

Commentary: The Role of Demand Management Policies in Reducing Unemployment

Welfare State Unemployment: A Comment

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Charles Bean has written an informative discussion of unemployment that brings to a larger audience some parts of his comprehensive discussion of European unemployment (Bean, 1994).

His current paper also discusses the role that policy might take to reduce unemployment. I will put policy issues aside initially to concentrate on the causes of unemployment. I begin by stating and commenting on four main points about the causes of unemployment that I draw from his work, particularly his survey paper.

Why European unemployment rose

First, most of the increase in unemployment within the European Union is on the supply side. Chart 1 in Bean's conference paper, and his earlier survey paper (1994, Figure 2), show that the steady-state unemployment rate rose from less than 2½ percent in the late 1960s to about 10 percent twenty years later. Bean's chart, reproduced as Chart 1, shows that the unemployment rate at any rate of inflation is higher in all countries but, outside the European Community (EC), the increases are modest. The rise in the EC is almost a constant rate of increase over a fifteen-year period. Since the rise in the unemployment

Chart 1 Unemployment and Inflation

Bean: European Unemployment: A Survey

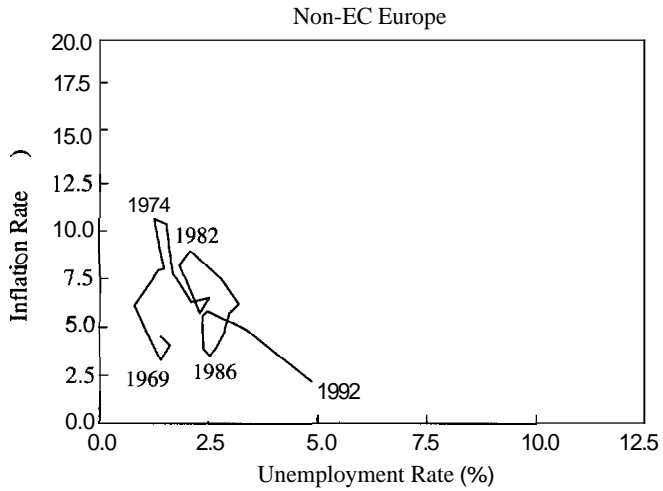
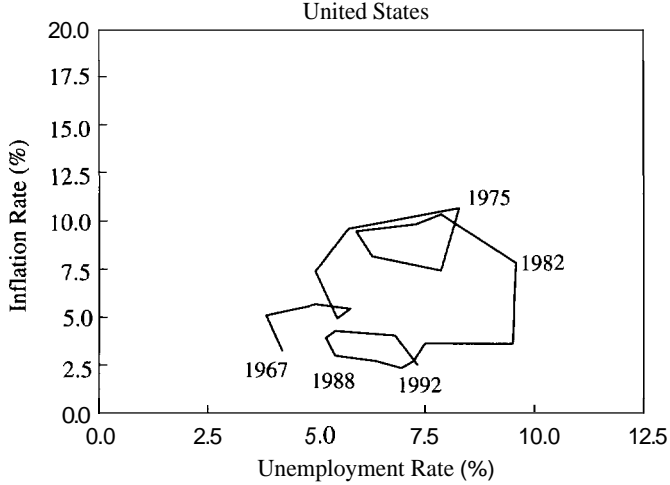
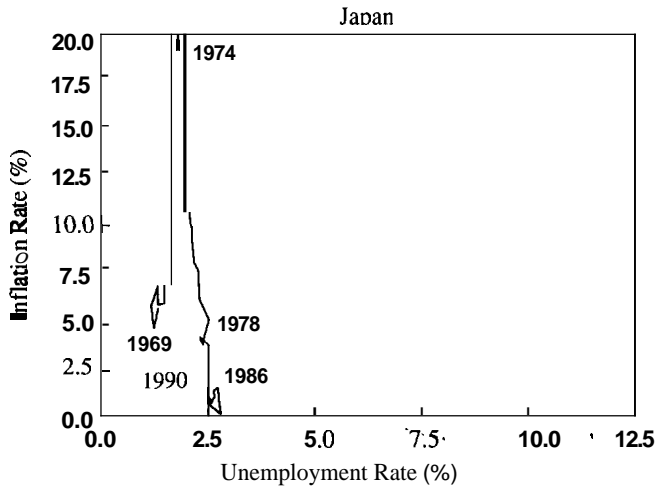
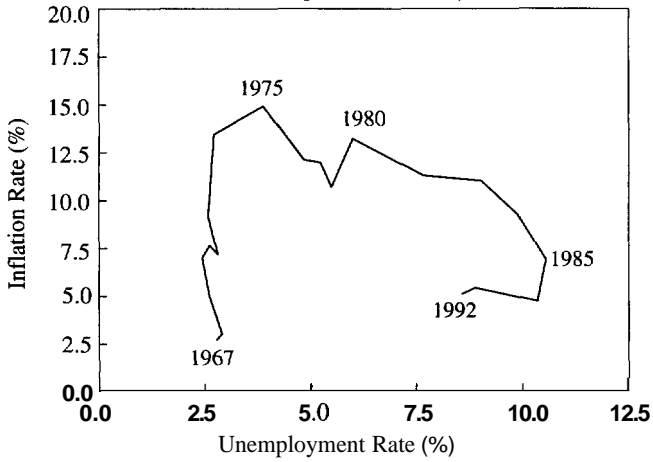


Chart 1: Unemployment and Inflation continued

Bean: European Unemployment: A Survey
European Community



rate is mainly on the supply side, it is not "Keynesian unemployment." I suggest that a better name is "welfare state unemployment."

A distinguishing difference between welfare state and Keynesian unemployment is that the former, unlike the latter, cannot be reduced *permanently* by policies that increase aggregate demand. Welfare state unemployment raises the natural rate of unemployment. Bean's (1994, p. 575) survey suggests that the natural rate has increased in the last twenty years in the United States, Europe outside the EC, Japan, and in the EC. The increase in the rate for the EC, however, is orders of magnitude greater than in the other regions. I concentrate on this long-term rise.

Second, cyclical fluctuations in aggregate demand play a much smaller role. Bean's data suggest that, at its worst in the mid-1980s, cyclical unemployment was 2½ percent, so the unemployment rate, in the EC or European Union (EU), would have been less than 5 percent instead of more than 10 percent had welfare state or supply-side unemployment remained at the late 1960s level.

Third, Bean concludes that there is no accepted explanation of the rise in European unemployment. His survey suggests that economists have worked hard investigating many plausible explanations without reaching a firm conclusion. The explanations include the oil price shocks, changes in the terms of trade, slower productivity growth, higher and longer-lasting unemployment benefits, and minimum wages. Some of these explanations are incomplete as they stand. The lasting effects of productivity growth, oil shocks, and changes in the terms of trade should be on real wages, not unemployment, and any effect of the oil shocks should have reversed when real oil prices fell.

Other, more inventive economists, have proposed fanciful explanations of persistence or, as some prefer, hysteresis. In one popular version, workers are said to lose their skills when they remain unemployed. Such explanations neglect some facts. Much of the rise in unemployment is not the result of employed workers losing jobs. Unemployment in the EU is heavily concentrated among new entrants. In Bean's words (1994, p. 576): "The high levels of unemployment in

the European Community are thus associated primarily with the reduction in the probability of finding a job, rather than an increased likelihood of losing one." Further, to reach the remarkably low unemployment rates of the 1950s and 1960s, the labor force absorbed the generation that experienced the depression of the 1930s and the war in the 1940s. This generation had no problem finding and keeping jobs in the 1950s and 1960s despite a lengthy absence from the labor force.

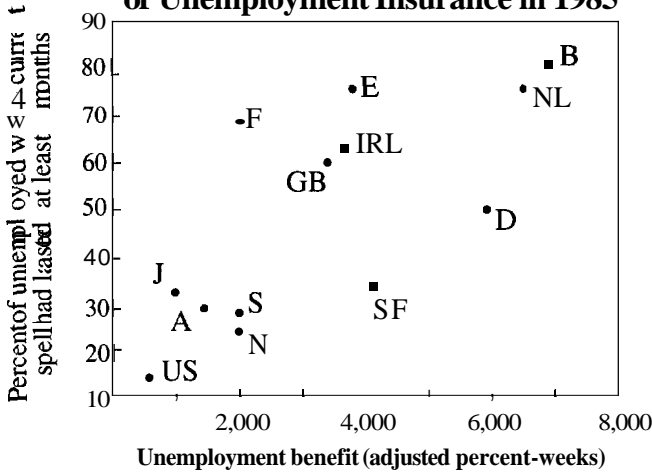
Fourth, Bean's (1994) survey suggests that most of the research on the role of the welfare state has concentrated on unemployment benefits and taxation. He dismisses these policies as an explanation of an increased steady-state unemployment rate.

Bean recognizes (1994, pp. 592 and 602) that the duration of unemployment benefits is indefinitely long in several EC countries that now have high unemployment rates, whereas the duration of benefits is limited in the Nordic countries (and the United States) where unemployment rates rose much less in the 1980s.¹ He dismisses any long-term effect of taxes and permanent benefits by arguing that the two should be offsetting on an individual's choice of labor and leisure. His argument is that leisure depends on permanent income. Higher taxes reduce permanent income but the higher benefits restore the loss. In Bean's model, the permanent effects on unemployment cancel (1994, p. 589).

I believe that the error in this argument is the fallacy of aggregation. Taxes on earned income or labor income (whether assessed on employers or employees) are paid by those who work. Unemployment benefits are paid to those who are idle. Hence work or effort is discouraged and leisure or idleness is encouraged. Or, workers move into the underground economy. Permanent benefits that cannot be taken away (to use a now familiar phrase) have a double effect on the unemployment rate if paid for by taxes on earned or labor income. Far from canceling, the two effects are reinforcing.

Burda (1988, p. 407) studied the relation between the duration of unemployment benefits and the proportion of the unemployed out of work for six months or longer. Chart 2 reproduces his data. The correlation between long-term unemployment and duration of benefits

Chart 2
Long-term Unemployment Rates and the Level
of Unemployment Insurance in 1985



Note: A = Austria, B = Belgium, D = West Germany, E = Spain, F = France, GB = Great Britain, IRL = Ireland, J = Japan, N = Norway, NL = Netherlands, S = Sweden, SF = Finland, US = United States

is 0.75 for 1985 based on across-section of Organization for Economic Cooperation and Development (OECD) countries. At the time, duration of benefits was unlimited in the United Kingdom, Belgium, the Netherlands, Germany, and Spain, and two and one-half years in France, compared to twenty-one and one-half weeks in Switzerland, thirty weeks in Austria, and thirty-four weeks in the United States. These differences help to explain the differences in unemployment rates and the duration of unemployment in the EC compared to non-EC Europe and the United States.

Permanent unemployment benefits and taxes on labor income are not the whole story. They are only one of the contributions of the welfare state to unemployment.

Role of the welfare state

Three features of the welfare state are important for the steady-state unemployment rate. To have a significant effect on measured unemployment, benefits must be (1) comprehensive, (2) independent of the

amount of work performed, and (3) permanent or of long duration. Not all benefits are of this kind, so correlations of tax rates or transfer payments are not likely to be relevant or revealing.

At least since Burda's (1988) study, the duration of benefits has been recognized as important in the analysis of unemployment compensation. Bean's survey brings this work up to date. Duration of benefits explains part of the difference in measured unemployment rates within Europe or between the EC and the United States. Less attention has been paid to other aspects of the welfare state. Many studies of the response of unemployment to the welfare state concentrate on the effect of taxes. Taxes distort the individual's labor-leisure tradeoff and increase the measured unemployment rate. This effect is one of many distortions but, if benefits are not comprehensive and permanent, the effect appears to be relatively small.

Analysis of the effect of a negative income tax and in-kind benefits suggests why the permanent, comprehensive benefits of modern welfare states distort labor-leisure choices and increase measured unemployment rates (Meltzer and Richard, 1985). Decisions to work are less affected if benefits are not comprehensive. For example, giving food stamps, housing allowances, or other in-kind transfers reduces employment less than an equivalent payment of cash. Beneficiaries must work to purchase the goods and services not provided by the welfare state. A cash equivalent payment, therefore, reduces the incentive to work. The more comprehensive and durable the benefits, and the more they are independent of labor force participation, the larger is the reduction in employment. The extreme case is a cash transfer, or negative income tax, paid permanently as an entitlement. The effect is diluted if benefits can be sold, but housing allowances, health care, and education are difficult to sell.

The United States has housing allowances, food stamps, and some medical care, but cash payments for welfare recipients are small relative to the average wage, and unemployment benefits are not permanent. In countries with permanent unemployment benefits that are a large share of the average wage, the unemployed also receive a variety of in-kind transfers independent of their work history. Health care, housing allowances, and schooling for children supplement the

permanent cash payment. Studies that neglect these differences in welfare state benefits are likely to mismeasure the role of the welfare state in reducing labor force participation and increasing the equilibrium unemployment rate. This is particularly true in some European countries where unemployment has much lower turnover than in the United States. Bean (1994, Table 2) reports that in 1988 long-term unemployment was 55 percent of total unemployment in the EC, and 7 percent in the United States.

Sweden illustrates some of the problems in assessing the role of a welfare state. Sweden has a comprehensive welfare state on most measures. Cash benefits to the unemployed, however, are paid for less than one year. Training and retraining programs, and special programs for disabled workers, absorbed between 1½ to 2½ percent of the labor force from 1985 to 1990. This is close to the share of the labor force that is reported as unemployed, so reported unemployment rates were understated relative to countries with smaller training programs.²

The Swedish example is one reason for mismeasurement of unemployment rates. A more widespread problem is the difference in government hiring or overmanning in state-owned firms.

Two frequent criticisms of this line of reasoning are that the welfare state antedates the rise in unemployment rates, and some welfare states have not experienced the rise in unemployment rates reported for the EC. Bean's survey paper shows average unemployment rates for nineteen of the twenty-three countries in the OECD during sub-periods from 1969 to 1992. In the first sub-period, 1969-73, the range of average unemployment rates was from less than 1 percent to nearly 6 percent, and the unweighted average was 2.5 percent. By 1986-92, the bottom of the range had increased almost to the 1969-73 average. The average rose to 7.7 percent, and the range to 2.3 percent to 18.1 percent. The average unemployment rate increased in all nineteen countries.³

More importantly, the data suggest that relative positions were not very different in the two periods. A rank correlation coefficient between countries' average unemployment rates in 1969-73 and 1986-92 is 0.66, significant at the 1 percent level. The median percentage

increase is 270 percent.⁴ Many countries in the EC are close to the median increase and show about the same percentage increase as such non-EC countries as Austria, Finland, and Norway. While it is true that eight or nine countries above the median unemployment rate in 1986-92 are in the EC, the same is true for six of the nine countries above the median unemployment rate in 1969-73. The prior existence of welfare states does not pose a problem if the size and scope of welfare states increased in rough proportion to their levels in 1969-73.

Social benefits rose in many of the European countries in which unemployment increased. Alesina and Perotti (1994) compiled data on social expenditures as a share of GDP in the EC for 1960 and 1988. These are shown in Table 1 for eight countries. Also shown are the changes in the unemployment rate for the same countries using data for 1969-73 and 1986-92 from Bean (1994). Except for Ireland, the rise in the unemployment rate correlates well with the increase in welfare spending.

Table 1
Changes in Social Expenditure as a Percentage of GDP
and Changes in the Unemployment Rate

Country	Changes in Social Spending/GDP ¹ 1988/1960	Change in Average Unemployment Rate 1986/92 - 1969/73
Spain	4.30	15.4
Denmark	2.64	9.8
France	2.40	7.3
Belgium	2.25	6.5
Italy	2.18	4.8
United Kingdom	2.03	5.6
Germany	1.46	4.6
Ireland	1.20	9.8

Sources: Alesina and Perotti (1994), Bean (1994).

¹Social expenditure includes sickness, disability, old age, unemployment, family allowance, maternity, vocational training, and housing.

The data are not for the same period, so caution is in order. Also, data are not available for the full sample. Nevertheless, the increase in unemployment is not unrelated to the increase in welfare spending.

Policy issues

Bean looks with more favor than I on monetary manipulation, demand stimulus, and temporary incomes policy as an aid to reducing unemployment. He opposes policy coordination even within Europe. And he sees little scope for demand-side fiscal policy to increase demand because most countries have large deficits relative to GDP. His main policy recommendation is for supply-side reforms, but he is not very specific about the particular reforms he favors. He proposes modest monetary stimulus and incomes policies to support the transition to the new steady state at lower unemployment rates.

Bean recognizes — indeed emphasizes — that both policymakers and economists face considerable uncertainty about the prevailing equilibrium rate of unemployment. In the face of this uncertainty, it seems wrong to suggest that policymakers should increase uncertainty about the future price level by engaging in monetary fine tuning or try to fool workers and owners into thinking real demand is higher than it is. A coherent, consistent, well-articulated monetary policy to achieve zero expected inflation in each country seems a better way to take advantage of the latitude provided by current exchange rate bands and floating rates.

I believe Bean dismisses fiscal action too quickly. Reductions in transfers payments could be financed by equivalent reductions in taxes on labor. Since those who receive the transfers and those who bear tax burdens are not the same, incentives to work can be increased by reductions in taxes and benefits. The dynamic effects on aggregate output and income would lower the deficit.

This suggestion, like many other proposals for supply-side policies, raises political issues about redistribution. Welfare state policies are chosen, or at least supported, by voters. The economic equilibrium that sustains a high measured unemployment rate appears to be not just an economic but a political equilibrium. The unemployed and

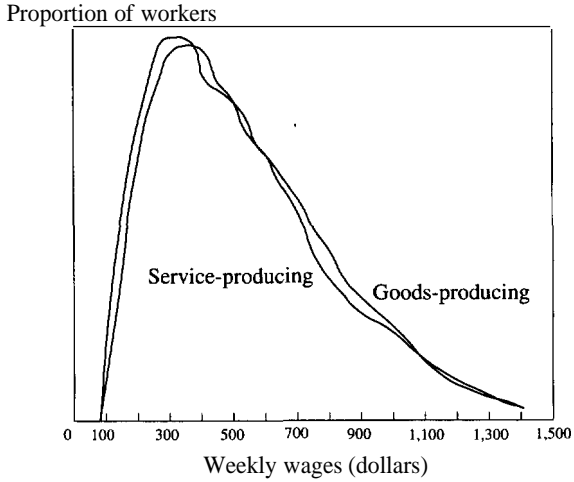
their legislative representatives do not demonstrate or demand reductions in taxes and transfers to increase employment. Most often they ask for increased transfers financed by taxes on earned income. Such policies increase measured unemployment or the number of "discouraged workers." Demands for reductions in welfare state benefits come mainly from those in the middle and upper income groups who pay taxes in excess of the benefits they receive. Typically the latter demands exclude the transfers received by the taxpaying groups.⁵ Most politicians act as if they doubt that a majority of their constituents favor reductions in comprehensive benefit programs.

Finally, a few words about the alleged tradeoff between low-paying service jobs and higher unemployment rates discussed in other papers at this conference. During the last election campaign in the United States, some economists and their friends in the media misled the public by promoting the idea that many of the 20 million jobs created during the 1980s were low-paying service sector jobs. A different version of the same idea is that the United States has kept unemployment rates low by replacing high-paying jobs in goods producing industries with low-paying service sector jobs.

Chart 3 compares the distributions of weekly wages in goods and service producing industries in 1992. The two distributions overlap to a considerable extent. This should dispose of the false notion that service sector jobs are low-paying jobs and, with it, the idea that most of the new jobs created in the 1980s were low-paying jobs.⁶ The policies of the 1980s drew people into the labor force where many developed the skills and work experience essential for increasing lifetime income.

Author's Note: I have benefited from several discussions with Bennett McCallum.

Chart 3 Wage Distributions, Goods and Services, 1992



Source: Federal Reserve Bank of Cleveland calculations based on data from U.S. Department of Labor, Bureau of Labor Statistics.

Endnotes

¹Increases in unemployment rates in Sweden and Finland in the 1990s have not lasted long enough to be described as persistent.

²In 1993-94, Swedish unemployment rates rose to about the European average. The number of workers in training programs rose also but less than proportionally. (Ministry of Finance, 1993, p. 48)

³Data are not available for Greece, Luxembourg, Portugal, and Turkey.

⁴Since several countries reported unemployment rates below 1 percent for 1969-73, the mean percentage change is misleading.

⁵For models of this political-economic equilibrium with taxes and redistribution, see Meltzer, Cukierman, and Richard (1991).

⁶As Kosters (1994) shows, the main reason for the recent shift in income distributions is the higher premium for college-educated workers in the 1980s.

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