

## Commentary: Reducing Supply-Side Disincentives to Job Creation

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The focus of this conference on the supply side of the economy is fine, but we can get more mileage out of the discussion if we zoom in on the interaction between the supply side and the demand side. It was not a sudden deterioration in the supply side of the economy, such as a drastic reduction in the flexibility of the labor market, that triggered the rise in unemployment in the Organization for Economic Cooperation and Development (OECD) countries in the mid-1970s, early 1980s and, again, in the early 1990s. Rather, the proximate causes of the **stepwise** rise in unemployment in these instances seem to have been the two oil price hikes and the restrictive demand management policy which was pursued, in particular in the early 1980s and 1990s, to bring down the high rate of inflation.

It would seem, however, that earlier existing deficiencies on the supply side, including the consequences for the labor market of various welfare state arrangements, influenced the way in which our economies reacted to these shocks. In other words, my interpretation of events is that various features on the supply side contributed to the propagation and persistence mechanisms of the oil price shocks and demand shocks.

This interpretation is also consistent with the Nordic experience. In spite of very generous unemployment benefits, high hiring and firing costs, and rigid relative wages, unemployment was quite low in these countries until they were hit by severe macroeconomic shocks—in

Denmark in the early 1980s, in Norway in the second half of the 1980s, and in Sweden and Finland in the early 1990s.

There are also other important interactions between the demand and supply sides. Policies aimed at eliminating various rigidities on the supply side of the economy will not result in many new jobs if there are no vacancies to fill. Similarly, expansionary demand-side policies will not result in a larger increase in aggregate employment if the supply side, including the labor market, does not function reasonably well.

Let us look at Dale Mortensen's rich, elegant, and interesting paper in this context. The systematic distinction between the effects of policies on aggregate employment and on economic welfare is particularly useful. Mortensen's flow model of matching, job creation, and job destruction is apparently quite appropriate for the purpose of the analysis, with aggregate employment determined by the equality between the flow of labor into and out of unemployment. The model has some similarity with recently rather popular models (applied in the paper by Bean) in which equilibrium aggregate employment is instead determined by the intersection of a stock-demand curve for labor and a wage-setting curve. The comparative statics analysis in the two models is also rather similar; indeed, Mortensen's basic diagram (Figure 1) may be reinterpreted in terms of a stock-demand curve for labor and a wage-setting curve, with the real wage rate on the vertical axis.

The main difference between the two approaches is, I believe, that the flow approach gives a richer description of the labor market by emphasizing the dynamic processes that go on, including the emergence and the filling of vacancies. The flow approach also provides a disaggregation of the unemployment rate into unemployment incidence and unemployment duration.

It is useful to organize the following comments around Mortensen's quantitative policy experiments. The conclusions from the experiments usually seem quite reasonable, but there are, of course, some problems. The analysis of lower unemployment benefits (Table 2) is flawed by the fact that Mortensen does not respect the balanced budget

constraint (neither *ex ante* nor *ex post*). This shows up in the conclusion that workers collectively experience income loss in spite of the fact that net output per worker increases, the reason being the fall in transfers to the unemployed. This conclusion would not survive a balanced budget constraint. For instance, tax reductions or increased transfers (such as child care or pensions) of the same size as the reduction in the unemployment benefit payments, would reverse the conclusion that workers do not gain as a group. The experiment with stricter limits on the duration of unemployment benefits suffers from the same problem. If the balanced budget constraint had been respected, the aggregate income gain for workers would have been larger than in Mortensen's analysis.

The experiment with higher firing costs, representing stricter job-security legislation, results in his model in somewhat higher unemployment and lower income for workers. This is a net effect of the standard result that both firing and hiring are discouraged, which means that aggregate employment tends to be stabilized at approximately the initially existing level—whatever this happens to be.

It is perhaps worth making the obvious point that a policy action that tends to stabilize aggregate employment at the initially existing level has very different welfare implications when unemployment is initially low and when it is initially high, as in Western Europe today. It is also likely that high labor turnover costs have quite different effects when there is great uncertainty about future business conditions than when such uncertainty is small: in the former case high labor turnover costs would be expected to be particularly damaging to new hiring. This suggests that crucial aspects in the analysis are lost if we only look at some average effects over the cycle. The effects would also be expected to differ between large and small firms, with greater effects on the latter.

Mortensen treats the experiment with a shift to fully experience-rated payroll taxes in the unemployment-benefit system in the same way as higher firing costs for labor: both raise the costs of firing and therefore, in an intertemporal framework, also the costs of hiring workers. There is, however, another important aspect of experience-rated payroll taxes, which is lost in a model without systematic

differences between jobs. Strongly cyclical production sectors, such as the building industry, are systematically subsidized in the real world when unemployment benefits are financed by uniform payroll taxes. This is avoided with fully experience-rated fees. The fact that this aspect is neglected in the model should be kept in mind when Mortensen concludes, "Without further study, I cannot recommend this reform (fully experience-rated fees) here or abroad." My point illustrates the limitations, for the purpose of the analysis pursued, of a model with only one type of labor, hence in fact with only one production sector.

Considering the richness that is already embedded in Mortensen's model, it is too much to ask the author to incorporate considerations like these in his formal model. I have made these remarks only to illustrate the dangers of building policy recommendations on models that abstract from potentially important aspects of the problem under analysis.

Subsidies to new hiring of labor look particularly useful in Mortensen's study — interpreted as government assistance in the *job/worker* matching process, government financed training programs, or outright marginal employment subsidies (for instance in the form of the New Jobs Credits of 1977 in the United States). This is a natural conclusion in this type of model — as in many other labor market models.

It is, however, not quite clear why the new jobs that are created by marginal employment subsidies, as Mortensen asserts, are necessarily more productive than the nonsubsidized jobs that then disappear — an assumption that plays a considerable role in the analysis. After all, the transaction friction embodied in the matching function reflects real resource costs and utility losses. Is it obvious that aggregate productivity will increase in the national economy if the costs to private agents of such frictions are mitigated by subsidies? As I understand them, the hiring subsidies in Mortensen's analysis are really designed to counteract, in a second-best fashion, various distortions that limit the hiring of labor to begin with, such as tax wedges, job security legislation, or unemployment benefits.

It may also have been interesting to study the consequences of

different types of hiring subsidies. For instance, subsidies to training, possibly also to labor-market exchange systems and job counseling, could perhaps be defended by reference to externalities, while this argument may be weaker for outright marginal employment subsidies.

A complication with marginal employment subsidies is that we cannot, in a long-term perspective, take the structure of firms as given. Suppose, for instance, that it is the net additions to the employment level of the firm that qualify for subsidies. Firms may then split into expanding and contracting entities to get marginal employment subsidies. Indeed, experience of policy interventions shows that the ingenuity among citizens to exploit, and cheat with, subsidies is usually underestimated by economists and politicians.

Moreover, in an intertemporal setting, wage bargaining may be influenced by expectations that the government will react to higher unemployment in the future by additional marginal unemployment subsidies. In other words, wage bargaining may be more aggressive not only because of already implemented marginal employment subsidies, but also because of expected subsidies in the future if higher wages create higher unemployment. Large unions may be particularly tempted to engage in such strategic behavior. Might not this mechanism turn such subsidies into a permanent feature?

Perhaps the government may also be forced, by political pressure, to keep giving hiring subsidies year after year to workers who were hired earlier on the basis of such subsidies. After all, the government has taken responsibility for the expansion of employment in the firms. Will citizens then not expect the government to take responsibility for continued employment in these firms as well? If so, the current labor cost may, after a while, differ systematically between sectors and firms with different historical employment paths, which is not likely to be efficient.

According to studies in the 1960s and 1970s, the relation between benefits and costs of active labor market policy in Sweden, in the form of public-sector retraining and public works programs, was quite favorable. Economists in Sweden are today more uncertain about the usefulness of such policies. In particular, empirical studies do not give

strong support for assertions that workers who have attended such training programs have a significantly higher probability of getting a job than workers who have not participated in such programs. (The results of these studies are somewhat uncertain, however, as the researchers may not have been able to avoid selection bias completely, in spite of considerable attempts to do so.) Studies also suggest that people in public works programs largely stop searching for jobs, and that they do not exert any downward pressure on real wages. .

Moreover, when there are very few vacancies, retraining largely fulfills the function of keeping people away from open unemployment, and of helping them qualify for a new round of unemployment benefits. After all, active labor market policy was initially designed to improve the functioning of the labor market in high-employment economies. The idea was to help people swim faster from the unemployment islands to the vacancy islands, partly to limit wage inflation in such economies. In this sense, active labor market policies function best under high-pressure conditions with ample vacancies.

Mortensen also arrives at the conclusion that general employment subsidies improve aggregate employment in the long run, though at very high costs for the government. Symmetrically, a general payroll tax would in the long run reduce aggregate employment. Mortensen's conclusion is reached, I believe, through his assumption that the value of the alternative to income, that is, of leisure, is independent of the real wage. I would rather emphasize some different mechanisms to explain why general payroll taxes (or general unemployment subsidies) influence aggregate employment. First, higher payroll taxes tend to raise labor costs for firms for a while, perhaps even as long as a number of years, because of nominal wage rigidity. During this period, unemployment tends to increase, and various persistence mechanisms tend to prolong this rise in unemployment.

Second, in the case of very broad tax wedges, as exist in many European countries today, wages for low-wage groups cannot always fall in proportion to the payroll taxes. One reason is minimum wages through legislation or wage bargaining. Another reason is that after-tax wages in some cases would have to fall below the reservation wage of these groups to keep labor costs for firms unchanged—the reser-

tion wage being influenced not only by the evaluation of leisure but also by the return on household production, the level of unemployment benefits, the level of social assistance, and income levels in other benefit systems, such as early retirement.

In conclusion, Mortensen's paper is an excellent one. It is, however, important to compare the supply policies analyzed with alternative supply-side policies, such as policies designed to help the labor market function just as a market, rather than as a system regulated administratively by governments and unions. Obvious examples are a lowering of high minimum wages and the removal of various privileges to labor unions that help them to keep up wages for unskilled workers. Other examples are the removal of barriers to the entry of firms, the mitigation of imperfections in capital markets, and the reduction of tax wedges, in particular in the sector of market production of household services.

It is also necessary to think carefully about the political mechanisms that may be initiated by various policy actions. Otherwise we may, after a while, wind up with policies which the proponents of various policy proposals would never have recommended in the first place. This has happened before. Private agents have much stronger incentives than politicians and public sector administrators to find ways of drawing benefits out of government interventions. The effects of policy interventions, therefore, often turn out to be quite different from the intended ones.