Commentary: Active Labor Market Policies to Expand Employment and Opportunity

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Larry Katz has documented and commented on the substantial rise in wage inequalities in the United States and the United Kingdom compared with other Organization for Economic Cooperation and Development (OECD) countries over the past decade, and indicated some of the adverse social consequences. He is not obviously optimistic about a spontaneous narrowing of differentials in the short term.

The paper is supportive of active labor market measures as supply-side responses to unemployment problems—especially those targeted on the seriously disadvantaged—and positive with regard to the long-run returns to educational and training investment. Overall, it is a comprehensive and well-rounded argument for policies which can contribute to addressing distributional concerns as well as raising aggregate efficiency.

I will add a little on European experience with active labor market measures. However, I will mainly build on the evidence of the paper to discuss ways in which I feel the policy debate—now fully engaged in Europe in the context of the White Paper on Growth, Competitiveness, and Employment—has been distorted in the past by the emphasis on reducing unemployment, rather than increasing employment, and by the treatment of wage inequalities as a side issue rather than an integral part of the policy problem.

To put the argument in the dominant terminology of this symposium, I would suggest that it would be appropriate to focus policy on raising the natural rate of employment, rather than reducing the natural rate of unemployment and, more strongly, that there is a need to introduce a further element into the overall policy frame—which I will call reducing the natural distribution of wage inequalities.

It may not make life any easier for policymakers to have to acknowledge three policy targets rather than two—inflation being the third—and professional economists may not be thanked. However, this approach offers a better representation of reality, helps explain divergences in U.S. and European policy practices and experiences, and provides a clearer basis for making policy choices.

The new transatlantic conventional wisdom

The presentation in the Katz paper of the new, post-Detroit Job Summit conventional policy wisdom—that all industrialized countries have employment problems, and that a growth in the working poor is not necessarily to be preferred over growth in the numbers unemployed on welfare—is some comfort to European ears, given our long-standing discomfort regarding our poor employment creation record compared with the United States.

Relief is partial, however. This new wisdom, by introducing the wage distribution issue, underlines the limits to which U.S. experience can be drawn upon in improving European performance.

For much of the last two decades, European Community (EC) member states' policies have focused primarily on reducing the numbers of recorded unemployed—using both fair means and foul in the eyes of many commentators. Actions have included:

—expanding the scale of publicly funded active labor market measures targeted on the unemployed, and intended to achieve their reintegration, with training as an important component;

—encouraging departures from the labor market by early retirement, partly publicly funded in many cases, or by removing many of those eligible for income support from the unemployment schemes—where they are liable to appear in the statistics—and placing them in parallel systems like the Cassa Integrazione in Italy, the disability schemes in Holland, and so forth—where they do not; and

—tightening the eligibility criteria for unemployment compensation, and reducing the level of compensation for those who are eligible—thereby discouraging registrations and reducing the numbers recorded as unemployed.

The positive side of this policy has been the maintenance, more or less, of wage distributions for those in employment. The problem has been that their numbers have declined, or failed to grow in line with labor supply.

Europe now has a very low rate of employment—measured as a percentage of the population of working age who are in work. Two decades ago, the United States and Europe had similar rates—at around 62 percent. Since then, the U.S. rate has risen to around 70 percent and the European rate fallen to.58 percent.[1] Throughout this period Japan and Scandinavia averaged more than 70 percent.

One obvious consequence is that Europe has a significant hidden labor supply. Thus, even when Europe has job growth, as it did in the late 1980s—when employment grew by over 10 million in four to five years (almost the same rate as the United States)—only 3 million of the extra 10 million jobs created went to the unemployed. The rest went to new entrants.

Another way to look at divergences in U.S.-European experience is in terms of the use made of productivity growth. In both the United States and Europe this has averaged around 2 percent a year for the last two decades. In the United States, most of this growth has been used to increase employment. In Europe most has been used to raise real incomes of those in employment. In effect, the United States has indulged in widespread work sharing—to use a somewhat provocative phrase—and income sharing.

White Paper on Growth, Competitiveness, and Employment

The *White Paper on Growth, Competitiveness, and Employment* which was presented by the European Commission to the European Council of Heads of State in Brussels in December 1993, and which is now "official" Community policy following its endorsement, represents a major change of policy focus—shifting the targeting of policy efforts from reducing unemployment to increasing employment.[2]

It also represents a shift in favor of actions to remove supply-side obstacles—to use the terminology of this symposium. The White Paper speaks of the need for a general reform of the systems of incentives which affect employment, making particular reference to labor market, taxation, and social security incentives. Emphasis is placed, for example, on reducing disincentives to employing fewer skilled workers by adjustments in payroll taxes (which are currently proportionally higher for lower paid workers in most member states); and on improving labor market flexibility on the external labor market as well as within firms—especially regarding hours of work and, in some member states, loosening up hiring and firing regulations.

At the same time, the White Paper seeks to avoid an expansion in employment being associated with a growth in wage inequalities. Various policy proposals are made, ranging from those designed to bring about ex ante changes by altering the parameters of collective bargaining, to those designed to bring ex post adjustments through changes in the tax and benefit systems which would allow, for example, for the topping-up of low wage incomes from social protection systems.

Policy conflicts on labor market and social issues have been apparent within the European Community for some time. The United Kingdom, in particular, has criticized European social policy for seeking to protect and promote standards rather than expand employment. Its own employment policy has been to increase labor market flexibility through legislative deregulation on hiring and firing, working hours, low wage protection, and trade union rights. It has also reduced levels of social protection relative to wages, and been active in reducing recorded unemployment.[3] Unlike the U.S. administration, however, it has shown scant public concern about some of the apparent consequences of its policies—notably growing wage disparities—even when extensively reported in its own official publications.[4]

It is not yet clear how the new White Paper emphasis on changing the pattern of incentives surrounding the labor market will affect Europe's traditional reliance on active labor market measures and human resource investment. Both active and passive measures are in question, and many policy changes—for example, to increase the vocational content of education—have been less successful than had been hoped. French efforts along these lines have found resistance from both employers and students, and even the German model of vocational education and training is being questioned despite its proven capacity to adapt, albeit slowly, to new needs.[5] Despite educational reforms, the flight from science in schools and universities is continuing to cause concern in the United Kingdom.[6]

Part of the pressure on policy reflects budget concerns. One consequence of targeting unemployment has been to contain direct public expenditure on unemployment compensation to around 1.5 percent of GDP on average across the Community. However, displacement has naturally led to expenditure growth under other social policy budget headings. Likewise, while unit costs of active measures have generally been held down—by a shift toward cheaper activities like counseling, and by cost-cutting in expensive activities such as training—overall expenditure has held up, or increased, as the number of participants has increased.[7]

Although the strong evidence on the long-run returns to education is recognized in Europe as in the United States, there are questions about causality—do rich countries spend more on education because they can afford it? Questions are also being increasingly raised about the returns to publicly funded training measures, at least when they are used as the principal means of reintegrating the unemployed.

Much of the new policy emphasis is on integrated policy packages which address both the demand and supply side of the labor market, and the interaction. Micro case study evaluations are producing many good practice guidelines—counseling with everything, training to be linked to the local economy and the individual, and so on. Good returns are also seen from the careful use of wage subsidies and well targeted public employment schemes or, even better, schemes in which private or voluntary agencies deliver publicly funded jobs.

However, in Europe as in the United States, it seems difficult for public administrations to develop cost-effective mainstream labor market programs which match up to the performance of experimental actions. There are clearly a lot of X-efficiency gains to be made from the successful development of a "MacDonald's approach" to the provision of labor market reintegration programs, which could guarantee local delivery performance and quality at low cost.

Natural rates of employment and unemployment in Europe

Nobody should object to the search for a rigorous, scientific, explanation of unemployment, or to attempts to quantify the potential effects of different policy actions. However, the way in which work on the natural rate of unemployment has developed may, paradoxically, have distracted us from the main policy targets.

It is well known that unemployment statistics are open to administrative "abuse," but that is only part of the problem. Unemployment figures are statistical constructs—derived from replies to questions, or the application of administrative rules. Unemployment does not have a counterpart in economic reality, except at the most abstract level, and it has proved an unreliable proxy.

Europe provides its own comparative evidence, because it has two data series on unemployment. The first is based on annual labor force surveys, conducted in all member states to a common format and which, in respect of unemployment, collate replies to "tough" International Labor Organization (ILO) criteria questions—are you actively looking for, and available for, work?[8] A second series is derived from registrations at public employment agencies in the member states, and doctored to some degree to achieve greater comparability.[9] The first series uses changes in the second series to provide monthly estimates against its annual benchmarks.

Differences in estimates derived from these two approaches are big enough to exasperate European Commissioners who have to explain them—the former currently gives 18 million, the latter, 20 million. However, analysts are more sanguine. Differences of 10 percent are not seen as overly significant, and the series generally move in the same direction. That confidence is misplaced. The statistics actually cover two different, if overlapping, groups of people. Only three-quarters of those who appear in the labor force statistics appear in the other series, and fewer than two-thirds of the nationally recorded unemployed appear in the labor force statistics.[10]

This sort of evidence (which may help explain some of the instability in econometric estimates) added to the general policy distortions that result from focusing on unemployment, and argues forcibly for a shift away from the focus on a natural rate of unemployment to the use of a natural rate of employment concept.

There are disadvantages in using employment data, notably the delays in processing and publishing. Nor is employment an entirely unambiguous statistic.[11] However, it is possible to either have series showing the numbers of people in employment, or to adjust numbers according to hours of work—weekly, annually, or otherwise—to produce some full-time equivalent. More importantly, for those who prefer their economics this way, employment, unlike unemployment, does have a counterpart in reality within the circular flow of income.

The natural distribution of wage inequalities

I would now like to say a little more on the issue of wage inequalities. Comments in other papers and in discussion throughout the symposium have made passing reference to these issues, but largely as irritants, or complications, getting in the way of the main task.

That, in my view, is mistaken. The central policy objective, and dilemma, for all modern economies—inflation control apart—is how to achieve not only high standards of living, but also an equitable distribution of that income across the population. And the historical and global evidence is clearly that economies with unconstrained labor markets generate wage distributions far wider than are socially acceptable, or indeed necessary in order to induce structural mobility, in developed countries.

If one is to maintain the natural rate methodology, it is necessary to extend it to encompass the natural distribution of wage inequalities. In the logic of the methodology, this represents the distribution of wages that the economy will generate—taking account of the balance of supply and demand for labor, including imbalances in market power; and disparities in productivity, reflecting abilities, skills, health, and so forth—all within the context of globalization, technological change, and the rest.[12] In the same logic, the costs and benefits of specific policy interventions can be estimated.

European policy performance

There is an implicit presumption in much economic commentary that European unemployment has remained high, and employment low, largely, or even wholly, because politicians and policymakers have been too dumb to understand how markets work, or too subject to interest group pressures. On the same level of debate, it can be argued back that reducing unemployment to low levels is a relatively trivial theoretical exercise, provided you have no social and political constraints, and one which scarcely merits all the attention paid to it in recent years. Both sides may have their point, but professional economists could do well to remember what the economist, Ralph Turvey, late of the ILO, wrote many years ago—that while it might be simpler if labor markets behaved like commodity markets, they do not.

European policy may not have been optimal or equitable, but most European countries, and their political leaders, have been, explicitly or implicitly, seeking to balance employment and distributional issues. Unfortunately, most—but not all—have done so in ways which have largely benefited male adult workers at the cost of younger workers or women.

Future policy is intended to shift that balance in favor of those who have been increasingly excluded from the process, while continuing to address the income and equality questions. How far Europe can succeed in expanding its employment, and how far it can do so without experiencing increases in wage inequalities are, however, very much open questions, and results will depend heavily on the policy changes that are actually made.

Uncertainty about the effects of increasing labor market flexibility lies at the heart of current concerns. The evidence that wage inequality in the United Kingdom has risen sharply—in line with the United States, but out of line with most other European experience—over a period in which it has pursued widespread labor market deregulation, has discouraged others from following this path.

However, it is not clear whether increased wage inequality is the direct consequence of increased flexibility—essentially resulting from changes in power relationships in the labor market—or whether increased flexibility has simply meant that new factors, such as trade openness or new technological changes (both of which may have adversely affected the job prospects of those at the lower end of the labor market) have been translated more rapidly into wage differences in the United Kingdom and the United States than is the case in countries where labor markets are less flexible, in this sense.[13]

The interconnection between these issues is central to current policy concerns in Europe. Ignorance of the issues is widespread, and empirical work limited. We are currently looking to research further the relationships surrounding what I have called the natural distribution of wage inequalities and the natural rate of employment. Those who have ideas to contribute, and are available to pursue the issues, are welcome on board.

Endnotes

[1]There is a wide dispersion of rates between member states, largely reflecting differences in activity rates of women. Danish rates, for men and women combined, exceed 75 percent. Those in Spain and Italy are less than 50 percent.

[2]The key chapter, for our purposes, Chapter 8, is entitled "Turning Growth into Jobs."

[3]Including carrying out more than thirty administrative changes affecting eligibility.

[4]Social Trends, HMSO. This position is now changing and the Chancellor of the Exchequer, Kenneth Clarke, has spoken about the risks of dual societies—Mais lecture 1994.

[5]Human Capital Investments and Economic Performance: Conference Proceedings. November 1993, Santa Barbara.

[6]Employer Association comments on high school examination results, summer 1994.

[7]Social Protection Report 1993 and Employment in Europe Report 1994, both Commission of the European Communities publications.

[8]Which effectively excludes many women—who have shown that they will work if work is available, but who are sensible enough not to waste time looking if there is none.

[9]Some initial explanation is contained in the Employment in Europe Report 1994.

[10]Employment in Europe Report 1994.

[11]Some 4 percent of women who are counted as being in employment in Europe work fewer than ten hours a week.

[12]Globalization, in particular, introduces strains on socially constrained income distributions, as is currently the case, for example, within the Japanese banking sector.

[13]Logically, the latter explanation holds since the United States already had flexible labor markets before its income distribution widened, but other factors may well be at work.