

Learning a lesson from America

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Faced with Europe's high levels of unemployment, there is a standard view of the root cause of the problem. Europe has rigid wage structures, which deter job creation; it has high minimum wages, which benefit those in employment but erect barriers to entry for those who aren't; and it has an overly generous welfare state, which crowds out private investment by putting high tax burdens on companies.

Almost everybody believes this - economists, businessmen and politicians alike. Gerhard Schröder believes it. Tony Blair believes it. Wim Duisenberg believes it. The Organisation for Economic Cooperation and Development believes it and so does the International Monetary Fund. According to the orthodoxy, there is a simple relationship between equality and unemployment: the price you pay for more jobs is more inequality. America has the jobs, Europe has the welfare state. The third way is based on the idea that Europe needs to re-shape its labour market and its tax and benefits system along US lines while retaining its core social democratic values.

Flexibility is key

Labour market flexibility is seen as the key. America's hire and fire culture, low levels of unionisation and rudimentary social safety net create an environment in which workers price themselves into jobs. In Europe, by contrast, high levels of job protection, atavistic trade unions and generous benefits cause high structural unemployment.

There is only one thing wrong with this view. It is hard to square with the facts. As the small renegade unit in the employment section at the OECD pointed out in their annual report this year, there is no evidence that employment protection legislation costs jobs. On the other hand, the recent Joseph Rowntree study on insecurity found that those workers who felt happy and secure were far more productive than those living in a state of permanent uncertainty.

A new paper delivered at a Cambridge conference last month suggests that we could indeed learn a lesson from America, but not the one promoted by the flexibility brigade. It is that, measured as a whole, inequality in Europe may actually be higher than it is in the US, and that the key to reducing unemployment is reducing inequality.

This suggestion is so counter-intuitive that it is worth going through the argument in some detail. Economists James Galbraith of the University of Texas, Pedro Conceição and Pedro Ferreira, both of Instituto Superior Tecnico in Lisbon have examined industrial earnings data from individual European Union countries over the past 20 years. On the basis of these figures, they find that inequality and unemployment are positively correlated - rising wage inequality and rising unemployment go hand in hand.

They also construct a pan-European measure for inequality in the EU as a whole, from low wage Spain through to high wage Germany. Using their measure, Europe has more inequality than the US.

The findings of Mr Galbraith and his colleagues pose a challenge for the flexibility brigade. If the conventional wisdom is correct, then logically those countries in Europe that have the most inequality should have the lowest unemployment. The opposite is, in fact, the case.

Inequality debate

"Unemployment has always been higher where inequality was greater in Europe," the report said.

"Today, national unemployment rates are systematically lower in the richer and more equal countries of Europe where wages are high and social welfare systems are strong. Meanwhile, it is the lower-income countries with the weakest social welfare systems and the most inequality, such as Spain, where unemployment is highest in today's Europe."

By the same token, unemployment in the US should have fallen in the 1980s as the impact of Reaganite policies led to an increase in inequality, while the reduction in inequality during the late 1990s should have led to lengthening dole queues. Again, not so. Further, those parts of the US which have seen the largest increases in income inequality - California and New York - should have created the most jobs. Wrong again. Non-farm payroll employment rose 1.6% a year in the US as a whole between 1989 and 1997: in California it climbed just 0.9% a year, in New York it fell 0.3% a year.

The conventional argument also suggests that those countries with high wages and generous welfare systems should have higher unemployment because they fail to generate low-wage, low-productivity jobs. Again, the Galbraith, Conceição, Ferreira paper says this is not the case. High wage countries are characterised by a wide range of industries and services, including many that have low productivity and that must compete with low-cost imports.

The report said: "High-wage economies are actually more diverse in their employment structures than low-wage countries; somehow they manage to have high wages alongside many low-productivity jobs. How do they do it?

"The answer is scandalously simple. High-income countries subsidise and support the pay of low-productivity people. They do not rely on markets. They provide high minimum wages, buyers for farm produce, jobs in vast public bureaucracies, free health care and higher education."

It's hard to argue with the authors' conclusion that the real rigidities are in the thinking of those running economic policy in Europe rather than in the continent's labour-market structures.

Firstly, they have been unable or unwilling to pursue macro-economic policies designed to create jobs in Europe's peripheral economies. Secondly, they have shied away from creating a system of vast income transfers across national borders to make working in the Spanish civil service as attractive as it is in Sweden.

Surely, however, the US is a country where inequality is endemic and entrenched. Not so, say Galbraith and his colleagues. As late as the 1970s, the US was viewed as a land of the middle-class, while there was a massive expansion in the role of government during the New Deal and the Great Society.

American policies have remained open to the joint reduction of inequality and unemployment - witness the speed with which the Federal Reserve reduced real interest rates to zero in 1991 and kept monetary policy expansionary throughout the decade. Earnings dispersion in manufacturing has been declining steadily since 1994, and this has been accompanied by the fall in unemployment.

"We suggest that the true American advantage is not inequality, which by our measure is lower than that across the whole of Europe, but America's national policy means for income redistribution and the pursuit of full employment," the report said.

Sticking point

Although the suggestion that America is the true social democracy may stick in the European craw, it is certainly worth Europeans considering what the impact of liberal access to credit, a national social security system and the earned income tax credit have done both to increase incomes and reduce unemployment.

Their study raises two interesting points: first that the conventional wisdom that you need to smash welfare

states in order to get more jobs is utterly wrong. Their second point, that America has higher employment because it has lower inequality than Europe - probably requires further evidence. It seems more likely that the line of causality goes in the other direction - full employment lowers inequality.

Galbraith and his colleagues suggest that Europe has three choices. Firstly, it could restore national means for the pursuit of full employment in the form of monetary, fiscal and trade policies, alongside capital controls, which was broadly the policy for the first 30 years after the war. The prospects of it doing this are, of course, slim.

Secondly, it could establish a single labour market for the European Union so that Europe's poor can move to the rich parts of the continent, as America's blacks did when they moved from the Mississippi delta to Chicago. Given the rise of European xenophobia, this too looks improbable.

If neither of these options, Europe "must establish the kind of social welfare transfer and employment-subsidy mechanisms that have heretofore existed only within the smallest, richest and most resolutely socialist nations of the continent - and are also routine in the US."

On the other hand, Europe's politicians could carry on in their own sweet way. They can make labour markets more flexible and they can slash social spending. But it won't be a pretty sight. What's more, it won't work.