. The insight about this relationship is the most optimistic, but at the same time one of the most well-established, results of modern economic research." (Cassel, 1900, p. 387–388).

Wage compression and incentives for human capital formation. A very common argument in the debate about European labour markets is that a compressed wage structure reduces people's incentives to acquire human capital. As governments and egalitarian unions attempt to raise the pay of those at the low-end of the skill distribution, they also reduce the return on investment in education and training. As a consequence there will be too little investment in human capital.

Recent work suggests that this argument needs to be qualified. An institutional compression of the wage structure from below can in fact initiate push-effects, which counter the traditional disincentive effect of wage compression. The schooling decision depends on the return to schooling. But what is forgotten in the traditional analysis is that it will also depend on the skill requirements of firms. When the relative wage of unskilled workers increases, firms hire fewer workers with little schooling and experience. To avoid unemployment, and to get access to the primary job market, young people will then simply have to acquire more schooling. As shown by Cahuc and Michel (1996), Agell and Lommerud (1997) and Ravn and Sørensen (1997), it is not difficult to write down models in which a binding minimum wage for unskilled workers will lead to a more highly educated workforce. It is important to note that it is the very fact that the minimum wage creates unemployment among unskilled workers (i.e. the standard objection to minimum wages) that leads to an upgrading of the human capital stock.

Kahn (2000) provides some empirical support for this mechanism. Using micro-data for 15 OECD countries, Kahn finds that greater union coverage/union membership leads to higher relative wages and lower employment for young men. The effects for young women are similar but weaker. Interestingly, Kahn reports that greater union coverage/union membership also leads to a greater propensity to attend school for both genders. These correlations are exactly what we would expect from the theoretical arguments of the preceding paragraph.

A related analysis of the link between wage compression and human capital formation is provided by Acemoglu and Pischke (1999), who concentrate on on-the-job training. In their model various frictions in the labour market are assumed to lock a firm and its employees into a bilateral monopoly situation. In the local wage bargain the firm will therefore be able to appropriate part of the returns to workers' investments in general training. Because workers anticipate this, they may end up not investing in general training. Acemoglu and Pischke show that the firm may want to compensate for this by investing resources in the general skills of their employees. They also show that such firm-sponsored investment should be more common when the wage structure is compressed against skilled workers.

Summing up, it is often taken for granted that unions, and the welfare state, might be good for reasons of equity, but that these institutions are harmful to economic efficiency. But it is in fact possible to find efficiency-based justifications for unions and the welfare state. Obviously, this does not imply that today's labour market institutions in Europe are without faults. Many institutions appear to be designed in ways that impose deadweight burdens that are unnecessarily large. But the research reviewed in this section suggests that

supporters of a big-bang approach to European labour market reform have an unbalanced case. The intellectual support for the idea that only far-reaching labour market deregulation can restore European prosperity can be traced to investigations that assume that the appropriate benchmark when discussing European institutions is a perfectly competitive labour market. Though such an approach might be useful in mapping out the costs of labour market institutions, it has nothing to say about the potential benefits.

Inequality, poverty and income mobility

The traditional motivation for many of the institutional arrangements in European labour markets is that they promote fairness and egalitarian outcomes. More recently, however, a growing number of critics have argued that also those in favour of equity and income equality have reason to reconsider these institutions. It is argued that the welfare states of Northern Europe create inequality/poverty by protecting the interests of employed insiders at the expense of unemployed outsiders. It is also argued that welfare states tend to be static societies with little income mobility, and that large segments of the populations of these countries are locked into long-term dependence on social assistance. By contrast, it is often argued that the flexible labour markets of the United States provide poor people with significantly greater opportunity for upward income mobility.

The purpose of this section is to briefly review some basic facts and research on income inequality, poverty and income mobility in different countries. Most of my discussion focuses on a comparison between the United States and the United Kingdom (i.e. countries with flexible labour markets) and European countries with rigid labour markets. I will rely heavily on evidence from the Luxembourg Income Study (LIS).[3] LIS comprises household survey data for 26 industrialized countries. Though cross-country comparisons of income inequality are subject to a number of methodological problems, LIS is most certainly the most reliable source of such information. First, over the years much has been invested in achieving comparability across countries. Second, it is well known that the inequality of earnings is much smaller in many European countries than it is in the United States. But since statistics on earnings inequality exclude the long-term unemployed, which is a sizeable group in some European countries, such comparisons may overstate equality in Europe; see Heckman (2001). Since the LIS project allows for a systematic comparison of the distribution of disposable income in random household samples, this bias is avoided.

The table below presents some basic statistics on income inequality and poverty. For each country the figures refer to the most recently available year, which typically is a year in the mid to late 1990s.[4] The first column shows the ratio of the disposable incomes of the persons at the bottom and top deciles. This ”decile ratio” is easy to interpret, and it allows for a direct comparison of the distance between people at the top and bottom of the income distribution. As noted by several authors, countries tend to cluster into different geographical groups. Income differentials are the smallest in Scandinavia (Sweden, Finland, Denmark and Norway) and parts of Northern Europe (Luxembourg, Netherlands, Germany and Belgium), with decile ratios below or around 3. Parts of Continental Europe come next: in France, Switzerland and Austria decile ratios range from 3.54 to 3.73. Income inequality is the highest in Southern Europe (Spain and Italy) and the English speaking countries of Canada, Australia, Ireland, the United Kingdom and the United States, where the decile ratios typically exceed 4. The biggest distance between rich and poor is in the United States, where the ratio is 5.57. This is about twice the ratio that can be found in the quartet of Sweden, Finland, Luxembourg and Denmark.

The indicators shown in the following columns convey a similar picture. The Gini coefficient is a commonly used global inequality measure, which takes a value of zero in a country where everyone has the same disposable income, and a value of unity in a country where a single individual earns all income. Column 2 shows that the ranking of countries remains almost the same as in column 1. Scandinavia and Northern Europe have Gini coefficients falling between .22 and .26; the United Kingdom and the United States have Gini coefficients of .344 and .372. By the standard of Gini comparisons this is a large discrepancy.

[3] For presentations of the LIS project, see Atkinson, Rainwater and Smeeding (1995), and Smeeding (2002).

[4] These results are directly available at the LIS home page: www.lisproject.org/keyfigures.

Inequality indices according to the Luxembourg Income Study (mid to late 1990s)

	90/10 decile ratio	Gini-coefficient	Percentage of population in relative poverty	Percentage of children in relative poverty	Percentage of children in absolute poverty
Scandinavia					
Sweden	2.61	.221	6.6	2.6	5.3
Finland	2.68	.226	5.4	2.8	6.9
Denmark	2.83	.257	9.2	8.7	5.1
Norway	3.15	.238	6.9	3.9	3.0
Northern and Continental Europe					
Luxembourg	2.92	.235	3.9	4.5	1.2
Netherlands	3.15	.253	8.1	8.1	11.1
Germany	3.18	.261	7.5	10.6	12.5
Belgium	3.26	.255	8.0	7.7	7.5
France	3.54	.288	8.0	7.9	10.7
Switzerland	3.62	.307	9.3	10.0	--
Austria	3.73	.277	10.6	15.0	--
Southern Europe					
Spain	3.96	.303	10.1	12.2	42.8
Italy	4.77	.342	14.2	20.2	36.1
English-speaking countries					
Canada	4.13	.305	12.8	16.3	9.5
Australia	4.33	.311	14.3	15.8	16.2
Ireland	4.33	.325	12.3	14.4	21.4
United Kingdom	4.57	.344	12.5	15.4	29.1
United States	5.57	.372	17.0	21.9	13.9

Sources: Numbers in columns 1-4 are from Smeeding (2002) and www.lisproject.org/keyfigures. Those in column 5 are from Bradbury and Jäntti (2002). Relative poverty is the percentage of individuals with a disposable income below 50 percent of the median disposable income. Absolute poverty is the percentage of children with real incomes below the official US poverty line. The square root of the number of household members is used as the equivalence scale. For most countries the data refer to the late 1990s. The numbers for Germany include both the former East and West Germany.

A common measure of inequality at the lower end of the income distribution is the relative poverty rate, shown in column 3. This column shows the percentage of the population with an income below 50 percent of median income (poverty researchers sometimes view this as an indicator of the extent of social exclusion in society). Relative poverty is the lowest in Scandinavia and Northern Europe, and the highest in Southern Europe and the English-speaking countries. The United States has the highest relative poverty rate, at 17 percent.

It could be argued that poverty among healthy adults is a lesser problem; a poor individual could simply be someone with a preference for consuming leisure rather than consumption goods. However, this argument does not apply to children. Column 4 shows that the imbalances in relative poverty rates across countries grow larger when we confine attention to the distribution of disposable income among children. Some of the Scandinavian welfare states spend large sums to support families with children, and the relative poverty rates among children in Finland and Sweden are below 3 percent. The relative poverty rates among children in the United Kingdom and the United States are 15.4 and 21.9 percent, respectively.

Finally, it is of interest to measure poverty using an absolute rather than a relative measurement rod. Using the official poverty rate of the United States as the relevant (purchasing power adjusted) standard in all countries, Bradbury and Jäntti (2002) compute the share of children in each country that can be classified as living in absolute poverty. Their results are shown in column 5. Though GDP per capita is some 30 percent larger in the United States than in Scandinavia and Northern Europe, the United States has the highest incidence of absolute child poverty. While 13.9 percent of children in the United States live in poverty, the corresponding figures are 1.2 percent in Luxembourg, 3.0 percent in Norway, 5.1 percent in Denmark, 5.3 percent in Sweden, and 6.9 percent in Finland. Finally, the incidence of absolute child poverty in the United Kingdom – a country with a GDP per capita on par with Finland and Sweden – is as high as 29.1 percent.

The conclusion from these comparisons seems to be that the institutions of Scandinavia and Northern Europe are – whatever their efficiency costs may be – relatively successful in achieving economic equality. According to the criteria used by distribution analysts and poverty researchers,

the institutions of the United States and the United Kingdom create more inequality, and more poverty, among children and among the population at large. It should be noted that the poor showing of the United States in the table occurs in spite of a decade with rapid employment growth in the American labour market. Thus, a job miracle is no cure-all for the problems of inequality and poverty. An objection to these comparisons is that they rely on data for a single year. The fact that the welfare states of Scandinavia and Northern Europe seem to be doing rather well in equalizing incomes could simply be an artefact from measuring incomes over too short periods. In societies with much upward income mobility, which is often thought to be the case in the United States, the inequality of annual income will exaggerate the inequality of long-run – or permanent – income. Because of high income mobility, the inequality of permanent income in the United States might in fact be low, in spite of high inequality of annual income.

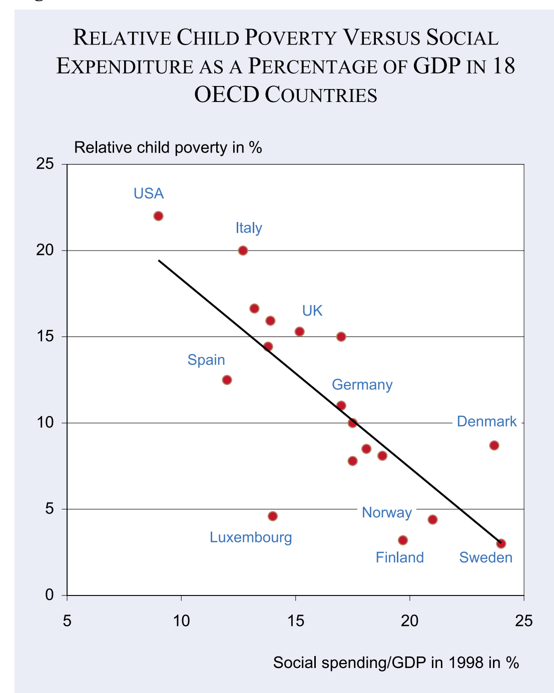
A recent analysis of this issue is provided by Aaberge et al. (2002). This paper compares income inequality and income mobility in the Scandinavian countries and the United States during the period 1980–90. The results suggest that inequality of annual income is far greater in the United States, but it is also shown that this continues to be the case when the accounting period is extended from one to eleven years. Other results are that there is no unequivocal way of ranking different countries in terms of income mobility, and that the mobility differences between countries appear to be small. In a related analysis, Burkhauser and Poupore (1997) study income mobility in Germany and the United States over the five-year period 1983–1988. They find that Germany and the United States have remarkably similar mobility patterns. Duncan et al. (1993) compare transitions in and out of poverty in eight countries, including e.g. the United States, Germany (not including former East Germany), France, the Netherlands, and Sweden. They conclude that the "… extent of upward mobility appears to be just as great among the poor in Europe as among US poor" (Duncan et al. (1993, p. 229)).

A more long-term perspective on income mobility is provided by the literature on intergenerational income mobility. Here, the issue at stake is the correlation between the earnings of fathers and sons. In a society where this correlation is close to zero there will be a high degree of intergenerational mobility, in the sense that the earnings of the father will not condition the earnings of his son. The recent review of Solon (2002) suggests – very much contrary to the popular belief – that there is less intergenerational mobility in the United States and the United Kingdom than in other countries. While studies for these two countries report correlations in excess of .4, studies for Sweden, Finland and Germany report correlations in a range from .11 to .34.

In sum, there is no evidence that high income mobility in the United States – over life-cycles and across generations – compensates for the higher or much higher rates of income inequality and poverty observed in annual income data. The welfare states of Scandinavia and Northern Europe have both significantly less cross-sectional inequality and higher intergenerational mobility than the United States.

Which institutional characteristics generate equality? Since the welfare states of Northern Europe have it all, answering this question in a very precise manner might not be so easy. These countries have generous social transfer systems, but they also have labour market institutions that compress the distribution of earnings from below, education systems that produce a more compressed distribution of human capital, and progressive tax systems. Trying to decompose the overall equalising impact of this

Figure 1



institutional sum into its component parts raises difficult issues in general equilibrium modelling. Nevertheless, many poverty researchers argue that there is a negative relationship between poverty rates and a country's social spending. This is illustrated in Figure 1, which plots the incidence of child poverty against total social spending (after deducting cash payments to the elderly) in 18 OECD-countries.[5] The OLS regression line is downward sloping, with a t-value of 4.98.

Is the flexible US labour market an appropriate model for Europe?

The view that major labour market deregulation and scaling down of the welfare state is the only way forward rests on two key assumptions. First, it assumes that a deregulated labour market is the best way to serve economic efficiency. Second, it assumes that far-reaching labour market deregulation and major reform of the welfare state would be of little consequence for equality and the fight against poverty. In my view both assumptions are dubious, or wrong. Sound principles of welfare economics, and available cross-country evidence on income inequality and income mobility, suggest that some rigidities are good for economic efficiency, and that the welfare state has been successful in reducing inequality.

All countries must find ways of striking a balance between efficiency and equality in the labour market. This balancing act will depend on the preferences of voters. It will also depend on all the factors in the economic environment that impact on voters' perceptions of the benefits and costs from institutions that provide social insurance and redistribute income between rich and poor. Here, the important observation is that European voters appear to have a strong preference for the welfare state. In many countries sizeable majorities appear to be opposed to cut of social security and welfare spending.

What can be done?

Which labour market reforms may improve economic efficiency without violating European voters' preference for fairness? Answering this question is not so easy. After all, there is not supposed to be a free lunch in economics. And since Europe is so diverse, optimal reform packages will differ quite a lot between countries. The labour market problems of Germany are not the same as the problems of Sweden and Italy. Keeping this in mind, I will here stick to the safe haven of general reasoning rather than concrete policy advice.

Schooling

In striking a balance between efficiency and equality, redistributive taxes and transfers are not the only available policy instruments. In the long term, a country's schooling and training policies are more decisive factors. Schooling systems and training programs that are successful in upgrading the skills and human capital at the low end of the ability distribution yield multiple returns. First, there will be private returns to the individuals involved. Second, in countries where voters have an aversion to income dispersion, a more compressed productivity distribution has a value of its own. Third, a more compressed productivity distribution will reduce the need to rely on redistributive taxation, which reduces the dead-weight loss from taxation.

The preceding argument has some bearing upon the recent discussion about whether the European welfare states should try to create a job miracle of their own by forming a low-wage service sector without minimum wages and collective bargaining contracts. The largest efficiency gains from having such a sector should materialise in countries with a dispersed distribution of human capital. When a US computer specialist gets some extra time at his office by "outsourcing" household production to a lowly educated immigrant worker, there will be a large societal gain in the utilisation of the human capital of the former. In European countries, where schools and training programs produce a more compressed distribution of skills, the gain will be much smaller. Based on this logic, I argue that the reason that the unskilled service sector is significantly less important in Northern Europe than in the United States probably hinges at least as much on several decades of past education policy as on unions and collective bargaining.

The trade-off between generosity and punishments

Atkinson (1999) points out that critics of social insurance and social policy often tend to neglect the

[5] The relative child poverty rate is the one shown in Table 1. The data on social spending (after deducting old age cash benefits) as a percentage of GDP apply to 1998, and they are downloadable from the OECD Social Expenditure Database, at www.sourceoecd.org.

importance of institutional detail. The behavioural consequences of a given social spending budget will depend crucially on a wide range of design features. Taking unemployment benefits as an illustration, Atkinson notes that real-world benefit systems are subject to contribution conditions, often prescribe that benefits should have limited duration, and may impose active job search requirements. Moreover, persons who quit voluntarily, are dismissed because of misconduct, or reject job offers, may be disqualified from receiving benefits. Supporters of the big-bang approach rarely acknowledge such fine prints; typically, the issue that is stressed is the adverse consequences of generous benefit levels. Yet, Atkinson presents several examples of how generous benefits can be made incentive-compatible by adding eligibility and job search requirements, and sanctions for misconduct.

These insights are of considerable importance for many areas of social policy design. Generous compensation levels in social insurance need not be a problem as long as there are ways of preventing misuse. Spelling out clear eligibility criteria, monitoring compliance and imposing sanctions are crucial aspects of optimal social policy design. It appears, however, that these issues are often treated with undue neglect. Many governments spend large resources to detect and punish tax evaders, and yet do very little to detect and punish people that cheat on social insurance.

It is also of interest to note that recent experimental evidence shows that people are willing to invest substantial resources in public goods, as long as they have the possibility to inflict punishment on those who free-ride on the co-operation of others; see Fehr and Gächter (2002). Fehr and Gächter show that free-riding triggers strong negative emotions, and that co-operation may break down altogether in the absence of punishments. Taken at face value, these results appear to have some profound implications for the organization of the welfare state. Majority support for a generous welfare state may require that the government invests significant resources in identifying and punishing those engaging in anti-social behaviour.

Labour supply incentives – the problematic U-curve

A common characteristic of labour supply incentives in many countries is that workers at the low and high ends of the wage distribution face the highest marginal tax rates. In a diagram plotting the marginal tax rate on the y-axis and taxable income on the x-axis the schedule of marginal tax brackets will be shaped like a U. At the low end, the interaction of income taxes and income-dependent transfers (like housing subsidies and social assistance) implies that e.g. unskilled, single parents will be confronted with very high effective marginal tax rates. When the marginal tax rate exceeds 100 percent there will be a poverty trap, which effectively discourages labour force participation. At the high end, skilled workers face higher than normal marginal tax rates, the reason being that real-world tax systems prescribe that the marginal tax rate should be some increasing function of taxable income. Available econometric studies of labour supply indicate that the U-curve of labour supply disincentives may create potentially large excess burdens.

Both practical and theoretical considerations suggest that these problems can be mitigated without compromising distributional objectives. During the 1990s, the United States greatly expanded the use of the so-called earned income tax credit. This scheme is only available to working poor families, and it gives a tax credit directly related to the size of earnings and the number of children. The attractive aspect is that it enhances the incomes of the working poor, and at the same time provides a substantial boost to work incentives. The downside is that for individuals with earned incomes falling in the phase-out range of the tax credit there will be an added disincentive effect. However, recent research suggests that the earned income tax credit has had a positive net impact on the labour supply of single mothers.

When it comes to the high end of the wage distribution, the theory of optimal income taxation offers some guidance. This theory may appear arcane to the non-specialist, but there is one finding of significant policy interest. There is no support at all for the common view that equality is best served by a tax system with increasing marginal tax rates at the top of the wage distribution. Numerical simulations suggest that marginal tax rates should stay fairly constant, or even decrease, as we reach the higher end of the earnings distribution. This result applies even when the government cares a lot about the utility of the poor: rate cuts that increase the labour supply of high-wage individuals provide extra tax revenue that can be redistributed to low-wage individuals.

Work and training requirements

Many empirical studies have documented that paying out generous unemployment benefits or cash assistance for long durations generate long-term unemployment. One way of reducing this problem is to introduce explicit work and/or training requirements: after a suitable waiting period, further financial assistance will only be allowed if the person accepts to participate in some work or training programme. While some European countries already adopt such schemes, the United States has seen a large expansion of work programs during the 1990s. A particularly interesting aspect is that the US programmes have been extensively evaluated using state-of-the-art randomised evaluations; see Blank (2002, 2003) for overviews. Blank (2003, p. 59) concludes that there is now a "… substantial body of evidence on the effectiveness of welfare-to-work programs in reducing welfare usage and public costs, and increasing labour supply."

Blank (2003) also notes that mandatory work requirements (a negative incentive) probably work best in combination with a positive incentive, of which the earned income tax credit might be a good example. Viewed in isolation, welfare-to-work programmes may have a significant effect on labour supply, but no effect at all on overall income or poverty. When combined with something like the earned income tax credit, there will also be a positive income effect that may reduce poverty.

Taming non-coordinated unions

Cross-country investigations of why unemployment rates differ suggest that co-ordinated unions are more likely to consider the aggregate employment consequences when wage bargains are struck. Such co-ordination will occur naturally in countries with highly centralised wage bargaining, like e.g. Austria and the Netherlands, or Sweden in the decades following the Second World War. Unions operating at the national level may even have an incentive to internalise some of the negative incentive effects from high tax wedges.

In many countries unemployment benefits are financed out of general tax money to a very large extent. In Sweden, for example, unemployment insurance has traditionally been run by the unions in the form of a number of certified unemployment insurance funds. While part of the financing stems from union membership fees, the government provides large subsidies, financed by general tax money. After a design change in the 1980s, the membership fee is in fact independent of the unemployment rate in the area of the specific fund; in effect, the marginal cost of unemployment for a single fund became zero. In an economy with centralised bargaining at the national level, marginal subsidies on this scale should be of no consequence, since the employees' federation should see through the government's budget constraint, and recognise that higher subsidies mean higher taxes on labour.

In an economy where bargaining rather takes place along sectoral lines, which is the case in many European countries, such generous marginal subsidies imply strong incentives for macroeconomic free-riding. The cost for the unemployment consequences of excessive wage deals in a specific sector can be passed on to tax paying workers in other sectors of the labor market. In the resulting Nash equilibrium real wages will be too high, and aggregate employment too low. This situation can be remedied by changing the financing of unemployment insurance, so that members of sectoral unions have to shoulder a greater part of the marginal cost of unemployment.

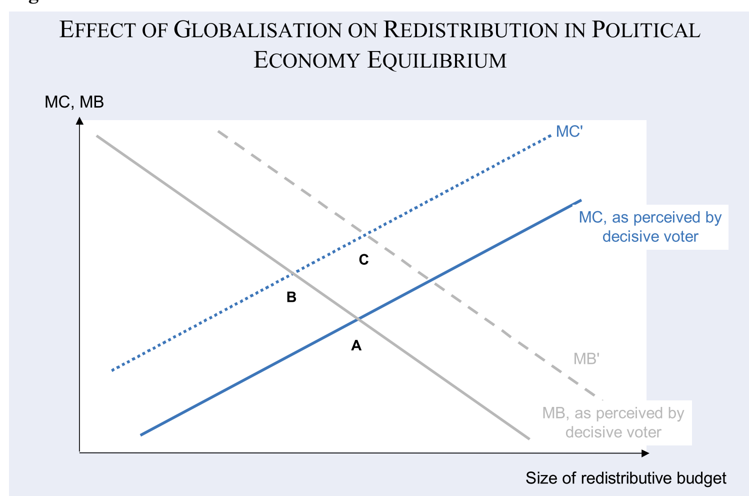
Will the welfare state survive?

According to the conventional view, increased openness and the requirements imposed by the new economy will increase the social efficiency costs of preserving institutions that hinder the flexible adjustment of relative wages. As a consequence governments sooner or later have to liberalise rigid labour market institutions, cut down on generous unemployment insurance, and implement measures that restrict the influence of rent seeking unions. But considerations of political economy suggest that this process is not automatic.

Figure 2 shows the marginal costs and benefits of income redistribution, as perceived by the decisive voter. Since the excess burden increases with the square of the tax wedge, the marginal cost curve slopes upwards. Under the plausible assumption that a dollar's worth of income redistribution matters most at a low overall level of income redistribution, the marginal benefit curve slopes downwards. In the initial political economy equilibrium, the decisive voter chooses the amount of redistribution so that the marginal cost and benefit curves intersect, i.e.

Figure 2

EFFECT OF GLOBALISATION ON REDISTRIBUTION IN POLITICAL ECONOMY EQUILIBRIUM



point *A*. The popular view assumes that globalisation increases the efficiency costs associated with a given level of income redistribution; i.e. the marginal cost curve shifts upwards. We then end up in the political economy equilibrium at point *B*, where the new cost curve intersects the old benefit curve. Clearly, there will be less income redistribution. But to the extent that globalisation also increases the decisive voter's demand for social insurance, there will in fact be a simultaneous upward shift in the benefit curve. We then end up at point *C*, where the new cost curve intersects the new benefit curve. Whether this final political equilibrium is associated with less or more income redistribution is an open question, on which it is hard to form a definite *a priori* opinion.

Where does this leave us? In the words of Krueger (2000, p. 132) "… when the dust settles I suspect that the competing forces of integration and demand for social protection will roughly balance out, and that the broad outlines of today's labour compact in European nations will still be recognisable in the future". In my view, this is as good a guess as any.

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Federal Employment Service

NEW EFFORTS FOR RAISING EMPLOYMENT IN GERMANY

Let me, by way of introduction, first discuss some basics about the job miracle in the United States. From the mid 1980s to the mid 1990s real GDP in the U.S. grew less than in Germany and in Europe. But US employment grew faster than German employment. Thus, US growth was much more employment intensive than German growth. The employment threshold of growth in Germany is higher, at 1.5 percent, than in the US where it is near zero. And now we have increasing unemployment with a growth rate of 0 to 1 percent in Germany.

But to judge this correctly we must see that Germany's burdens of reunification have been tremendous. To mention just one figure: Every year we transfer nearly €17 billion from west to east Germany, partly through the systems of social security and partly through the tax system. Without this burden the contribution rate to the German social insurance system, for example, could be about four or more percentage points less than at present. So one should be careful in describing the problems in the labour market as the 'German illness'. There is no doubt that Europe and Germany in particular have a problem here, but there are some special effects which should not be neglected.

What affects the employment level?

The first question we have to raise in the light of the German unemployment problem is how to raise the employment level in Germany.

Growth-oriented fiscal policy

Here we have to mention the so-called "Ordnungspolitik": In this context it means the system of public services and social tasks, foremost the dimension of the social budget as part of GDP and the way of financing it. In Germany we have a social budget of about one third of GDP and it is financed mainly by contributions of employees and employers. Thus the costs fall primarily on the factor labour. There are other ways of financing such a system. For example, Denmark has changed its system of financing the social budget from the contributions paid by the factor labour to the tax system and the consequences are visible in the very low unemployment rate.

Employment promoting collective bargaining policy

In an economy with high unemployment of nearly 10 percent – as in Germany as a whole – the attempt to redistribute income via higher negotiated wages must have the consequence of higher unemployment. This is one of our main problems and cannot work.

Supportive labour market policy

Policies which support the labour market include, for example, the abolition of unnecessary regulation. Not every regulation we currently have is necessary.

Supportive social policy

We need a new approach to social policy that maintains the incentives to work. The incentives we give to unemployed persons may be positive or negative.

These major reform elements to provide a new direction for labour market policy and social policy are already at work: There is the Hartz Commission that was set up to reform the labour market and its institutions, primarily the Federal Employment Service. Now that the elections are over, the government has started to implement these proposals.

Agenda 2010

The federal government has proposed the "Agenda 2010", to bring about full employment within ten

years. This Agenda is being discussed intensively in parliament as well as in the whole society. The trade unions especially are against the proposals contained in it; others, like many labour market experts, say they are insufficient. In my opinion, the Agenda must be implemented now without any changes. Still, it can only be the beginning of a decade of reforms to get full employment in ten years.

Job placement

One part of the Agenda concerns a stronger focus on job placement in employment promotion under the headline "Challenging and Assisting" (Fordern und Fördern). It consists of various elements:

We have to make sure that placement assistance has priority over wage replacement payments and that we mainly use labour market methods with high effectiveness of labour market integration. In addition, we have to work on the nation-wide utilisation of temporary work as a means of labour market policy by establishing personnel service agencies.

We need a better mix of instruments for placement procedures, a better mix of training efforts and training measures and a very strong evaluation mechanism to see after half a year what happens to a person after a period of training. Is he in work or not? If not, the system must be changed for similar groups of unemployed. At the nucleus of the Hartz proposals is temporary work as an easy way to get back into the labour market smoothly step by step rather than from zero to hundred.

Another new focus of labour market policy is prevention, meaning, for example, that in the case of pending unemployment, an employee must go to the employment agency as soon as he knows that he will become unemployed. He must come very early to get support for self-help. To get support for his own activities he must be activated. He should not have a consumer's attitude toward the agency or toward the social system, saying "they have to offer me jobs and then I can choose". This attitude must be changed forcefully with positive and negative incentives by the requirement for early registration as unemployed, reinforced by sanctions, occupational reorientation during the period of notice, and employment transfer and "job-to-job" placement.

Promoting the acceptance of low-paying jobs

The acceptance of low-paying jobs is a very crucial step in reforming the German labour market because we have the highest unemployment rates for unskilled and older people. This is the consequence of wrong incentives offering too many exit options out of the job system for people in their fifties.

The high unemployment of low-skilled persons on the other hand is a consequence of relatively high welfare levels in Germany and very high contributions paid by the active labour force. That means you have to earn a high wage to get more income than you would get if you stayed on social assistance. The threshold is too high before it pays to work. It is essential that work must pay off for everyone, the unskilled and the skilled.

One of the approaches to this problem is to make it easier to employ persons in so-called mini jobs for up to €400 per month and to give positive incentives to get jobs paying between €400 and €800 per month (the so called midi jobs). This is to make it easier to find a way out of the welfare system into the regular labour market. At the moment, the last step of this reform is the proposal announced by the government that unemployed persons have to accept mini jobs, but can keep more of their earnings in addition to their unemployment benefits. That is one of the philosophies that is not very new in Europe or world-wide. But it is now very concrete in the sense of forcing unemployed people to accept work. In Germany we have about 4 to 5 million mini jobs in the official system. But we have only 300,000 full-time jobs in our statistics. So we have offers for the unemployed which they must accept. If they do not accept the job offered, they have to suffer a cut in their social benefits.

Reform of the Public Employment Service

Currently there are 25 project groups preparing a reorientation of the Federal Employment Service. First results will be available in summer 2003. The entire restructuring process will take approximately five years.

One goal is a stronger customer focus, not only toward unemployed persons but also the potential

employers. At present we are not in the middle between supply and demand, but rather very close to the unemployed and very far from the employers. This is one of our problems. And this is the way we have to go:

The provision of special services for employers, for example assistance and online systems for the acquisition of jobs. More internal and external competition, a stronger focus on the results using target agreements and controlling. That is one of the points which is very intensively discussed in Germany.

There are also new institutional responsibilities. One nucleus is the so- called job centers. Job centers combine the efforts and the know-how of our agency for every kind of unemployment with the creation of a second labour market which is publicly financed for persons who are very far away from getting jobs in the first labour market. Our instruments helping these long-term unemployed are not perfect yet, but the job centers will also become contact points of social welfare offices and it would be better – especially in eastern Germany – if we had better offers for such persons.

Reform of the transfer system

Perhaps more important than the institutional reform is the reform of the transfer system. To give you an idea: Our struggle these days is to reduce unemployment payments for older people. At present these older people receive unemployment benefits for a period of 32 months. After that a system of relatively reduced benefits steps in, and after quite a few years an unemployed person drops to the level of social assistance.

This system gives the people the impression that they have a long time before they have to accept a job offer that yields less income than before.

The proposed change is for a shorter claims period for unemployment benefits. In Agenda 2010 the government wants to cut unemployment benefits for middle-aged people to 12 months and for older people to 18 months. It is to be hoped that the parliamentary opposition will support this proposal.

One of the goals of these measures is to reduce non-wage labour costs by cutting the contribution rate to the social security system of currently about 42 to 43 percent of wages, partly paid by the employer and partly by the employee. If we reduce the contribution rate step by step to 39 percent, we will increase employment by about half a million people. This figure is supported by economic research and some of the economists present can confirm that.

Conclusion

Some reform projects have been implemented already, others are under way or have yet to be addressed. Neither painful cuts nor benefit restrictions can be taboo if they mean more employment and thus the long-term survival of the social welfare state.

The goal of the Agenda and any following reform agendas is the survival of the very well developed social security system we have in Continental Europe and in Germany. The result must be a better social welfare system. I fully respect the route taken by Anglo-Saxon reforms, but they are not acceptable in Germany. There is one term of the so-called third way between Old Europe and the Anglo-Saxon way which I would subscribe to, that is “flexecurity”, the combination of flexibility and security.

Thank you very much.

FRIEDRICH MERZ,
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THE LABOUR MARKET AND THE JOB MIRACLE

Allow me to start by expressing my thanks for the opportunity to discuss important issues of economic policy in this circle today and tomorrow.

The reason for my expressing these thanks is that we in Germany, at least, unfortunately do not often enough have the chance to discuss current and future central challenges in a debate between business, the scientific community and politics – although, in view of its structural problems, Germany in particular should have an above-average interest in this exchange of opinions.

The previous speakers have already described the problems of the labour market from their respective points of view, and I would like to make a few additional comments to illustrate my standpoint. You will find that there will inevitably be some duplication.

Starting situation

Anyone who wants to resolve our labour market problems needs to start with an accurate description of the starting situation.

Germany and Europe have been confronted with structural unemployment for some thirty years. Since the first oil price crisis in 1973, unemployment has been increasing in waves, from one economic crisis to the next. Since that time, it has not even been possible to reduce unemployment during a period of economic growth to the level prevailing before the preceding economic downturn.

In Germany, it was not only the oil price crises that led to this development. The 1974 wage negotiations in the public service, which led to a rise of 10.5 percent, the two subsequent general wage increases in trade and industry in 1975 and 1976, and the rapid rise in social benefits that began at that time, are still burdening us today. After all, two of the resultant effects are still making themselves felt:

- First, the progress made in productivity has predominantly been applied to increase real incomes, too little being used to improve the international competitiveness of the national economy.
- Second, what is known as the "expected wage" – the term used by the Ifo Institute for the wage that an unemployed person or a recipient of social assistance without a job is entitled to claim as social security benefit in Germany – has risen even faster than the disposable income of employee households since that time. The fatal consequence of this is that major portions of our labour market are in fact dead and that it has for a long time no longer been possible to speak of a labour "market".

The consequences have a long-term impact and are reflected in the data for our national economy:

- The public-sector share is almost 50 percent. In other words, the state consumes almost half the output of its citizens.
- For years now, growth of the German economy has been below the European average, which is itself too low by international standards. Since 2001, Germany has even had the lowest growth rate in the European Union, dragging the European average even further down.
- The ratio between investments and social security benefits paid out from public funds is continuing to deteriorate. Germany's towns and communities are suffering particularly badly from this development, since they have to bear the brunt of unemployment and its social consequences.
- Consequently, the overstrained public funds are in a structural crisis, because they are incapable of escaping the vicious circle of increasing bur-

dens, insufficient investments, declining competitiveness and a renewed rise in unemployment.

- The excessive burden of taxes and duties that accompanies the excessive strain on the public funds not only poisons the atmosphere in the consumer goods sector; a more serious fact is that German businesses, particularly small and medium-sized enterprises, have far too little equity. However, companies in a poor equity position are not strong enough to grow rapidly when the economy revives, and are soon threatened by insolvency when faced by an economic downturn. In 2002, that was the fate of 38,000 enterprises in Germany that no longer exist today.
- Finally, German society is confronted with greater demographic challenges than other countries. One result of this is admittedly a reduction in the number of potentially employable persons and thus in unemployment. At the same time, however, the ratio of contributors to benefit recipients in the social security systems is becoming so imbalanced that the system's survival is in jeopardy. Without structural reforms, we in Germany face the threat of a serious conflict between the generations.

Proposals for solving the existing problems

That already brings me to a first answer to the opening question facing us on this panel:

The problem we have in numerous national economies in the European Union is not an economic one, but a structural problem of insufficient competitiveness.

The German economy is particularly severely affected in this context, because problems and burdens have accumulated here over a period of three decades – interrupted only between 1983 and 1990 – and it is becoming more difficult to eliminate them from one year to the next. Incidentally, these enormous problems also explain why the Federal Government led by the Social Democrats is having such difficulty enforcing even its relatively modest reforms. The fact is that the Federal Chancellor needs to bring his party back to reality. However, this reality largely contradicts the vision of life of many Social Democrats, and also of many trade union activists, who always wanted precisely this kind of paternalistic welfare state.

Yet, the goal of full employment, that Germany's Minister of Economic Affairs and Labour keeps repeating at the moment, can certainly also be achieved in Germany as well. In times of fundamental change and ever shorter innovation cycles, full employment would be reached at an unemployment rate of about 4 percent, such as in Switzerland and a number of other European and non-European countries.

However, this presupposes that we are prepared to accept far greater changes than in the past. Allow me to mention a few prerequisites from my point of view:

- Of course, we need a low-wage sector. Tony Blair called his programme "from welfare to work". No one could put it better, even in German.
- The social security systems must be gradually switched to a higher level of funding. A start should be made in the low-wage sector, in particular, because that is where the largest gaps in the cover exist in case of illness and in old age.
- People need financial leeway to be able to assume this degree of responsibility for themselves again. That is why the burden of taxes and duties must be reduced.
- That, in turn, can only be achieved if social transfer incomes simultaneously decline in the long term. In particular, recipients of social welfare who are capable of working must have an incentive to try to earn their livelihood themselves again.
- I would once again like to place separate and special emphasis on the aspect of self-responsibility. All social security systems must be restructured in such a way that people themselves have a personal, financial interest in making thrifty use of the available resources.
- In addition to their old age and health, people must be willing to invest more in their education. Indeed, the ratio of investment to spending on consumption needs to be re-aligned both in public and household spending.
- And finally, business enterprises must be put in a position to increase their equity. Unfortunately, Germany's financial markets do not yet have the necessary breadth and depth for this purpose. The increased formation of capital as provision for old age and the furnishing of businesses with equity could go hand-in-hand. We in Germany can well model ourselves on the

examples of Switzerland, the Netherlands, the Northern European countries and, above all, the English-speaking countries.

I would particularly like to discuss the last aspects I mentioned with you in depth. After all, we can probably learn a good deal from other people's experience. Conversely, you all know that Germany's upswing in the years following 1945 was not an "economic miracle", but the result of a long-term policy based on a sound concept and good regulatory policy. We are facing a similar challenge today, at the start of a new century and in much the same circumstances. Convincing political leadership would enable us to cope with the challenge in our own country and, at the same time, to make a contribution to the prosperity of Europe.