

Snower, Dennis J.

Lecture

Reducing unemployment through fundamental labour market reform

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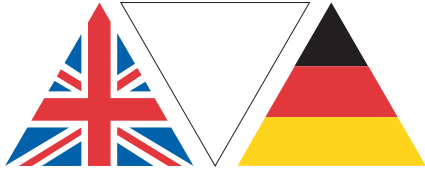
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**Anglo-German Foundation for the
Study of Industrial Society/
*Deutsch-Britische Stiftung für das
Studium der Industriegesellschaft***

Reducing unemployment through fundamental labour market reform

Dennis J. Snower

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**The following text is based on a lecture and
public discussion hosted by the AGF at its Berlin offices**

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Dennis J. Snower

February 2006

**Anglo-German Foundation
for the Study of Industrial Society**

LABOUR MARKET REFORM

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**Anglo-German Foundation for the Study of Industrial Society/
Deutsch-Britische Stiftung für das Studium der Industriegesellschaft
34 Belgrave Square, London SW1X 8DZ
Tel: +44 (0)20 7823 1123 Fax: + 44 (0)20 7823 2324
Website: www.agf.org.uk**

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The riddle of unemployment

The sight of people looking for work but not finding it for long periods of time has become increasingly common in free market economies over the past two decades. The phenomenon is inherently puzzling. In free markets, after all, wages are free to respond to labour market conditions. A worker who is tired of seeking a job need only reduce his or her wage demands. So why are so many people so persistently unsuccessful at finding jobs?

Most people have their pet hunches for why this happens. Economists have produced theories rationalizing most of these hunches, plus a few that lie far beyond the imagination of the layman. It is terribly important to get this matter right, for each diagnosis has different policy implications.

After a bit of reflection, it is easy to identify the non-starters:

Popular explanations

Non-starter No. 1 is that the long-term unemployed do not really want to find jobs. The European unemployment experience makes this theory look more than suspect. EC unemployment remained roughly between 2–3% from 1960 to 1973, swelled from about 4% in 1975 to 6% in 1980, and has fluctuated between about 8% and 12% since then. Why should people have become so increasingly complacent about finding jobs?

Non-starter No. 2 is that it takes time for wages to adjust to changing economic fortunes, and thus people leaving declining sectors are not immediately taken up in the expanding sectors. But economists have not been successful in finding any measure of labour market turbulence that matches the steep rises in European unemployment over the last three decades. The massive increase in European *long-term unemployment* and the associated rise of the unemployment relative to the vacancy rate does not fit this explanation.

Non-starter No. 3 – a very popular one among economists – is the intertemporal substitution hypothesis. As the name implies, this hypothesis is concerned with people's desire to engage in intertemporal substitution of work for leisure, and vice versa, in response to various economic incentives. For example, if workers believe that real wages are temporarily depressed and will rise in the future, they may wish to partake of more leisure now and work harder later. The same may be true if they perceive real interest rates to be temporarily low, since that means that their current wage income cannot be transferred into the future at an advantageous rate. In that case, of course, the observed fluctuations in unemployment are desirable, since they are the outcome of people's optimal reactions to external shocks.

How this hypothesis could seriously explain European unemployment is hard to understand outside the economics profession. Many millions of people in Europe joined the unemployment register in the mid-1970s, early 1980s, and early 1990s. Can we honestly believe that these were simply colossal leisure binges, taken because workers

were expecting real wages or real interest rates to rise later on? Regarding the upward trend in European unemployment rates since the mid-1970s, can we seriously assert that we are observing a very long-term intertemporal substitution, whereby workers have decided to enjoy a lot of free time for two decades, perhaps with the intention of working very long hours for the next two decades? And even if the monstrous implausibility of these suppositions is put aside, we are still left with the fact that the available empirical evidence indicates that people's hours of work are unresponsive to real wage and real interest rate variations, and that much of these variations tend to be permanent rather than temporary.

Academic explanations

More plausible explanations of unemployment in Europe and elsewhere in industrialized countries centre on reasons why labour demand may permanently fall short of labour supply under free market conditions.

For example, according to the *efficiency wage theory*, firms stimulate the productivities of their employees by offering them higher wages, since the higher wages enable the firms to recruit more highly qualified employees, or motivate these employees to work harder, or discourage the employees from quitting their jobs. Consequently, firms may have incentives to keep wages above the levels necessary to ensure full employment.

The theories of *labour union behavior* picture unions as exercising market power on wages, driving wages up and employment down. Thereby some people are left unemployed.

According to the *Keynesian theory*, people are left unemployed because firms are not producing enough; and the firms are not doing so because there is too little demand for their products; and demand is deficient because people are left unemployed. What lies at the source of this vicious cycle is the insight that deficient demand in the labour market originates in the product market, and deficient demand in the product market originates in the labour market.

The *insider-outsider theory* focuses attention on labour turnover costs, such as hiring and firing costs, as a source of unemployment. These costs, falling on firms, give market power to the "insiders" (experienced, incumbent employees), who know that their employers would find it costly to replace them. The insiders use this power to improve their wages. The labour turnover costs discourage the firms from firing their current insiders, but the high insider wages also discourage the hiring of new recruits.

What all these theories have in common is that they explain why labour demand may turn out to be too low over long periods of time, even under free market conditions. Regardless of what your favorite explanation is, the policy implication is more or less the same, namely, that it is advisable *to provide incentives for employment*.

Passive labour market policy as a source of persistent unemployment

Another important source of unemployment, paradoxically enough, is to be found in the very policies that attempt to protect people from unemployment – particularly passive labour market policy. The policy is to pay people when they are unemployed and to tax them when they find jobs. So, far from inducing workers to seek employment and firms to take them on, the policy in fact discourages them from doing so and thereby contributes to the unemployment problem. Having done so, the unemployment benefit system is then seen as a particularly vital safety net for those out of work.

The policy implication of this problem is that it would be advisable to *redirect the money* that governments spend on unemployment benefits and other welfare state entitlements to the jobless so as to *provide an incentive, rather than a disincentive, for employment*.

For the remainder of this piece I will devote myself to two policy proposals that move in the requisite directions, namely, (i) to provide incentives for employment and (ii) to turn the policy-induced disincentives to find jobs into incentives.

Benefit Transfer Programme

The first proposal is the *Benefit Transfer Programme* (BTP). The basic idea is to give the unemployed – particularly those who have been unemployed for a long time – a new option: *to use a portion of their unemployment support as vouchers for employers that hire them*. In this way unemployment benefit systems, which currently impose an implicit tax on work, could become a source of employment subsidies for the people who need these subsidies most, namely, the long-term unemployed. Being voluntary, the policy would expand the choice sets of the unemployed and their potential employers. Employers would join only if the resulting labour costs are sufficiently low, and the unemployed would join only if the resulting wage offers are sufficiently high. The difference between what the employees receive and what the firms pay would be the unemployment benefits that are converted into employment subsidies.

Under the BTP, the size of the employment vouchers would depend positively on unemployment duration and training. Specifically, the longer a person had been unemployed (up to some maximum), the larger would be his initial voucher; after getting a job, the voucher would gradually fall as the period of employment proceeds. Moreover, larger vouchers (for given unemployment duration) would be given to firms that can prove they are using these vouchers entirely for training.

The underlying reasoning is simple. The longer a person's unemployment duration, the greater his or her chances of remaining unemployed and thus often the greater the present value of his expected unemployment benefits (including social welfare receipts when unemployment support runs out). So a policy that relates employment vouchers to unemployment benefits will generally have the vouchers rising with unemployment duration. (The temporal profile must not be so steep, however, as to give some

unemployed people a significant incentive to postpone job search now in order to qualify for higher vouchers later.) Moreover, the longer a person is employed, the greater his chances of remaining employed – particularly if the position involves on-the-job training. Thus the size of the vouchers should fall with employment duration, with larger vouchers going to firms that devote them to training.

The BTP has several attractive features: (i) It would give the government an instrument for tackling head-on the problem of long-term unemployment and thereby help equalize people's employment opportunities. (ii) The programme would generally not be inflationary, since the long-term unemployment rate has little effect on wage inflation and since the vouchers would reduce labour costs. (iii) The BTP would be costless to the government, since the funds spent on employment vouchers would have been spent on unemployment benefits anyway. In fact, by setting appropriately the fraction of benefits convertible into vouchers, the government may reap a surplus. (iv) The programme would be an automatic stabilizer, for when unemployment falls, the amount spent on unemployment benefits falls as well, thereby reducing the funds available for the employment vouchers. (v) By offering higher vouchers for firms that use them for training, the BTP could help create long-term jobs and overcome market failures in training provision. Participating firms would clearly seek to make the training maximally appropriate to the available jobs, which is something government-provided training programmes don't do. Moreover, regions of high unemployment would become ones containing many workers with training subsidies, providing an incentive for firms to move there and retrain the local workforce.

Unemployment accounts

My second proposal is the establishment of *unemployment accounts* (UAs). To keep the unemployment benefit system from augmenting the unemployment problem it is meant to alleviate, there is a need for a reform that (i) lets the unemployed help pay the cost of their unemployment benefits but (ii) does not reduce their living standard relative to the employed. Once unemployed people cease to benefit at the expense of others, they clearly have the right incentives to find jobs.

Unemployment Accounts (UAs) are meant to help achieve this objective. Under this scheme, employed people would be required to make ongoing contributions to their UAs and their UA balances would be used to cover them whenever periods of unemployment lead to financial distress.

When people become unemployed, their withdrawals from their UAs would substitute for the unemployment benefits they currently receive. In this way, unemployment benefits would be replaced by a system of compulsory saving to provide security against unemployment.

To maintain the living standards of the unemployed, the government would top up the UA contributions of individuals in the lowest income groups.

When people's UA balances are sufficiently high, they could use the surplus funds for other purposes; and at the end of their working lives, their remaining UA balances would be transferred into pension schemes.

When a person's UA balance falls to zero, he or she becomes eligible for unemployment assistance, on the same terms as the unemployment assistance under the current system.

An unemployed person is permitted to use a portion of his or her UA balance to provide employment vouchers to employers who employ him or her.

The economic implications

This reform of the current unemployment benefit system would reduce the level of unemployment and promote labour market activity. It will have a particularly strong effect on people entering into part-time work.

Since people under the UA system would have greater incentives to avoid periods of unemployment and to avoid taking inefficient risks of dismissal by making excessive wage claims, the UA contributions necessary to finance a particular level of unemployment support will be lower than the taxes necessary to finance the same level of unemployment benefits. In this way, employers and employees stand to gain from the switch from the current system to UAs.

The UAs are also more efficient than the current system in redistributing income from rich to poor, since unemployment benefits are targeted at the unemployed, whereas the government support under the UA system is targeted at the poor.