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Labor market policy in a global economy

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Bayerische Julius-Maximilians-Universität Würzburg

Wirtschaftswissenschaftliche Fakultät

**Labor Market Policy
in a
Global Economy**

**Norbert Berthold
Rainer Fehn**

Wirtschaftswissenschaftliche Beiträge
des Lehrstuhls für Volkswirtschaftslehre,
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Labor Market Policy in a Global Economy

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Summary

This paper deals with the much discussed question how to design labor market policy in a global economy. The starting point of the paper is the fact that national unemployment rates differ greatly, which alludes to country-specific institutional factors being the most plausible culprit for rising and lasting unemployment. Hence, identifying institutional setups which promote employment growth is a prerequisite for successfully fighting unemployment. To this end the paper is divided into three main sections. The first section provides a non-technical synopsis of the main causes of persistently high unemployment which can in particular be observed in continental Europe. Special emphasis is put on the question how the ongoing process of globalization of goods and factor markets relates to the rise of unemployment. The by now standard explanation of rising unemployment is a change in the structure of labor demand towards higher skill requirements, be they caused by growing inter-industry trade or skill-biased technical progress, which conflicts with rigid wage structures in continental Europe. However, a number of important shortcomings of this approach are pointed out, which show that this is hardly an encompassing explanation.

It is therefore argued that other factors must also be important. There can be little question that globalization opens greater exit possibilities for not-yet invested capital which is, once invested, threatened by appropriation by strong insiders in certain countries, that it increases the potential for specialization in production and the pressure towards switching from a Tayloristic to a holistic organization of production structures thus exacerbating appropriability problems, that it broadens the technological menu by facilitating international technology transfers thus allowing a greater degree of substitution of labor by capital and finally that it exposes firms and workers to greater volatilities, i.e. a less stable macroeconomic environment. It is shown how these factors interact and how they conflict with important characteristics of in particular the German economy, which however is not too dissimilar from a number of other continental European countries. These characteristics are mainly generous and long-lasting transfer payments to the unemployed, high firing costs and centralized wage-setting.

The second section discusses how labor-market institutions should be reformed and how labor-market policy should be redesigned in order to achieve better employment results. Under the premise that the above-mentioned factors are indeed important in explaining the severe unemployment problem, it is clear that the thrust of such reforms must be in the direction of reducing aggregate wage pressure, of achieving greater flexibility in wage-setting and in employment contracts, of correcting currently distorted incentive structures of the unemployed towards accepting a greater variety of jobs, and of helping the unemployed in building the kind of human capital that is actually demanded by firms. There can be no doubt that global competition forces countries to put greater emphasis on the efficiency aspects of labor market institutions by leaving less scope for achieving distributional goals via labor market institutions. The government has got mainly three instruments of labor market policy at its disposal: unemployment insurance, active labor market policy and firing costs. The first two are put under particular scrutiny in the paper. It is discussed in detail how both policy instruments can be redesigned and interwoven in order to alter the incentive structures of outsiders, insiders and firms in favor of more employment, not only by reducing wage pressure and labor costs for firms, but also by exposing outsiders to a mixture of pressure and financial incentives towards searching more intensively for a new job. The paper elaborates on how an integrated system of unemployment benefits and of active labor market policies should look like. The issue of firing costs is also briefly addressed. Reducing state-imposed firing costs is an evident policy conclusion arising out of the analysis. An elaborate reform of the unemployment insurance system would make a reduction of firing costs less controversial as employers would then be penalized by higher contributions to the unemployment insurance system for above average turnover in their firms. This would already give workers some protection against arbitrary layoffs reducing the necessity of further state-imposed firing costs.

The third section finally discusses the positive economics of labor market policy in a global economy. Essentially all OECD countries are under pressure towards redesigning labor market institutions and policy in a more efficient way. However, progress in this direction varies widely between countries not least due to difficulties in enforcing efficiency-enhancing reforms in the political decision making process. However, it is shown that encompassing reform packages are more likely to be politically viable than piecemeal reforms.

I. Introduction

This paper deals with the much discussed question how to design labor market policy in a global economy. Mass unemployment is clearly the principal economic policy problem in most continental European countries nowadays and rising unemployment is often associated with more open goods and factor markets which are labeled with the catchword "globalization". Patience of the public diminishes in expecting governments to offer and successfully execute remedies to this grossly inefficient and unjust state of affairs on labor markets. The liberalization of trade and of capital flows is in acute danger of being reverted if the perception becomes even more widespread that growing unemployment is the inevitable consequence of globalization. Governments which fail or are too slow in reducing unemployment are relentlessly voted out of office these days. The German case is only one example in kind. However, lasting success in the fight against unemployment can only be expected if a correct diagnosis precedes the design and implementation of policy measures. Quixotic policies such as a move towards protectionism, which governments are all too tempted to undertake, are in general at best successful in the very short run while often exacerbating the unemployment problem in the longer run.

Hence, even a policy-oriented paper such as this one must in a first step outline the principal causes of rising unemployment. Economists have by now written extensively on European unemployment. It is generally recognized that unemployment in Europe is predominantly structural, i. e. a quasi-equilibrium phenomenon with only a minor cyclical component.¹ Hence, expansionary demand policies cannot be the main tool in fighting unemployment. Most of the burden must be shouldered by supply-side policies which above all have to improve the functioning of labor markets. However, there is much less agreement on which shocks and which transmission mechanisms cause unemployment to grow inexorably in some countries while returning to and apparently staying at moderate levels in other countries. Yet, a precise understanding of these shocks and of the relevant transmission mechanisms is crucial for selecting the most effective institutional reforms and labor-market policies. The observable great differences in national unemployment rates point to country-specific institutional factors as being

¹ See Feldstein (1997), Krugman (1994), Lindbeck (1996), van der Willigen (1995), and Viñals and Jimeno (1996). The OECD estimates that 85% of German unemployment in 1997 were of the structural type.

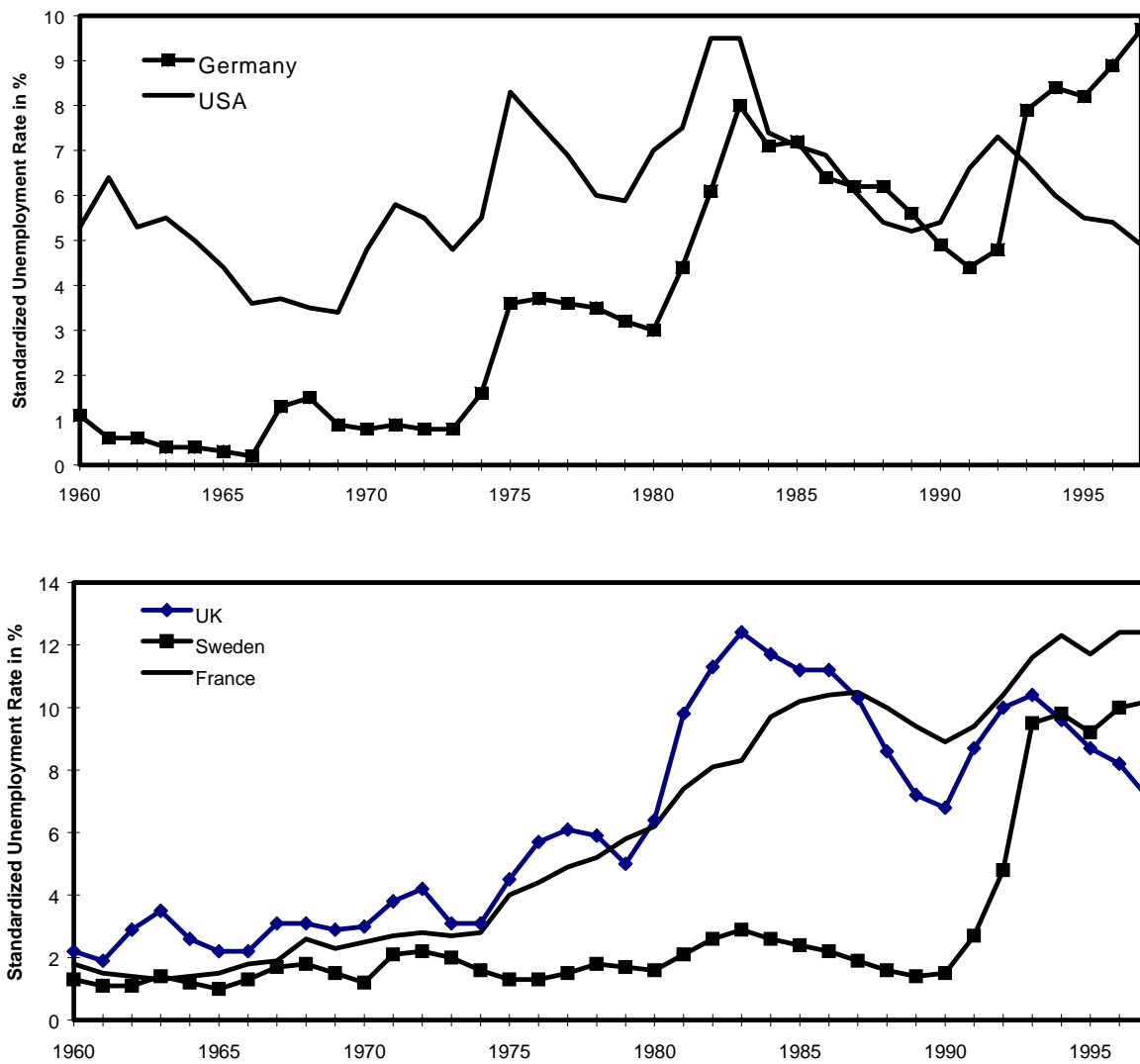
important in explaining unemployment performances. Hence, identifying institutional setups which promote employment growth in a global economy is a prerequisite for successfully fighting unemployment.

To this end the paper is divided into three main sections. The first section provides a non-technical synopsis of the main causes of persistently high unemployment which can in particular be observed in continental Europe. Special emphasis is put on the question how the ongoing process of globalization of goods and factor markets conflicts with the institutional setup of these economies in general, but in particular of the labor market in continental Europe thus producing rising unemployment. The second section discusses how labor-market institutions and labor-market policy should be reformed in order to achieve better employment results. Building on the results of the first section, two areas are put under particular scrutiny: the system of transfer payments to the unemployed and the design of active labor market policies. The third section elaborates on how labor-market reforms can be made viable in the politico-economic decision-making process.

II. A Synopsis of the Principal Causes of Unemployment in Europe

Unemployment has not always been higher in continental Europe compared to the U.S. Starting in the early seventies and taking in particular France and Germany as the two largest continental European countries for comparison, figure 1 shows that unemployment was at that time considerably lower than in the U.S. So the question really is what has happened in the meantime to reverse the picture in such a dramatic way. Of course, since the early seventies were almost thirty years ago, a lot of things influencing the situation on labor markets have happened. However, in order to gain a broad picture it is useful to briefly highlight two stories, which are often presented before moving to more recent ideas in this respect: hysteresis and shifts in relative labor demand.

Fig. 1: An International Comparison of Unemployment Rates



Source: OECD Employment Outlook.

1. Hysteresis

The first story is based on large temporary shocks coupled with hysteresis in unemployment rates. The two oil price shocks in the seventies along with the switch towards restrictive demand policies in the early eighties constituted such large macroeconomic shocks.² Although these

² The German economy was of course in addition hit by the reunification shock. However, to keep the perspective of labor market policy in a global economy, special problems arising out of the transition from a socialist to a market

shocks were only temporary they can lead to a lasting rise in unemployment if coupled with hysteresis mechanisms on labor markets. The insider-outsider trap is the main reason why the unemployment rate might stay at a higher level even though the original shock has subsided in the meantime. Insider-outsider problems arise in particular if the bargaining position of insiders in wage negotiations is strong even when confronted with a high unemployment rate and if outsiders are generously and indefinitely supported by the welfare state. Both hysteresis mechanisms are certainly to a much larger extent present in countries such as France and Germany compared to the more rigorously market-oriented system of the U.S. Yet, the pure hysteresis approach for explaining the dismal unemployment performance in continental Europe does not appear convincing. The mentioned shocks occurred a long time ago and unemployment rates can already by definition not exhibit strict hysteresis. Estimations of wage-setting equations suggest strong persistence in unemployment rates, due to the lack of a wage-moderating effect of the level of long-term unemployment, but not pure hysteresis in wage setting, because the level of unemployment and not only its change influence wage setting.³ Furthermore, the hysteresis approach is too static as it delivers no explanation for the much better ability of the American economy to create new jobs and for the fact that young workers with the right skills have in fact often been able to enter successfully continental European labor markets. Hence, although hysteresis mechanisms are certainly stronger in continental Europe than in the U.S., today's unemployment cannot be based solely on this foundation. Rather, more fundamental and lasting changes in the determinants of labor demand, labor supply and wage setting must be looked for.

2. Shifts in Relative Labor Demand

The by now standard explanation of rising unemployment is a change in the structure of labor demand towards higher skill requirements of firms, either caused by growing inter-industry trade or skill-biased technical progress or sector-specific technical progress, which conflicts with rigid wage structures in continental Europe. At first sight, this approach fits nicely with the facts that unemployment in continental Europe predominantly afflicts low-skilled workers, while this group

economy are excluded from the analysis. This restriction is furthermore justified by the fact that this is a large research area of its own.

³ See e.g. Elmeskov (1993) and Layard (1996).

faces a growing working-poor problem in the U.S., where wage structures are more flexible due to a less generous welfare state, weaker unions and less union coverage. Thus, in the words of Krugman (1994), the unemployment problem in continental Europe and the working poor problem in the U.S. could be two sides of the same coin. If based on the trade argument or on the faster diffusion of knowledge, this approach has also got the appealing property of linking the much discussed process of globalization to the unemployment issue.

However, a number of points have to be raised before precipitately accepting this reasoning as the major explanation for the rise of unemployment in continental Europe. First, it has been increasingly recognized by now that inter-industry trade, and this is the one that only counts here, cannot have contributed much in the way of changing the structure of labor demand with respect to skills. Second, it is by no means clear, whether the world-wide speed of skill-biased technical progress, which is undoubtedly accelerated by growing trade, has grown sufficiently in recent years.⁴ A high but constant speed of technical progress does not suffice to explain rising unemployment, if wage structures have not become more rigid and if the qualification spectrum of workers has not deteriorated. Yet, there is no convincing evidence for either one of these two possibilities. Third, unemployment among low-skilled workers is as much a problem in the U.S. as it is in Europe (table 1). Unskilled unemployment in the U.S. has in fact risen by more than 100% since the early seventies despite of the substantial fall in unskilled wages. Yet, in contrast to continental Europe, the more flexible wage structure allowed substantial employment growth even among low-earning workers.⁵

⁴ Technical progress is usually measured as a residual so that its high explanatory power could also be interpreted as a lack of concrete knowledge.

⁵ See Ochel (1998).

Table 1: Male Unemployment Rates by Educational Attainment

	Time	Total unemployment rate	Lower secondary education or below	Higher secondary education or above	Ratio
USA	1979-82	5,7	9,4	2,1	4,5
	1983-86	7,3	12,8	2,7	4,7
	1987-90	5,1	9,8	2,1	4,7
	1991-93	6,0	11,0	3,0	3,7
	1994	6,2	12,8	4,8	2,7
	1995	5,6	10,9	4,1	2,7
Germany	1979-82	3,4	7,6	2,0	3,8
	1983-86	6,3	13,9	3,3	4,2
	1987-90	4,9	12,1	2,9	4,2
	1991-93	4,1	10,7	2,2	4,9
	1994	7,3	14,8	5,8	2,6
	1995	7,2	13,5	5,4	2,5
France	1979-82	5,2	6,5	2,1	3,1
	1983-86	6,7	9,0	2,5	3,6
	1987-90	7,2	10,8	2,6	4,1
	1991-93	8,1	12,1	4,2	2,9
	1994	10,9	13,5	7,6	1,8
	1995	9,8	12,8	7,1	1,8
UK	1979-82	7,7	12,2	3,9	3,1
	1983-86	10,5	18,2	4,7	3,9
	1987-90	7,5	13,5	4,0	3,4
	1991-93	10,8	17,1	6,2	2,8
	1994	11,5	18,8	7,1	2,6
	1995	10,2	17,2	6,3	2,7
Sweden	1979-82	2,4	3,1	0,9	3,4
	1983-86	3,1	4,1	1,1	3,7
	1987-90	1,8	2,4	1,0	2,4
	1991-93	5,8	6,9	2,8	2,5
	1994	9,1	9,6	6,5	1,5
	1995	8,5	10,6	7,4	1,4

Sources: Nickell (1996, 26 f.) und OECD Employment Outlook.

The distinguishing features between unemployment in the U.S. and Europe are nonetheless the better performance in the overall unemployment rate and the much lower rate of long-term unemployment (table 2). This alludes to the two probably most important caveats concerning this approach: its validity requires that there has only been a change in the structure of labor demand towards higher skill requirements of firms and not an overall reduction of labor demand at given real wages. Hence, the increase in unemployment must essentially be a mismatch phenomenon with unemployment among low-skilled workers rising and among high-skilled workers falling. This cannot be the whole story as becomes immediately clear upon closer inspection of table 1.

Unemployment among high-skilled workers has also risen in most OECD countries and in particular in France, Germany and the U.S. In fact, assuming an isoelastic wage-setting curve as in Blanchflower and Oswald (1994), the relative sizes of the increases in unemployment in the different skill groups point more to macroeconomic shocks than to changes in the structure of labor demand. A greater percentage point increase in unemployment among low-skilled workers is perfectly compatible with macroeconomic shocks as real wages are more rigid at the lower end of the wage distribution and as sorting effects induce firms to keep preferably higher skilled persons in case of crisis, e.g. due to higher investments in their firm-specific human capital.⁶

Table 2: The Share of Long-Term Unemployment

Year	USA	Germany	France	UK	Sweden
1983	13,3	41,6	42,2	45,6	10,3
1989	5,7	49,0	43,9	40,8	6,3
1990	5,5	46,8	38,0	34,4	4,7
1991	6,3	31,5	37,2	28,8	4,2
1992	11,1	33,5	36,1	35,4	8,3
1993	11,5	40,0	34,2	42,5	10,9
1994	12,2	44,3	38,3	45,4	17,3
1995	9,7	48,7	42,3	43,6	15,8
1996	9,5	47,8	39,5	39,8	17,1

Source: OECD Employment Outlook.

This assessment is also confirmed by empirical analyses of the relationship between the rate of vacancies and the rate of unemployment over time. They show, e.g. for Germany, that the Beveridge curve has moved outwards but that the increase in unemployment is not accompanied by an equal rise in the rate of vacancies. Persistently high unemployment in continental Europe can therefore not be a pure mismatch phenomenon based on a changing structure of labor demand in combination with rigid relative wages. More flexible wage structures would certainly help in reducing unemployment, but a thorough explanation for the dismal situation on labor markets in continental Europe must rather move on and also look for macroeconomic problems.⁷

⁶ See Nickell and Bell (1995) and Blanchard (1995).

⁷ Nickell (1997) points out that the skill shift accounts for at most 20 percent of the rise in unemployment in Europe, and that supposedly flexible Britain did not fare better in this respect than the rigid continental European countries.

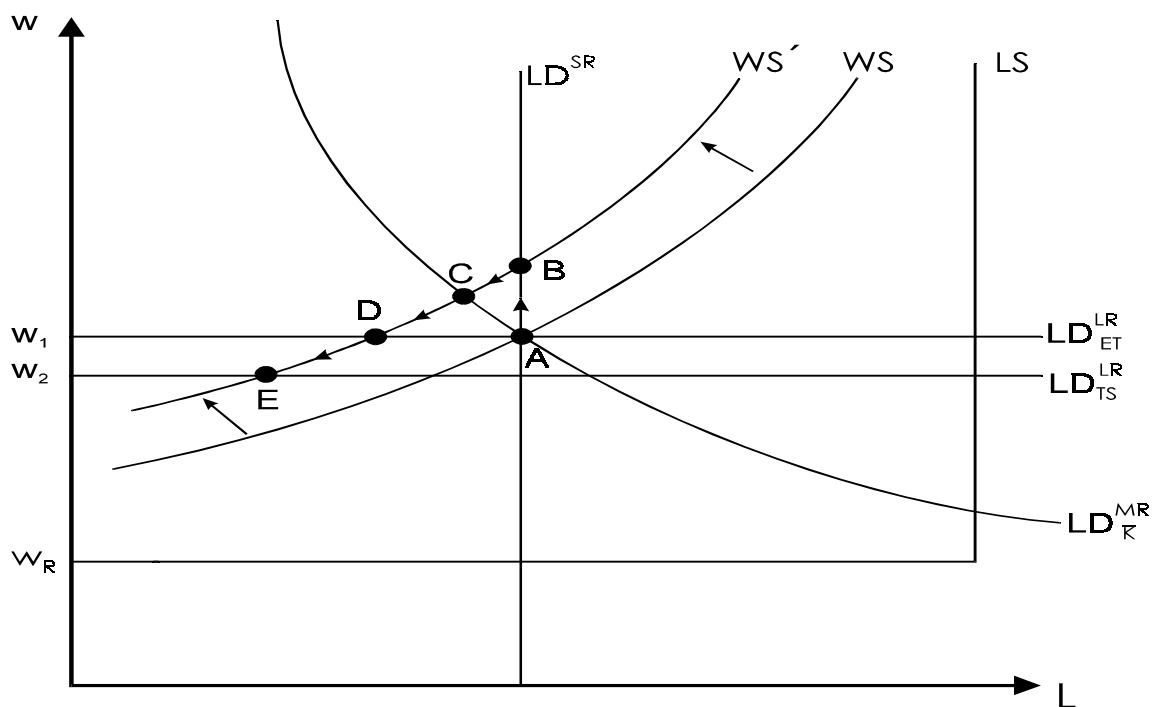
3. Appropriation, Capital Formation and Technological Sclerosis

A general and ongoing increase in the aggressiveness of wage setting in continental Europe could of course in principle account for rising unemployment. However, while there is some evidence in this direction based on rising labor shares and mounting wage gaps in the seventies and early eighties, this conjecture is less convincing for the late eighties and early nineties. This should not be surprising. The late sixties and early seventies were characterized by a strengthening of unions and by an expansion of welfare states in continental Europe. This development of strengthening workers' bargaining position culminated and ended in Germany with the introduction of extensive codetermination rights in the mid seventies. The power of unions, e.g. in terms of union coverage and membership, has, if anything, decreased since then and it is fair to say that the generosity of welfare states has by and large been kept unchanged, albeit at a high level. Hence, changes in the aggressiveness of wage setting and for that matter also changes in the incentive structure of the unemployed to stay idle are hardly promising avenues for explaining further rising unemployment in continental Europe in the eighties and nineties. It rather appears that labor demand has undergone additional changes beyond a move towards higher skill requirements of firms which undoubtedly has occurred to some extent. It is noteworthy that labor shares have by now dropped in France and Germany below the level in the U.S.

To make some leeway in analyzing in an admittedly highly stylized form the evolution of labor demand in continental Europe, the following standard description of the labor market is useful. Labor supply LS is for simplicity assumed to be infinitely elastic with respect to the real wage w up to full employment and completely inelastic beyond. The wage-setting curve WS , which reflects union wage bargaining and/or efficiency wage considerations, is as usual upward sloped so that increasing employment L leads to higher real wage settlements. The key to understanding the evolution of unemployment in continental Europe seems to be adjustments of labor demand LD . The reaction of labor demand to wage-setting shocks depends very much on the time span which is considered. Firing costs, putty-clay production technology, convex costs of changing factor proportions, delivery contracts etc. make labor demand highly inelastic in the short run as depicted by the vertical instantaneous labor demand curve LD^{SR} . Hence, capital is exposed to appropriation by myopic insiders. If a wage shock occurs, e.g. due to higher firing costs, the

wage-setting curve moves from WS to WS' . Employment does in this extreme case not change at all in the short run and the economy is simply moved from point A to point B.⁸ However, there is of course some substitutability between labor and capital over time as is reflected by medium-run labor demand curve LD_K^{MR} , so that employment will decrease to a point like C where the size of the capital stock is still unchanged. This is by no means the end of the story, though. The return to capital in point C is still lower than in the initial point A. Assuming that capital received in A just the internationally required rate of return and furthermore assuming that this world-wide interest rate has not changed in the meantime, capital clearly has an incentive to move out of the country concerned until the rate of return on capital rises back to its original level. Hence, a further reduction in employment is effectuated until point D is realized. Point D lies on the long-run labor demand curve LD_{ET}^{LR} with a perfectly variable size of the capital stock and an efficient choice of technology.⁹

Fig. 2: The Long-Run Effects of Appropriation Problems



⁸ It is noteworthy that the speed in the reaction of labor demand to wage-push shocks is about four times higher in the U.S. than in Europe (Siebert 1997), so that capital is more exposed to appropriation in Europe.

⁹ See Blanchard (1997) and (1998).

The analysis has hitherto abstracted from repercussions of the original wage-setting shock on the efficiency properties of the process of creative destruction. This is of course not innocuous once the analysis is extended to the long-run. A wage-push shock due to higher firing costs derails the process of creative destruction and moves the economy on a sclerotic time path. It artificially induces firms to invest less and when investing new vintages of capital to select production technologies which rely more on the use of capital in the production process. In other words, such an economy embarks on a different time path concerning the evolution of the production technology: firms will switch to more capital intensive production technologies in order to become less open to appropriation by insiders. The appropriability problem arises due to the existence of specific quasi-rents in the production process which cannot be contracted away. Such specific quasi-rents can be due to technological reasons such as firm-specific knowledge of workers and firm-financed training of workers or they can also be due to political reasons such as high firing costs possibly reinforced by generous unemployment benefits and a high level of unionization. Strong legal protection of management in publicly traded firms against close control by firm-owners is another politically induced and possibly important appropriation problem causing technological sclerosis.¹⁰

The late sixties and early seventies clearly witnessed politically induced appropriation shocks. Firing costs were raised, unions gained in power and the welfare state in general expanded. Such an appropriation shock has negative long-run effects on the process of creative destruction and thus on employment. Not only was job creation unequivocally reduced, but rising unemployment depressed in addition shadow wages, i.e. earning opportunities of workers when they are laid off, thus reducing their appropriation potential and pressure to scrap old vintages of capital. The resulting increase in the average scrapping age of the existing capital stock causes a slowdown in the rate of technological progress thus diminishing productivity growth and equilibrium wages. These negative effects on the process of creative destruction can be taken into account in our simple diagram by an additional horizontal long-run labor demand curve LD_{TS}^{LR} . It must lie beneath LD_{ET}^{LR} as it incorporates the long-run technological sclerosis effects of an attempt by insiders to appropriate capital. Hence, unemployment increases even further to a point like E as long as WS' remains the relevant wage-setting curve. The problem of microeconomic

¹⁰ See Caballero and Hammour (1997) and (1998a).

specificities, which is aggravated by political institutions in particular in continental Europe, experiences a highly inefficient macroeconomic solution.

Hence, there are long-run consequences on unemployment of the appropriation shocks which occurred in continental Europe in the late sixties and early seventies which are usually neglected. Three interesting implications emerge. First, similar to the Krugman (1994) approach, appropriation problems also lead to a substitution of labor in the production process, albeit not only by human capital but rather also by real capital. Second, the resulting long-run increase in unemployment is related to insider power and wage setting, but the trade-off between real wage and employment growth not only disappears, but there is actually a positive long-run relationship because the average worker is at any given rate of unemployment eventually paid more money in real terms in high-employment countries where the appropriation threat to capital by insiders is less of a problem and where the process of creative destruction therefore works more smoothly thus inducing a better allocation of resources. Third, the labor share must by implication also be greater in the long run in such countries, so that demands to increase the labor share via an aggressive wage policy are from a long-run perspective completely mistaken.

The ongoing process of globalization is closely linked to this appropriation issue. The greater mobility of capital causes faster downward adjustments of the capital stock in response to an appropriation shock. Furthermore, factor-substitution possibilities have been enhanced by globalization, as not only the speed of technological progress but also the potential for specialization has been increased. The broadened technological menu which firms have nowadays at their disposal promotes investment and growth, but workers may not share in the benefits if labor markets are heavily regulated and therefore malfunctioning. Finally, globalization accelerates the ongoing fundamental transformation of production structures from Fordism to holistic organizations. The implied changes in the organization of production, which essentially take place in all highly developed countries, magnify appropriation problems as the importance of microeconomic specificities, e.g. in terms of firm-specific knowledge is increased. Yet, this development has a particularly severe effect on employment in countries where politically induced appropriation problems are already large, i.e. political and technological appropriation problems are not substitutes but they rather reinforce each other.

4. Rising Volatilities

However, there is another important macroeconomic channel via which globalization raises quasi-equilibrium unemployment specifically in continental Europe. The level of volatilities, i.e. the size and frequency of shocks which firms have to cope with, has increased significantly in recent years. This is above all the result of more globalized goods and capital markets, which give rise to the observable rapid restructuring from manufacturing to the service industry, the already mentioned fundamental reorganization of production and firms, "footloose" industries, "calegidoscopic" comparative advantages, shorter product life cycles, unstable portfolio choices of foreign investors, and more pronounced fluctuations of stock market prices.¹¹ The ability of economies to absorb such greater volatilities without rising unemployment depends decisively on their institutional characteristics. Continental Europe is in a number of ways not well prepared for this task. First, the above-mentioned appropriability problem, which is particularly severe in continental Europe exacerbates in an asymmetric way the susceptibility of economies to shocks. The employment effects of adverse shocks are greater than those of positive shocks in economies which exhibit appropriability problems. Hence, recessions become deeper and booms more shallow so that an overall increase in volatility causes average unemployment to rise.¹²

Second, greater volatilities entail the need for larger fluctuations on labor markets as firms have to adjust more often to changing economic circumstances. Yet, each layoff is coupled with an immediate loss of firm- or sector specific human capital which, through the existence of rent sharing, is part of the remuneration package of workers. If unemployment benefits are tied as in continental Europe to last earnings and long-lasting, it is clear that a larger percentage of workers will stay (voluntarily) unemployed compared to a very harsh unemployment benefit system like in the U.S. where receipt of unemployment benefits is strictly limited to up to six months. Job offers

¹¹ See Bhagwati and Dehejia (1994), Bertola and Ichino (1995a), Lindbeck and Snower (1996), Ljungqvist and Sargent (1998), Rodrik (1997), and Calvo and Mendoza (1997). The latter authors show in particular that more globalized capital markets make herd behavior of investors more likely because of fixed information costs concerning the fundamentals of countries and firms, and because they widen the band of multiple equilibria due to reputational effects. Gottschalk and Moffitt (1994) provide empirical evidence for the U.S. that not only the dispersion of earnings between individuals but also the volatility of an individual's earnings has increased since the early 1980s.

¹² See Caballero and Hammour (1998b).

in new firms or sectors will usually carry lower wages as they do not include the previously earned rent-sharing component, making them rather unattractive compared to remaining unemployed and still benefiting at least partially from the already depreciated specific human capital.¹³

Third, high firing costs aggravate the negative effects of greater volatilities on employment. Rising volatilities in combination with high firing costs increase total expected labor costs as the probability rises that any particular worker becomes redundant at a given point in time so that firms have to bear large firing costs. Hence, firms turn more reluctant to use the quasi-specific production factor labor in the production process leading to an overall reduction in labor demand. Rising volatilities therefore unambiguously have a greater negative effect on labor demand in a rigid economy with high firing costs than in a flexible economy with low firing costs.¹⁴

Fourth, a more volatile economic environment reduces in particular labor demand in countries where firms have weak balance-sheet positions and are mainly financed by credits. A greater volatility of shocks causes the risky rate of interest which firms are charged by banks to rise as banks must counterbalance a higher default risk. This reduces investments so that labor demand of firms shrinks in turn in the long run.¹⁵ The ensuing larger marginal productivity of employed labor is needed to compensate firms for their greater obligations concerning interest payments and for the larger expected value of bankruptcy costs. The last two problems, high firing costs and reliance on credit finance, in relation with greater volatilities, could in principle be offset by more moderate wage agreements. However, high firing costs by themselves reduce the willingness of workers to react to greater volatilities with wage moderation. Furthermore, if such shocks are largely firm-specific, strong and central unions are unlikely to cut wage demands in reaction.¹⁶

In sum, the ongoing process of globalization entails significant changes concerning labor demand which conflict with important institutional characteristics of the continental European economies.

¹³ See Ljungqvist and Sargent (1998).

¹⁴ See Bertola and Ichino (1995a) and Fehn (1997). This result stays in contrast to the findings of Bentilola and Bertola (1990), where the effects of an increase in firing costs on labor demand at a constant level of volatilities were found to be ambiguous.

¹⁵ Empirical evidence for the negative effect of weak balance sheet positions on labor demand is provided inter alia by Funke et al. (1998), Nickell and Nicolitsas (1997) and Winker (1998).

¹⁶ See Aizenman and Powell (1997) and Fehn (1998).

In particular, the following institutions appear to be highly detrimental to employment growth in the era of globalization: generous and indefinite transfer payments to the unemployed, large firing costs, strong and relatively centralized unions, a predominance of credit financing of firms and a strong position of management vis-à-vis firm owners. The last two points make clear that insider-oriented systems, be they on labor or on capital markets, always diminish employment. However, reflecting the title of the paper the following sections only deal with labor-market policy. It should nonetheless be kept in mind that reforms in other areas such as capital markets are highly complementary to labor-market reforms, in the sense that they raise the achievable positive employment effects.¹⁷

III. Designing an Efficient Labor-Market Policy

Efforts to mitigate the negative employment effects of globalization in continental Europe should concentrate on redesigning labor-market policy in order to help workers to cope with the consequences of globalization rather than on the futile attempt of restricting the process of globalization itself. The latter would in fact also reduce the opportunities to reap the benefits of globalization. Policies to increase employment must aim at raising the capacity of labor markets to adjust to negative shocks and at avoiding policy-induced shocks rather than on shielding labor markets from non policy-induced shocks. Although a multitude of shocks have led to rising unemployment in continental Europe, the number of institutional variables which act as negative transmission mechanisms is far more limited. The task of an efficiency-oriented labor-market policy can be boiled down even further: it must concentrate on breaking the dichotomy between insiders and outsiders on labor markets by promoting the reintegration of outsiders into the regular labor market. This can *inter alia* be achieved by an appropriate design of passive and active labor-market policies, which will be the topic of the following sections. However, rising and persistent unemployment is largely due to rigid, undifferentiated and overly aggressive wage setting. Hence, a key target in reforming passive and active labor-market policies must be exerting greater restraint on wage-setting behavior of insiders. These tasks are in principle not different compared to the era before globalization, but fulfilling them has become far more urgent

¹⁷ See Coe and Snower (1996).

because the welfare losses associated with inefficient institutional settings have increased dramatically.

The principal question is how outsiders, in particular the long-term unemployed, can be reintegrated into the regular labor market. It is important to recognize in this context that the ultimate goal must always be reemployment in the regular labor market as second or third labor markets tend to become a drag on the regular economy eventually, thus further reducing regular employment and entering into a vicious circle of rising taxes and government employment.¹⁸ Policies will only be successful in enfranchising outsiders if they either alter their incentive structure towards actively seeking jobs or enhance the incentives of firms to hire outsiders. The unemployment benefit system and the design of active labor-market policy are of particular importance in this respect. They therefore deserve to be discussed in some detail.

1. Reforming Unemployment-Benefit Systems

There can be no doubt that high levels of unemployment and especially of long-term unemployment are related to the generosity of the unemployment benefit system. Even without invoking Say's Law, it is immediately clear that if people are offered high and long-lasting pay for staying idle with little pressure to accept available jobs, a lot of them will of course stay idle. High benefits create high overall unemployment and long-term benefits generate lots of long-term unemployment. The detrimental effects of lavish unemployment benefit systems are among the best-documented and least controversial facts in labor economics. The negative employment effects arise not only due to a lower search intensity of the unemployed but also because the fallback position of insiders is improved thus making wage setting more aggressive. Empirical studies are almost unanimous in confirming this conjecture. Hence, reforming unemployment insurance must aim at reversing these effects, which is intricate as it involves difficult political choices.¹⁹

¹⁸ See Berthold and Fehn (1997).

¹⁹ See e.g. Layard et al. (1991), Nickell (1997) and Scarpetta (1996). Hunt (1995) has shown that prolonging unemployment benefits to the elderly in the 1980s in Germany significantly increased their unemployment spells. A more ambiguous assessment of the effects of unemployment insurance on the level and duration of unemployment can be found in Atkinson and Micklewright (1991).

a) Privatizing Unemployment Insurance?

A radical market-oriented reformer might suggest that government-run unemployment benefit systems should be completely abolished, thus letting private insurances take care of the different moral hazard effects concerning job search, wage setting and layoff patterns of firms, which are caused by unemployment benefits. Private insurances are able to cope with moral hazard problems on other markets, like e.g. car insurance, so that they should in principle also be able to do so on the labor market. However, the analogy is not quite that simple. As long as the government guarantees a minimum level of income to those citizens who cannot support themselves, as is the case in continental Europe, people clearly lack incentive to sufficiently insure themselves. They can always count on the government to step in if they are in need. Hence, to avoid free-rider behavior of its citizens, the government must at least force those who have a job to underwrite unemployment insurance contracts covering this guaranteed minimum standard of living for a certain time period.

Yet, there are furthermore doubts as to the viability of such a private unemployment insurance system. Not only is the probability distribution of becoming unemployed largely unknown, but this risk also is highly correlated in the case of macroeconomic shocks, so that private insurances might quickly go bankrupt if large macroeconomic shocks occur. Both factors make unemployment a risk that is difficult to insure on private markets. Considering that macroeconomic shocks, such as a large and sudden fall in stock prices, often hit several countries simultaneously, it would not even help much if private unemployment insurances tried to diversify internationally their portfolio of insured risks. A completely privatized system of unemployment insurance is therefore problematic as long as efficient diversification is impossible. It is from this perspective no coincidence that unemployment insurance is in all highly developed countries run by the government.²⁰

²⁰ See e.g. Anderson and Meyer (1993). One could however conceive of a mixed system where unemployment insurance is offered competitively by private insurance companies which are subjected to close government surveillance and which are bailed out by tax money in case of large macroeconomic shocks.

b) Reforms within the Current Unemployment-Benefit System

However, there is considerable scope for efficiency-enhancing reforms concerning unemployment insurance which fall short of completely privatizing the system. Taking Germany as the institutional benchmark, the following characteristics of the current unemployment benefit system are noteworthy: registered unemployed persons receive benefits for an extremely long time by international comparison (table 3). Unemployment benefits last up to 32 months depending on age and on the time contributions were previously made. Furthermore, unemployment benefits are followed by unemployment assistance, which is granted without time limit. Though unemployment assistance is means-tested, the amount paid in both types of benefits depends on previous net income as well as on family status. In each case this amount remains in principle unchanged until payments are terminated. Pressure exerted on registered unemployed persons to accept offered jobs has been increased in recent years but must still be considered to be low. In particular, nobody is forced to move to another region if jobs are available there but not in her hometown and not within a 180 minutes per day commuting distance. Unemployment insurance is organized on the national level and is mainly financed by a flat rate social security tax on gross wages which is levied in equal parts on workers and firms. There is no differentiation according to risk class of workers or firms or according to region. Unemployment assistance is exclusively financed by federal tax money.

Table 3: An International Comparison of Unemployment Insurance

	U.S.	Germany	France	UK	Sweden
Benefit Replacement Rate (%)	50	63	57	38	80
Benefit Duration (years)	0.5	unlimited (unemployment assistance)	3	unlimited (unemployment assistance)	1.2

Source: Nickell (1997, 61).

Considering the well-established negative effects of the German unemployment insurance system on the functioning of the labor market, a number of reforms need to be undertaken. The time span for which unemployment benefits can be received is empirically the most significant factor in

explaining country-specific differences in unemployment and especially in long-term unemployment. Hence, cutting this maximum time span should get first priority. The unemployment benefit system must furthermore entice people to actively seek jobs even if available jobs differ concerning pay, qualification, region etc. from the previous one. This is the only way of avoiding persistent unemployment in times of high volatilities and rapid structural change. The longer an individual is unemployed, the greater must be the pressure on her in this respect. Having held a well-paid job in a certain region for some time cannot constitute a reason that the rest of society guarantees a related income position in this region for the rest of one's life.

These considerations first and foremost suggest that the design of unemployment assistance is fundamentally flawed. Unemployment assistance is not part of the insurance system but benefits are nonetheless linked to previous net income and they are granted without time limit. However, if somebody has not been successful in finding a job until unemployment benefits have expired, she should in case of need receive welfare benefits which have nothing to do with previous net income. Hence, unemployment assistance should simply be abolished. Recipients should be made aware of the fact that they are no longer part of the insurance system. The maximum time span for receiving unemployment benefits should in addition be reduced to say something like one year from where on the person concerned is usually considered to be long-term unemployed. Countries with flexible labor markets and a far better unemployment performance such as the U.S. even limit the receipt of unemployment benefits to six months.²¹

It must furthermore be remembered that unemployment insurance involves severe principal-agent problems as it is impossible to even come close to identifying the causes why a worker was laid off and to perfectly monitoring the search efforts of the unemployed. Yet, workers and firms have plenty of room for discretionary maneuver concerning whether and why a work contract is actually terminated. The reemployment probability depends in addition in large part on search effort. Experiments in the U.S. have demonstrated that economic incentives greatly affect the speed with which people leave the unemployment insurance rolls. Hence, unemployment

²¹ In particular the U.S. has a much more restrictive system of unemployment insurance. Unemployment rates were about the same in West-Germany and the U.S. in 1990, but Germany spent in that year 0.23% of GDP on unemployment benefits whereas the U.S. only spent about 0.09% of GDP on unemployment benefits; see Schmid (1995, 93).

insurance is not a benign transfer, it rather has repercussions on claimants' behavior. Moral-hazard and free-rider problems can be contained by introducing the right incentives. Models based on intertemporal utility maximization and on these moral hazard considerations suggest that there should be a punishment for terminating work contracts and a reward for finding regular employment again. Concerning the size of benefits this translates into a large drop in income in the first period of unemployment, with benefits then increasing up to a peak from where they decrease again all the way down to the level of welfare benefits. Finding a job again should in contrast be rewarded in the early periods of reemployment possibly by only slowly phasing in social security contributions. The total reward for reemployment must be the greater, the longer was the previous unemployment spell in order to contain the risk of fraud. This approach to installing a reemployment bonus is preferable to a cash handout. A cash handout would rather raise the incentive to file for unemployment insurance even though a job might be available immediately and even though the laid-off person would currently not believe that filing for unemployment insurance is worth the trouble. Benefits should finally be terminated after a certain spell of unemployment, e.g. six months, if the unemployed person received suitable job offers, but at locations which are further away than 180 minutes per day commuting distance.²²

However, it might also be useful to introduce a strictly rule-bound system of automatically punishing firms for terminating work contracts. This alludes to the issue of experience rating firms' contributions to unemployment insurance. Making the size of firms' contributions to unemployment insurance depend on their layoff behavior would help to internalize the social costs of layoffs. The U.S. is the only OECD country with experience rating. Based on its beneficial effects there, U.S. researchers mostly suggest to expand the present system of experience rating in unemployment insurance rather than to abolish it. Hence, it should be considered to include elements of experience rating in a comprehensive reform of unemployment insurance in Germany. Unemployment would then be taxed thus providing an incentive for firms to engage in stable activities and to smooth production over seasons and cycles. Experience rating

²² See Wang and Williamson (1996). Hopenhayn and Nicolini (1997) suggest that optimal unemployment insurance consists of decreasing benefits coupled with a wage tax levied on workers that increases with the length of the previous unemployment spell to punish workers for continued unemployment by reducing their claims to all kinds of future consumption in unemployment and in employment. However, in the continental European setting, where welfare benefits constitute a minimum net wage, this appears to aggravate sorting effects among the unemployed as the incentive to reenter the regular labor market decreases with an increasing unemployment spell. Meyer (1995) provides a thorough discussion concerning the results of experiments with reemployment bonuses in the U.S.

would furthermore reduce cross subsidies from stable sectors, such as the service sector, to unstable sectors, such as construction. Hence, the overall stability of the economy would be promoted. Such a system of experience rating would have an additional advantage. It would protect workers against arbitrary layoffs thus reducing the case for government-imposed firing costs.²³

However, experience rating would further strengthen the position of insiders in wage negotiations. Hence, introducing a comprehensive system of experience rating would only make sense if government-imposed firing costs are simultaneously reduced. Firing costs e.g. in the form of severance payments are not only large in the German case, but they are also hard to calculate ex ante as their actual size mostly depends on rather discretionary decisions of labor courts. German labor courts usually give priority to the interests of the worker concerned with little consideration of the macroeconomic consequences. This has very negative repercussions on the hiring decisions of firms and thus on long-run employment growth. The detrimental effects not only rise with the volatility of the economic environment, but they also increase the potential of insiders to appropriate firms by improving the fallback position of insiders.

Firing costs are only justified as they force firms to carry part of the mobility costs which are otherwise exclusively borne by workers in case of layoff and by protecting workers against short-term and maybe arbitrary dismissals. However, both goals would already be achieved by experience rating in combination with sufficiently long notification periods so that severance payments become in fact superfluous. Labor law should furthermore state very clearly under which circumstances it is legal to fire a worker in order to reduce insecurity in this field. The rule-bound element in labor relations would be promoted by substituting experience rating in unemployment insurance for the current system of large and hard-to-calculate government-imposed firing costs. The tendency that labor is becoming more and more a quasi-fixed factor would be reversed. Firms could react more quickly to greater volatilities so that employment growth would be promoted. However, unemployment insurance must be reformed in tandem with abolishing government-imposed firing costs. The increase in volatilities would otherwise induce a

²³ See Baicker et al. (1997, 23) and Card and Levine (1994).

much greater rate of lay-offs, and this would cause an even further rise in long-term unemployment as long as unemployment insurance is not reformed in the outlined direction.

Returning to the issue of transfer payments to the unemployed, unemployment insurance should rely as much as possible on insurance principles. It is therefore not justified to differentiate payments according to family status. Income redistribution in favor of families should be completely detached from unemployment insurance.²⁴ Unemployed parents who receive unemployment benefits which are below their claims to welfare benefits are entitled anyway to receive the difference in the form of supplementary welfare benefits. If a needy person has not found a job after one year of unemployment, she has access to welfare benefits. However, to again contain moral hazard problems, the full amount of welfare benefits should only be granted if at least one of the two following conditions is satisfied. First, the unemployed person is not able to work, e.g. due to having small dependent children or due to being severely handicapped. Second, she does not refuse training or jobs offered by the local authorities even though these might be of menial character and involve no or only very little additional pay. Her level of welfare benefits should be reduced and in severe cases completely terminated if a long-term unemployed person who is able to work rejects such job offers or training. Confronting the unemployed with such a choice is the only effective way of dismantling their advantage concerning leisure time. The opportunities of the unemployed to work on the black market would be curtailed and envy effects of people holding a job would be kept in check. Such envy effects arise especially in case of families because a working spouse with children often earns a net wage which is only marginally above the level of welfare benefits. The fairness and reciprocity principles of the welfare state would be strengthened by strictly enforcing these conditions.

c) Opening Unemployment Insurance for Institutional Competition

However, society as a whole might not yet be willing to go down this road of reforming transfer payments to the unemployed. Confidence in market mechanisms is scarce and many people will therefore doubt whether positive employment effects will materialize. Yet, the support for such

²⁴ See Snower (1995).

reforms hinges on the size of the perceived positive employment effects because the unemployed are obviously treated more harshly. Considering the widespread but completely misguided thinking in given amounts of labor demand as the limiting factor for employment suggests that this support will be rather limited. The unemployment benefit system should therefore simply be opened for the concept of institutional competition between regions. The above proposals can then be taken as an institutional benchmark for an efficiency-oriented system but each region would be free in deciding the precise design of its unemployment benefit system. Each region should be allowed to give individuals considerable choice concerning their unemployment insurance package such as the level and contour of benefits and the eligibility criteria. The contributions of the insured would then depend on how encompassing the chosen package is. Reductions of firms' contributions due to a worker choosing a package which is less generous than a predefined standard package would have to be paid out to the worker to set her incentives right.²⁵

Some regions are likely to choose stricter and more elaborate systems than the inefficient current system. The positive employment effects of more efficient setups in these regions will over time become evident to other regions as well. Pressure will therefore increase to undertake reforms in the same direction. Such an institutional competition approach requires of course that the financing of unemployment benefits must then also be organized on the regional level so that regions along with their firms and workers benefit more directly from efficient solutions. Yet, insurance principles demand that the organization and financing of unemployment benefits only be delegated to the level of large states such as Bavaria or North-Rhine-Westfalia. Smaller states with few dominant sectors such as Saarlouis would have to join with others such as Hesse and Palatine. Looking again across the Atlantic shows that unemployment insurance in the U.S. is organized at the state level, and that the experience of the U.S. with institutional competition in this field is encouraging.

Opening unemployment insurance for institutional competition would also allow even bolder reforms in certain front-runner regions. Individuals could be allowed to leave unemployment insurance altogether if they do not depend on welfare benefits for the standard duration of

²⁵ See Snower (1995).

unemployment insurance, e.g. one year, in case they become unemployed. Free rider behavior could be excluded very simply by forcing individuals to keep savings amounting to at least their claim to welfare benefits for one year in a separate Individual Unemployment Account (IUA).²⁶ This IUA would have to be inaccessible for its owner while holding a job and before retirement, but it could substitute completely for contributions to unemployment insurance. Individuals would in case of unemployment simply draw on this IUA. If the person concerned found a job again, her choice of opting out of unemployment insurance would only be available again once the IUA is refilled up to her specific minimum amount. Positive balances on the IUA would have to earn interest payments approximately equal to those on government bonds. Any positive balance that would still remain at retirement age would be paid out to the individual. Such an IUA-system would have great advantages: individuals would draw on their own wealth to finance limited periods of unemployment rather than immediately collecting checks from the state. Consequently, they would tend to be more diligent in searching for work and they would also have a stronger incentive to explore alternatives to layoffs with employers. Furthermore, it would no longer matter why an individual had become unemployed so that there would be savings in terms of costs for bureaucracy. In sum, there is plenty of room for efficiency-enhancing reforms of unemployment insurance and it is time something is done about it.

²⁶ See Orszag and Snower (1997) and Snower (1995).

2. Redesigning Active Labor-Market Policy

Active labor market policy (ALMP) is often celebrated as a panacea for fighting unemployment. Politicians and international organizations alike are almost unanimous in their confidence in the efficacy of ALMP. This broad consensus is reflected in the fact that the massive use of ALMP in the eastern part of Germany is largely uncontroversial. ALMP are essentially measures which do not passively finance unemployment but which are rather expected to pave the way for the unemployed back into the regular labor market. There are three avenues via which ALMP can in principle increase employment. ALMP can reduce asymmetries of information between labor demand and labor supply. This is a rather uncontroversial task, which can be fulfilled both by a government agency and by private organizations. ALMP can furthermore contribute to qualifying the unemployed so that their qualification profile fits better with labor demand. These two strategies are essentially aimed at reducing mismatch unemployment. The government can finally attempt to increase aggregate employment directly via work creation schemes or via wage subsidies.²⁷

Expenditures for ALMP in Germany increased massively in the late 1980s and the early 1990s, i.e. from 0.8% of GDP in 1985 to about 1.6% of GDP in 1993. This development is obviously related to reunification. Outlays for ALMP have been slightly reduced since then amounting to 1.3% of GDP in 1995. These numbers put Germany in a little bit above average position concerning expenditure for ALMP in OECD countries. Especially the Scandinavian countries spend far more on ALMP. Sweden for example used a whopping 3.0% of GDP for this purpose in 1995. These non-negligible sums reflect the widespread trust of policymakers in the efficacy of current ALMP in fighting unemployment. However, the efficiency of ALMP in raising employment cannot be taken for granted and rather depends upon its institutional design.

²⁷ See Calmfors (1994).

a) Can ALMP Raise Regular Employment?

ALMP is a useful instrument for fighting unemployment if it addresses the causes of rising unemployment and if possible negative side effects are not too large. It must in particular contribute to increasing the adjustment capacity to shocks and to raising regular employment. If successful, ALMP acts as a trampoline for laid-off workers, helping them to return into the regular labor market. This is in sharp contrast to simply handing out transfer payments to the unemployed, where the welfare state degenerates into a hammock for the unemployed, in which they can rest without time limit and be a burden for the rest of society. It should be noted that the impact of ALMP on regular employment must be the criterion of judgment and not official unemployment. The government could otherwise simply declare all the unemployed to be state employees or students, who are entitled to receiving tax money, and claim the unemployment problem to be solved.

The idea of financing work instead of unemployment and thereby upgrading workers' skills is appealing but in its very simple form misleading. Unemployment is of course a waste of resources but the unemployed nonetheless fulfill an important macroeconomic function. They dampen wage demands of insiders thus producing macroeconomic stability in terms of constant inflation and in terms of guaranteeing capital its internationally required return. The stronger the position of insiders is, e.g. due to high union density, large firing costs and generous unemployment insurance, the more unemployment is needed to produce macroeconomic stability. Simply transferring the unemployed into state-organized ALMP schemes and paying them wages which are closely related to insider wages does therefore undermine macroeconomic stability. In terms of figure 2, such a measure would reduce effective labor supply thus moving the LS curve to the left and simultaneously pushing the WS curve upwards. The long-run consequences on employment would be even worse as such an inefficient ALMP would amount to another appropriation shock by improving the fall-back position of insiders. Hence, the economy would become even more sclerotic and long-run labor demand is further pushed downwards. Such an approach would end up in a government-guaranteed right to work, which is not compatible with a market economy. The failure of the Swedish model as well as the disastrous experience of the

centrally planned economies of Eastern Europe should have completely discredited such an overambitious government employment policy.²⁸

Repercussions on wage setting are therefore important and the total employment effects of any particular instrument of ALMP cannot be analyzed in isolation. A high reemployment quota of participants in an ALMP scheme is on the one hand not an unequivocal indicator that this scheme promotes employment at the macrolevel as reemployment might be at the expense of other workers and as the fallback position of insiders might be improved. The latter effect would lead to increased wage pressure and eventually to employment losses. On the other hand, ALMP schemes which appear useless on first sight might reduce the welfare level of participants. If insiders reckon that they would have to enroll into such a program in case of dismissal and bear the extra utility loss, this would reduce wage pressure thus raising total regular employment. Hence, a macroeconomic approach is called for evaluating ALMP.

In order to be successful, ALMP must therefore be organized in a more subtle way and especially avoid the fallacy of increasing appropriation problems and aggregate wage pressure. ALMP must improve the chances of the unemployed to return into the regular labor market and not simply hide unemployment. As wage pressure is mainly contained by the short-term unemployed, ALMP should concentrate on helping the long-term unemployed thus preventing a shrinkage of effective labor supply. The long-term unemployed suffer from a number of disadvantages concerning their prospects for reemployment. They not only lose work discipline and are stigmatized, but their skills are also often inappropriate for entering into expanding sectors such as the service sector. An efficient ALMP should counteract these effects thus increasing competitive pressure for insiders by raising effective labor supply. ALMP can also serve as a work-test device if those unemployed who refuse to participate in such schemes lose their claims to transfer payments. Hence, ALMP can in principle reduce mismatch unemployment as well as unemployment due to insider-outsider problems.

²⁸ See Berthold (1994) and Sachverständigenrat (1995). Essentially the same reasoning is true for general wage subsidies which let gross wages inevitably rise by the amount of the subsidy thus producing a negative overall effect on employment if the subsidy is financed by distortionary taxes.

However, badly designed ALMP can also give rise to negative employment effects.²⁹ First, ALMP may raise wage pressure if the government is perceived to become employer of last resort via this channel. This would further blur responsibility for persistently high unemployment. The public already tends to hold the government and not wage setters responsible for the dismal labor-market situation. However, wage setters and not the government should mainly be held accountable in a market economy where wages should be the result of negotiations between workers and firms unfettered by government interference. Expanding ALMP supports this widespread misconception and thus even further reduces pressure on wage-bargaining parties to consider the employment effects of their wage settlements. Moral-hazard behavior of insiders is promoted, so that they will push for higher real wages and more rigid wage structures.

Second, ALMP can also lead to more wage pressure by increasing the utility level of outsiders, e.g. by raising their disposable income, by improving their chances to become employed again or by renewing their claims to receive unemployment insurance once participation in the particular program ends (revolving door effect). This is in particular a problem if the short-term unemployed, which is the reference group for insiders, are not excluded from participation in ALMP schemes. An increase in their utility level improves the fallback position of insiders and reduces pressure on insiders to display wage restraint.

Third, ALMP needs to be financed and it is usually more expensive to run ALMP schemes for the unemployed than to simply pay them benefits. Not only are wages in ALMP schemes often considerably above unemployment benefits but the organization of such programs is also costly. High capital mobility in a globalized economy largely protects mobile capital from having to finance ALMP. Hence, taxes on less mobile labor, i.e. on insiders, have to do the job. Yet, as this reduces the net income of insiders relative to their income when unemployed, the utility loss of being laid off is lower. This gives rise to increasing wage pressure. These three caveats show that one must be circumspect in designing ALMP in such a way that a vicious circle consisting of rising taxes and social security contributions, greater wage costs and shrinking regular employment is avoided.

²⁹ See Berthold and Fehn (1997).

Fourth, the positive effects on regular employment of ALMP must also be questioned as it is unavoidable that some participants gain employment at the expense of other unemployed or of insiders or that they would have been hired anyway. Such substitution, displacement and deadweight effects reduce potential positive employment effects of ALMP. However, it can be shown that there remains in any such case a positive net employment effect if ALMP programs are exclusively targeted at the long-term unemployed.³⁰

Fifth, it must in a similar vein be questioned whether programs run by the government can qualify the unemployed according to market needs. General skills, which become more important due to the described changes in the organization of production, should be acquired at school age. As ALMP schemes are almost by definition targeted at adults, they should primarily convey firm- or sector-specific skills. Yet, firms have an inherent advantage over the government in teaching these types of skills, so that ALMP should as a rule be organized on the job and not off the job.³¹

Assessing the overall employment effect of current ALMPs is by no means an easy task since intricate empirical questions are involved. However, it should be clear by now that the widespread enthusiasm about ALMP being a highly effective instrument for fighting unemployment is hardly justified. Whether ALMP in its present form really helps to raise regular employment is not clear at all, the results are rather ambiguous. Some studies show that countries with a higher degree of activity concerning ALMP tend to have lower unemployment rates, though this is as mentioned above a dubious criterion for judging ALMP. Others end up with a negligible or even negative effect on regular employment which is the criterion that should be applied. There exists in particular the problem that the wage-raising effects of expanding ALMP sometimes turn out to be greater than if regular employment grows by the same amount. This underlines the importance of the argument that governments which expand ALMP exonerate wage setters from their responsibility for the employment situation. There is very little evidence that ALMP helps substantially in reintegrating the long-term unemployed into the regular labor market. It rather seems that ALMP mainly serves to transform open into hidden unemployment

³⁰ See Richardson (1997).

³¹ See Alogoskoufis et al. (1995).

thus putting a lid on the boiling pot of unemployment.³² Although ALMP is a favorite solution of all political camps to labor market problems, it has at best modest positive overall effects on regular employment. In particular, government training tends to have lower returns than private training. The case in point are Sweden's ALMPs which were for quite some time heralded as a razor-blade sharp weapon against unemployment, but put to the test in the 1990s they were found wanting.³³

b) What Should an Efficient ALMP Look Like?

ALMP is therefore only able to raise regular employment if it is targeted at the long-term unemployed, if it contributes in particular to providing the long-term unemployed with marketable skills on the job and if support for any specific individual has a strict upper time limit.³⁴ Such design features not only help to keep wage-raising effects and the financial burden to the government in check but they are also important in the sense that only well-qualified workers will in the longer run be employed on the regular labor market without falling into the working-poor category. The Benefit Transfer Program, which has been proposed in recent years by Dennis Snower incorporates by and large these criteria for an employment-oriented reform of ALMP.³⁵ It suggests that the unemployed should receive after a certain time spent in unemployment a hiring voucher which is worth a specific amount of money in addition to their regular unemployment benefits. The unemployed are entitled to hand these vouchers over to firms which are willing to hire them. The hiring firms can transform these vouchers into cash by handing them over to the government agency which is in charge, e.g. the labor office. Hence, these vouchers are essentially a wage subsidy which is directly linked to the claims of the unemployed to government benefits. There is no extra financial burden to the government as long as deadweight, substitution and displacement effects are not too large, because unemployment benefits are of course terminated once such a person finds a job.³⁶ The vouchers raise the critical

³² See Calmfors (1994), Calmfors and Skedinger (1995), Jackman (1994), Nickell (1997), Robinson (1995), Walter (1995) and Scarpetta (1996).

³³ See Freeman (1998) and Calmfors and Lang (1995).

³⁴ See Robinson (1995) and Richardson (1997).

³⁵ See Snower (1994) and Orszag and Snower (1996).

³⁶ See Fehn (1997).

wage level at which firms are willing to hire the respective unemployed. Thus, the number of mutually beneficial work contracts rises. To promote especially human capital formation, the cash value of any voucher should be higher if the firm proves that it provides the hired unemployed person with training schemes.

In order to prevent wage pressure from rising, receipt of such vouchers must be restricted to persons who have been unemployed for a longer time span. Two countervailing effects must be taken into account in this respect. The longer the unemployed must wait before they receive vouchers, the more difficult it is to reintegrate them into the regular labor market. This speaks in favor of handing out vouchers in addition to regular unemployment benefits early on. However, if short-term unemployed persons also obtain vouchers, wage pressure inevitably rises. Hence, in determining the time span after which an unemployed person receives a voucher, there is always a trade off between achieving a high reintegration quota into the regular labor market and avoiding negative repercussions on wage setting. In light of these opposing effects, it might be reasonable to deliver the first voucher after about six months of unemployment. Since chances for reemployment shrink with the length of the unemployment spell, the size of the monthly voucher should rise with each further month in unemployment to a maximum, say, after about two and a half years. If an unemployed person entitled to monthly vouchers receives a job, the size of the monthly voucher she continues to obtain is consecutively reduced. This is economically justified because the formerly unemployed person should build up new human capital with growing time back in employment thus being less dependent on wage subsidies. The size of the voucher must furthermore never exceed the claim of the unemployed person to unemployment benefits in order to not create an incentive for firms and unemployed persons to agree on fake work contracts paid for by the government. This condition must always be satisfied even when the size of the monthly voucher including the qualification premium reaches its maximum after say about two years of unemployment.

Such a system of vouchers which is directly linked to the unemployment benefit system exhibits a number of advantages. Above all, the twofold negative effect of the current unemployment benefit system is mitigated. The current system subsidizes unemployment while it punishes employment by financing benefits via taxes on the employed. Establishing such a voucher system

lets the formerly unemployed persons indirectly uphold their claims to government transfers for a while even after they are again employed. This reduces the marginal tax rate between unemployment and regular employment significantly below hundred percent thus opening up the current unemployment trap. Consequently, search efforts of the unemployed along with effective labor supply will rise. Furthermore, those subsidies are directly financed out of the unemployment insurance system which is clearly superior to a tax-financed system because wage setters are then held to a greater extent accountable for the unemployment they helped to produce via inadequate wage settlements. Skills are in addition conveyed on the job rather than off the job which is an important advantage relative to government-run ALMP-schemes. Finally, such a voucher system enables outsiders to effectively undercut insider wages thus at least temporarily enhancing competitive pressure for them. Such targeted subsidies are therefore unlikely to lead to growing wage pressure.

However, it might be objected that such a voucher system stigmatizes those unemployed persons which offer firms vouchers in addition to their work input. Vouchers could signal firms that the unemployed person is regarded by the government as having low chances of encountering reemployment if left on her own. This negative signaling effect could just cancel out the positive monetary incentive of hiring such an unemployed person. Yet, since it is in general not difficult at all for firms to find out how long a job applicant has been unemployed before applying, this is not an objection carrying significant weight. It could furthermore be objected that persons will then prefer to stay unemployed for a longer time span in order to be entitled to receiving higher vouchers. Yet, such a behavior is not optimal as long as the size of the initial voucher is not too large and as long as the increase in the monthly voucher is at most sufficient to make up for the loss in skills which has occurred in the meantime. Such an obstructive behavior on the part of the unemployed can furthermore be contained by implementing strict rules which jobs have to be accepted for unemployment benefits not to be canceled.

The last point shows that any reform of labor-market policies for reducing persistent structural unemployment will be found unsatisfactory if left on its own. As long as entrepreneurs do not have a significantly larger incentive to invest and to create new firms and jobs, obtaining sizeable reductions of unemployment will be nothing but a chimera. In order to achieve significant

employment gains, reforming passive and active labor-market policies must be embedded in a large package for creating a more employment oriented institutional framework. This means above all that wage setting must become more flexible, less aggressive and more differentiated. The most direct way of enacting such a change in wage setting is largely abolishing government-imposed firing costs and a bold and determined move towards decentralized wage setting. A further key factor in achieving more employment-oriented wage setting along with a greater level of investments and openings of new firms is a large reduction in the level of taxation that is levied on the private sector. The government must cut back on its grip on the economy in order to yield more freedom for entrepreneurial activities of the private sector. It is finally of utmost importance to tear down all barriers to the establishment of new firms such as excessive goods market regulations and badly functioning venture capital markets.³⁷

IV. The Political Economy of Reforming Labor-Market Policy

Calls for reforming the institutional framework of labor markets in the above indicated direction have been widespread in the economics literature in recent years. However, what appears paradoxical is the lack of determined and comprehensive reform packages in particular in the two most important continental European countries, namely France and Germany, which could lead to a breakthrough on the respective labor markets. The hitherto prevalent scenario may be termed the "Franco-German nightmare", as those two countries are the most prominent, but by no means only European countries to have exhibited the following economic symptoms: unemployment along with unemployment benefits and taxes are undesirably high, but the government finds it politically infeasible to do anything decisive about it. To be sure, policy was by no means completely inactive in recent years in a country like Germany. Rather, the reforms undertaken were part of a piecemeal approach with only small isolated steps at a time, each of which met with considerable political resistance and did therefore not lead to a mounting wave of reforms. Two questions arise. First, why is it apparently so difficult to politically enforce employment stimulating reforms of the institutional framework of labor markets? Second, is it possible to break the stalemate on labor markets?

³⁷ See Coe and Snower (1996), Berthold and Fehn (1996a) and (1998) and Fehn (1999).

1. Why Is It Politically So Difficult to Reform Labor Markets?

The first question has already received considerable attention in the literature in recent years.³⁸ It is rather obvious that the actual implementation of far-reaching reforms and the deregulation of labor markets are not particularly desirable from a political economy point of view. Labor markets are not rigid by accident, but rather because rigid labor markets indirectly serve the interests of politicians. Politicians are not well informed, benevolent social dictators who maximize aggregate welfare. A realistic way of portraying political behavior should in contrast start with the assumption that they pursue mainly their own self-interest. As their primary objective is to win elections, they have a different way of accounting from economists: While economists add up welfare gains and losses, politicians rather count votes. Politicians are therefore highly reluctant to pursue policies which are economically efficient but which hurt at least in the short run the majority of voters and/or influential special interest groups. The support of special interest groups in the form of voting recommendations to their members and in the form of campaign contributions is often a key factor in winning elections.

It is quite clear from this political economy perspective that policies to liberalize labor markets and to strengthen the price mechanism on labor markets are difficult to enforce politically. Albeit high and especially rising unemployment reduces the reelection probability of an incumbent government, most policy recommendations to reduce structural unemployment get nonetheless trapped in the pitfall of political infeasibility since a large part of the electorate will lose at least in the short run and/or losses are concentrated on influential special-interest groups like unions. Rigid labor markets let insiders gain at the expense of outsiders and at the expense of highly qualified workers as long as those are rather immobile. They create a larger core of society which is interested in political stability by narrowing the income differential not only between employed workers and human capitalists, but also between employed workers and firm-owners. Protests by outsiders are kept under control by generous welfare-state provisions and ALMPs. Politicians will therefore be very cautious in adopting tough policy recommendations for deregulating labor markets, especially if none of the political parties is ideologically committed to liberalizing the labor market. This appears to be the case in most continental European countries because there

³⁸ See Saint-Paul (1995) and (1996), Bertola and Ichino (1995b) and Berthold and Fehn (1996b).

exists a broad christian-social-democratic consensus that the labor market is to be sheltered as much as possible from market forces.

In sum, reforming the labor market is not in the interest of governments as long as influential interest groups like unions and the majority of voters along with the median voter prefer a rigid labor market. The ongoing stalemate concerning labor-market reforms should therefore be regarded as the rational choice of political decision-makers. This does not mean, though, that rigid labor markets are there to stay forever. As the literature on the positive economics of labor-market rigidities has shown, labor-market reform is characterized by multiple political economy equilibria. Reforms are feasible under certain circumstances, such as in times of rapidly increasing unemployment and immediately after elections, in particular if the electorate enacted a switch in government. In addition, a higher real-wage elasticity of labor demand will promote labor-market reforms since excessive wage increases become less attractive to insiders due to the ensuing large employment losses. With a close to horizontal labor demand curve most of the losses are carried by the insiders themselves via lay-offs. Hence, more open goods and factor markets, as described by the catchword globalization, promote labor-market reforms in the long run as they increase the real-wage elasticity of labor demand.³⁹

2. Can Comprehensive Reforms Break the Political Deadlock?

However, waiting for such fortuitous circumstances is a rather unsatisfying policy recommendation. Coming therefore to the second question, it might be asked whether anything can be done before globalization makes even short-run labor demand sufficiently elastic so that major reforms become finally politically feasible. An important recent idea in this respect is related to the complementarity of reforms.⁴⁰ Policy measures such as a cut in unemployment benefits have a much larger positive employment effect if the resulting greater intensity of job search is met by growing labor demand, e.g. due to greater restraint in wage setting or due to a reduction in the level of taxation. Especially the level of taxation is directly related to the

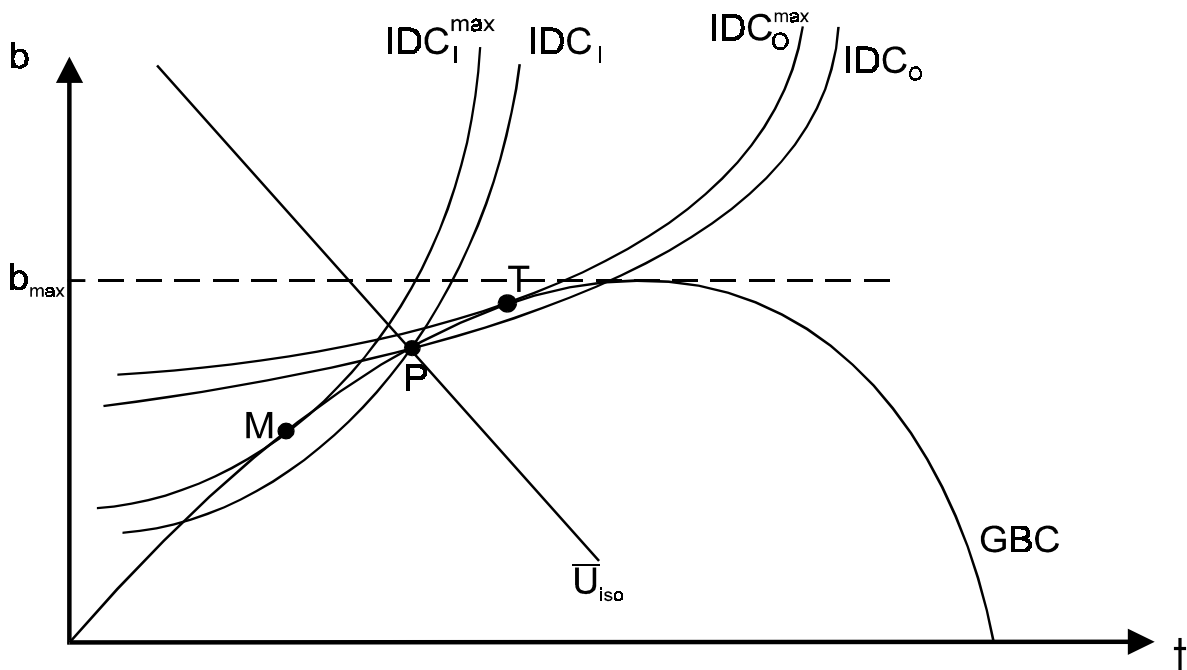
³⁹ See Fehn (1997).

⁴⁰ See Coe and Snower (1996) and Orszag and Snower (1998).

generosity of the unemployment insurance. Generous unemployment benefits clearly require a large level of taxation for financing them. Both policy variables can also be set by the government. So why not enact a reform that reduces unemployment benefits and the level of taxation simultaneously in order to embark on an upward spiral concerning employment, both via rising labor demand and via greater effective labor supply?

This particular problem can be analyzed by means of figure 3. The tax rate is denoted by t while the level of unemployment benefits is b . It is assumed that taxes are exclusively levied on workers and firms for financing unemployment benefits. Hence, if $b=0$, $t=0$ as well. Increasing unemployment benefits gradually from zero has a twofold effect. First, unemployment rises so that total government layouts for unemployment benefits rise faster than the level of benefits. Second, the tax base shrinks as employment falls, inducing a rise in the tax rate to finance a fixed amount of government expenditure. However, rising taxes reduce the reward to work and to invest, thus further diminishing employment. Hence, taking all effects together shows unambiguously that, starting from the origin, a given increase in the level of unemployment benefits leads to a more than proportionate rise in the level of taxation. This overproportionality rises with the level of benefits and taxation because the negative effect of further increases in taxation and unemployment benefits grow with their level. Hence, the government budget constraint GBC becomes progressively flatter. Eventually, unemployment benefits reach a maximum beyond which further rises in the tax rate reduce employment and thus the tax base by so much that tax revenues shrink as a result. Thus, unemployment benefits must decline in order to balance the government budget. This is the well-known "Laffer effect" which is depicted by the downward sloping portion of the GBC.

Fig. 3: Political Hysteresis Concerning Unemployment Benefits and Taxation



Source: Orszag and Snower (1998).

Analyzing the feasibility of a reform package which would simultaneously reduce the level of benefits and of taxation in order to stimulate employment requires introducing indifference curves of insiders and outsiders. Both sets of indifference curves are upward sloped because unemployment benefits are a good whereas taxes are a bad to both groups. The same utility level can therefore only be attained if higher taxes are balanced by a higher level of unemployment benefits. However, insider indifference curves are steeper than outsider indifference curves because insiders are more directly affected by the level of taxation whereas outsiders care more about the level of unemployment benefits. Insiders currently pay taxes while they are only affected by the level of unemployment benefits in case they are laid off. In contrast, outsiders currently receive unemployment benefits whereas they only pay taxes if they find a job. Hence, a given increase in the tax rate must be balanced by a higher increase in unemployment benefits for insiders than for outsiders in order to keep the utility level constant and to stay on the same indifference curve. The diagram is completed by isounemployment curves which are downward sloped because unemployment benefits as well as the level of taxation are both positively related to the rate of unemployment.

The equilibrium in this scenario with just two policy variables depends on the functioning of the political process. Assuming that only the median voter counts in political decision making and also assuming that the median voter is an insider produces an equilibrium at point M where the relevant insider indifference curve is just tangent to the GBC and where the utility of insiders is maximized. However, it is quite unlikely that governments of advanced, democratic countries, which are committed to the concept of "social market economy", will not take at all into account the interests of outsiders which are by now a sizeable part of the population. Such behavior would offend against the widely respected principle of liberal democracy, namely that the majority is only allowed to enforce particular decisions if it does not involve sacrifices by a significant minority. Thus, simply abolishing privileges of substantial minorities by majority vote without paying any attention to their interests is in general impossible in advanced democracies. However, interestingly and, at first glance somewhat paradoxically, taking also the interests of outsiders into account in political decision making leads to an equilibrium which involves a higher level of unemployment benefits and of tax rates. This is the case because outsider indifference curves are flatter than insider indifference curves and their optimum point T therefore lies to the right of the optimum for insiders. Intuitively, outsiders value unemployment benefits higher than insiders and their relative aversion against high tax rates is smaller compared to insiders so that the overall equilibrium is even less geared towards achieving a high level of employment than under pure majority voting.

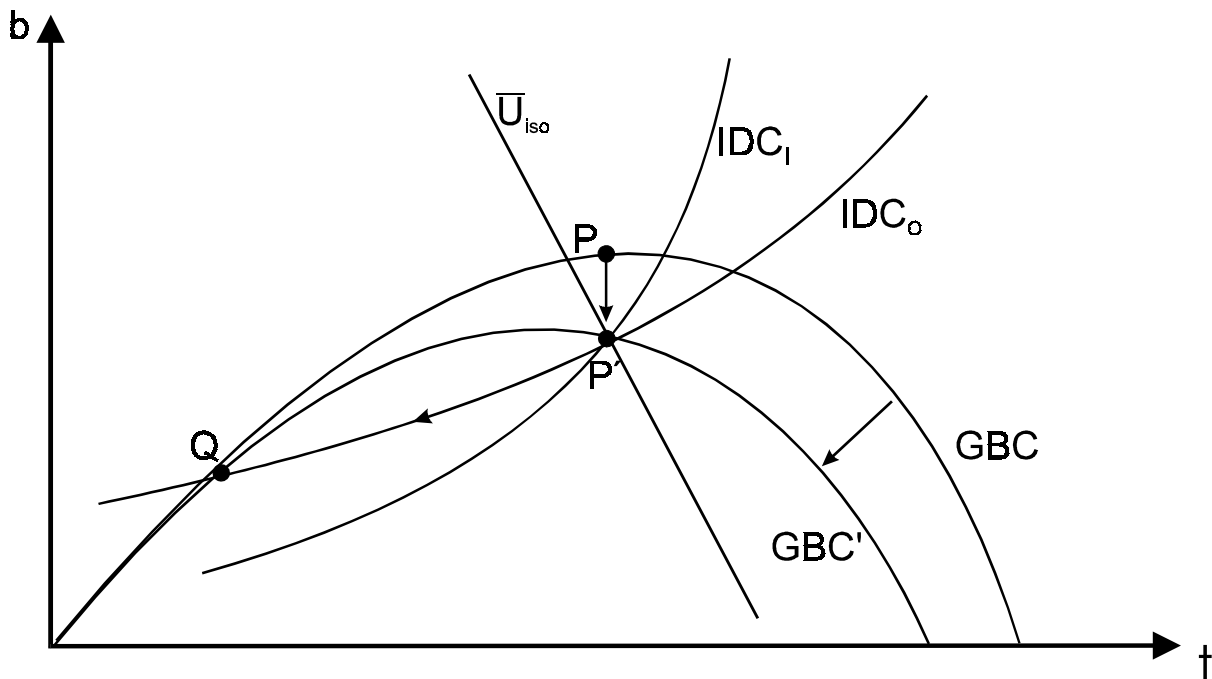
Elaborating further on this assumption that no reform against the interests of outsiders is possible also shows that problems of political hysteresis arise. If only Pareto-improving reforms are politically feasible, any point on the upward sloped portion of the GBC and between points M and T is a political equilibrium. Taking e.g. point P, it is straightforward to realize that there is no feasible combination of changes in unemployment benefits and in tax rates which is welfare improving to insiders and to outsiders alike. The set of Pareto-improving policies is empty. Hence, under such conditions the economy is stuck at whatever political equilibrium it happens to find itself initially. Calls by economists for lower unemployment benefits and lower tax rates for

stimulating employment, which are inspired by normative considerations, are in such situations useless from a political-economy point of view.⁴¹

Large-scale reforms become possible, however, if the economy happens to be on the downward-sloped portion of the GBC as in figure 4. Such a situation can occur e.g. after large adverse shocks or after a tax and spend government has been in office for some while. A particularly interesting example is globalization itself, which reduces the tax revenues earned at any given tax rate by giving mobile capital and workers greater exit possibilities. Hence, the GBC moves downwards and to the left. If the tax rate was already relatively large initially and if the tax rate is not immediately adjusted after the shock, globalization might displace the economy from point P to a point like P', which is to the right of the maximum of GBC'. Yet, there is now a large set of possible Pareto-improving reforms. Unemployment benefits as well as taxes can in principle now be lowered all the way down to the point where the relevant outsider indifference curve intersects with the upward sloped section of the GBC' in point Q. Hence, this is an example where globalization is a blessing because it can enlarge the politically feasible set of reforms by initially worsening the situation. Both policy variables need to be changed simultaneously, though, with the explicit purpose of exploiting the arising economic and political complementarities. Piecemeal, uncoordinated reform, in which one policy variable is adjusted at a time, runs the risk of getting stuck early on in the reform process because after the first policy instrument has been adjusted, the economy may arrive at a political equilibrium involving political hysteresis, preventing the second policy instrument from being changed as well.

⁴¹ See Orszag and Snower (1998).

Fig. 4: Large-Scale Reforms under "Laffer" Conditions



But what if a country does not find itself under Laffer conditions? Is such a country then doomed to stay in the status quo position such as point P in figure 3 which is not only inefficient due to high unemployment, but also inequitable, because insiders are much better off than outsiders? The political deadlock can be broken by broad-based reforms, i.e. by enlarging the set of available policy variables. Including further complementary policy measures in a package approach enables the government to compensate the losers of reforms without sacrificing efficiency gains. In the specific case considered, political hysteresis arises out of a simple conflict of interests: the government is unable to achieve simultaneous reductions in tax rates and in unemployment benefits, which are desirable from a normative point of view, because this would hurt the unemployed.

However, the stalemate can be overcome by including other instruments in the package, e.g. the afore-described hiring vouchers and/or a reduction of firing costs. Introducing a voucher system by itself clearly raises the welfare of outsiders because their reemployment chances rise. This occurs at the expense of insiders because competitive pressure for insiders would rise, in particular, because firms would have an incentive to replace some of their insiders by subsidized new recruits. Yet, insiders could be compensated for this loss by an adequate reduction in tax

rates, for which they are particularly susceptible, financed by a reduction in unemployment benefits. The same effect can in principle be achieved by reducing government-imposed firing costs which increase the hiring chances of outsiders but increase the probability of current insiders that they will be laid off sometimes in the future. The political feasibility could be further promoted by also including measures to alleviate imperfections in capital and goods markets, which especially hinder the creation of new firms and employment growth. Hence, a circumspect and balanced combination of all five policy instruments in a package - reduction of tax rates, of unemployment benefits and of government-imposed firing costs along with a simultaneous introduction of hiring vouchers and with efficiency-enhancing reforms of capital and goods markets - can lead to a Pareto improvement and should thus be politically feasible. The failure of governments to implement such broad-based packages of complementary reform measures may be a key reason for why unemployment is so persistent in continental Europe and for why the "Franco-German nightmare" endures. Interestingly in this respect, the only two European countries which have significantly improved their employment performance in recent years, namely the UK and the Netherlands, have precisely relied on such a package approach by implementing a large set of complementary reform measures close to simultaneously.

V. Concluding Remarks

Mass unemployment is the major challenge to capitalist societies in the post-communist era. The ongoing process of globalization is in particular often blamed for the dismal situation on continental European labor markets. However, as has been shown, whether globalization leads to rising unemployment depends crucially on the institutional setup of the economy under investigation. Globalization first and foremost raises global welfare. It does furthermore not increase unemployment in countries where markets are well functioning and where governments by and large restrict themselves to efficiency-enhancing activities. However, the more governments interfere with the functioning of markets, in particular of labor markets, often motivated by distributional objectives, the more globalization exposes the drawbacks of such efficiency-reducing activities. Globalization raises rather dramatically the costs of regulations which distort the allocation of resources. Hence, deregulating especially labor markets and

gearing labor-market policy more towards effectively fighting unemployment must remain high up on the agenda for economic policy.

Yet, any policy analysis which does not take into account the politico-economic objectives for installing rigid labor markets remains incomplete. Overcoming the politico-economic hurdles is the major obstacle against implementing labor-market reforms. In particular, any government which adopts a piecemeal approach in reforming labor markets and labor market policy is likely to get stuck early on in the reform process without having achieved much. The analysis revealed that only large scale reforms which include a multitude of complementary reform measures can be expected to produce major employment gains and at the same time be politically viable. Hence, concerning labor markets, installing a much more restrictive unemployment benefit system, reducing government-imposed firing restrictions, decentralizing wage bargaining down to the firm or individual level, introducing a comprehensive system of hiring vouchers and reducing tax wedges should be combined in an encompassing supply-side package for more growth and employment. The current reemergence of Keynesian thinking does in any case not address the major causes of European unemployment and is therefore highly likely to fail in the fight for lasting reductions of persistently high unemployment. The neglect of supply-side considerations associated with this renewed emphasis on Keynesian-type problems is likely to lead to another appropriation shock similar to those in the late sixties and early seventies with fatal long-run consequences for the employment situation.

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