

**ALTERNATIVE STRATEGIES FOR FIGHTING  
UNEMPLOYMENT:  
LESSONS FROM THE EUROPEAN EXPERIENCE<sup>1</sup>**

**Gilles Saint-Paul**

The author analyzes the economic policy behind changes in job market regulations. He says that the best reform is a radical one that directly eliminates the distortions existing on the market. Yet he recognizes that this is not easy because the political costs are high and, in the short term, the unemployment rate could rise as a result of the huge distortions that would require a significant adjustment in employment that is by no means automatic.

He argues that this situation is what explains the different European strategies to fight unemployment. He sees some positive aspects in them, but is skeptical about their real impact on unemployment or their contributions to improving market productivity, largely because they still limit the opportunities that the unemployed have to compete under arm's length conditions with the employed. Until this situation changes, it will be indicative of distortions that will keep unemployment rates high and job opportunities limited. This discussion is relevant to the debate ongoing in regard to the Chilean job market.

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## 1. Introduction

During more than three decades of protracted high unemployment, European countries have developed a variety of approaches in order to tackle the problem. These strategies differ in their philosophy, scopes and successes. A number of them can be understood in terms of shying away from full-fledged liberalization in order to preserve the “European Social Model”. In this paper I discuss their relative merits. I will focus on strategies that may reasonably be expected to reduce unemployment, and will ignore sheer blunders based on a false view of how the economic works (such as working time reduction), as well as measures that may improve the welfare of the unemployed but are nevertheless harmful to the labor market (such as generous unemployment benefits). The general message is that some of the strategies that “preserve the European Social Model” have merits, but are unlikely to lead to an efficient labor market where finding a job or hiring a worker are no longer considered as a painful challenge.

## 2. The Big Bang

The Big Bang consists in eliminating most labor market rigidities, so as to engineer a transition toward a flexible labor market. In a flexible labor market, both relative and absolute wages adjust so as to bring the market back to equilibrium. Furthermore, there are little quantitative restrictions of the firms’ ability to manage the size of their workforce. Employment protection is low, which builds a high rate of turnover in the labor market. These features generate low unemployment duration as well as low unemployment. An appealing aspect is that people are protected by the labor market rather than by labor market rigidities. There is little need for employment protection because, due to flexible wages, workers are paid closed to their opportunity cost of labor and consequently lose little when they lose their job. Similarly, there is little need for unemployment benefits because unemployment duration is low.

This strategy is illustrated by the labor markets of the United Kingdom and Ireland. As an illustration, Table 1 compares the United Kingdom with France. We see that the unemployment rate is twice lower in the UK, and that the fraction of people unemployed for more than a year is also twice lower. At the same time, unemployment benefits are less generous by a third, and their average duration is much lower.

TABLE 1 A COMPARISON OF THE UK AND FRENCH LABOR MARKETS.

	United Kingdom	France
Unemployment rate (2005)	4.7	9.5
% of long-term unemployed (>1 yr)	22	42
Initial replacement ratio %	54	75
Duration of benefits (Months)	6	30
Employment protection index	1	2.9
% of employees at minimum wage	1.4	15.6

*Source:* OECD, 2006.

We also note that the UK ranks low on a synthetic index of employment protection, while France is one of the countries which ranks the highest. Finally, the UK minimum wage is much less binding than the French one, as only 1.5% of workers are paid the minimum wage in the UK, while 16% are on the minimum wage in France.

These numbers suggest that the “Big bang” strategy works, in that it eventually leads to a well-functioning labor market, close to full employment and with low unemployment duration. Crucial were the reforms implemented by the Thatcher government in the 1980’s, which led to a large reduction in Union Power, in particular through the dismantling of the closed-shop system of wage formation. Thus eventually led to an increase in wage flexibility and in the economy’s ability to reallocate labor between sectors in response to structural shocks.

If this strategy seems so beneficial, why is it that it has not been adopted throughout Europe? We can list four potential obstacles:

- *Inequality:* Typically, an economy with wage rigidity and strong union power is also an economy with wage compression, that is, a lower degree of inequality between workers. Thus one may fear that if these institutions are dismantled, inequality could increase. This argument is at best weak. First, the very same institutions, while reducing inequality among the employed, increase inequality between the unemployed and the employed. When minimum wages are lowered, minimum-wage earners will earn less relative to skilled workers. But that is because more people are hired in their skill and occupational categories, which, at the same time it reduces their relative marginal product, benefits a number of unemployed workers

by moving them into jobs. Second, society can always correct inequality if it wishes by using redistributive tools that are more efficient than wage compression. Direct transfers distort the labor supply decision, but they are probably less harmful to employment than minimum wages, and they do not increase inequality between the employed and the unemployed. Earned income tax credit redistribute in favour of the poor while preserving incentives to work on the supply side, and, unlike minimum wages, they do not create a scarcity of jobs.

- *Volatility:* A flexible economy typically exhibits more macroeconomic volatility than a rigid one. A rigid economy will create less jobs in expansions, but will destroy less jobs in recessions. That is because, when employment protection is more stringent, it is more costly for firms to adjust their workforce. That is true for downward adjustment, since that is what employment protection penalizes, but also for upward adjustment, since firms impute the future potential firing costs of the newly hired workers—which therefore act as a shadow hiring cost. Thus, in 1994, at the trough of the recession, the UK unemployment rate was 9.3%, while the French unemployment rate was 11.7%. While French unemployment fluctuates around a higher level than UK unemployment, the amplitude of these fluctuations is smaller, let us say between 8 and 12 in France, vs. 4-10 in the UK.
- *Painful transition:* The UK experience suggests that, after a “Big Bang” reform, a fairly long and painful transition must be experienced before reaching the new low unemployment steady state. The central reason is that, prior to the reform, labor is misallocated, because market signals, i.e. the structure of wages and benefits, are distorted. The Big Bang sets market prices right and, by doing so, triggers a massive wave of labor reallocation. For example, employment protection may have maintained a large number of workers in jobs that are quite unproductive, and that remain only because it is costly for employers to destroy them. Minimum wage workers may find themselves flooded with competitors in some occupation, now that they can be hired at lower wages, and many of them might prefer to go through an unemployment spell in order to look for another job instead. The Big Bang may be followed by a 5-10 year, period when unemployment is higher, not lower. That is indeed what was observed in the UK, where unemployment only started to fall in the late eighties, 10 years after Thatcher was elected.

The transition can be made less painful by using *macroeconomic policy*, i.e. fiscal and monetary stimulus, to boost job creation during the transition (See for example Saint-Paul, 2002)

- *Political opposition:* For related reasons, the Big Bang strategy can be met by fierce political opposition. Such opposition is mostly likely to come from the “insiders”, i.e. incumbent workers who earn rents—whose wage is above their opportunity cost of labor. By moving toward a competitive system of wage formation, the Big Bang strategy reduces these rents. If the insiders are numerous enough and/or well organized, they may block the reform. According to that view, the circumstances that made reform possible in the UK in the eighties are specific and these reforms may not be replicable in other countries. In principle, though, it is possible to buy the support of the insiders by offering them a once-and-for-all monetary compensation. Why this has not been envisaged is not totally clear. It is doable and has been done for limited reforms that only affect a small fraction of the market (for example in the case of the closing of Spanish naval construction sites or the liberalization of the Dublin market for taxis). On the other hand, for the case of a large-scale labor market reform, adequate compensatory transfers are both more difficult to estimate and may represent a large cost to the budget. Take the following back-of-the-envelope calculation: Suppose 20% of workers earn 20% more than their alternative wage. With a wage share of GDP of 70%, their rents are about 2.8% of GDP. With a discount rate of 3%, the once-and-for-all transfer that would compensate them has the order of magnitude of 0.028/0.03 of GDP, i.e. ~ 100% of GDP. The government would have to issue a huge amount of public debt to compensate these workers.

### 3. Liberalization at the margin

A number of countries, especially in Southern Europe, have opted for liberalization at the margin instead of the Big Bang strategy. These countries include Spain, Portugal, Italy, and to some extent France. The idea is to make new labor contracts more flexible than existing labor contracts, while leaving existing labor contracts unchanged. This allows firms to have more flexibility at the margin, while at the same time protecting the interests of the insiders. This type of reform has been especially used in the area of employment protection. For example, in the mid-eighties, Spain made it

easier to use temporary contracts; while these had to be used for projects that were temporary in nature, it was now possible to use them to hire unemployed people. The reform had a very large effect: most new hires were in the form of temporary contracts, and the share of employment under temporary contracts quickly rose to 30% of employment, and stabilized around that level. Note that because of the high turnover of these contracts, they typically account for a much larger share of the flow of new hires than the stock; in Spain, their share of the flow is over 90%.

The Portuguese experience is quite similar, while France and Italy also rely on temporary contracts, but to a lesser extent than Spain and Portugal. The case of France is interesting, because the temporary contract regime is much less liberal than in Spain. Nevertheless, firms have heavily relied on it in order to get a margin of flexibility.

The main advantage of such a marginal reform is its political feasibility. The insiders' rents are grandfathered, which alleviates their opposition to the reform and may even turn it into a support, to the extent that they expect to benefit from the opportunities created by temporary contracts should they become unemployed in the future. Also, the Spanish reforms were followed by a sharp employment boom, which was partly due to the greater attractiveness of temporary contracts. However, when the subsequent recession came, it was very easy for firms to reduce their workforce by simply dismissing or not renewing their temporary workers. Thus, employment fell almost as fast as it had risen. By increasing flexibility at the margin, temporary contracts replicate an across-the-board liberalization of employment protection, since what matters for firms is the marginal worker, not the average one. Therefore, the economy's volatility is increased as in the Big Bang case.

TABLE 2: THE FRACTION OF TEMPORARY WORKERS IN TOTAL EMPLOYMENT.

Country	% of temporary workers
Spain	30
Portugal	20
France	13
Italy	12

Source: OECD, 2006.

Many economists tend to be critical of the liberalization at the margin. They have made the following arguments:

- Temporary contracts have been accused of creating a *two-tier society*, with a class of precarious workers (quite often women and the young) being forced to wander between unemployment and poor jobs, while other workers are protected. As far as the evidence is concerned, the bottle seems half empty/half full. While the labor market is indeed dual when one looks at jobs, it need not be when one looks at individuals. At one extreme, it may be that it is always the same people who hold the temporary jobs; at the other extreme, temporary workers may end up with a permanent job quite often. In this case, one can actually argue that temporary jobs are a good thing because they offer firms an opportunity to screen and select worker, an option that they would be reluctant to exercise under the terms of highly protected permanent contracts. The following Table, borrowed from Güell and Petrongolo (2003), documents the quarterly transition rates between different labor market states in Spain:

TABLE 3: LABOR MARKET TRANSITIONS IN SPAIN

	Non employment (NE)	Permanent Contract (PC)	New Temporary Contract (NTC)	Same Temporary Contract (STC)
NE	96.6	0.48	2.91	
PC	2.20	96.32	1.48	
Temporary Contract	16.26	5.70	13.93	64.11

Source: Güell and Petrongolo, 2003.

Out of the 36% of temporary workers who lose their temporary contract during a given quarter, less than half are not working the next quarter. About a third have found another temporary contract, while a sixth—representing 5.7% of temporary workers—have found a permanent contract. One may complain that this figure is not big, however it is much bigger than the likelihood of finding a permanent contract for the non-

employed. Furthermore, these figures are quarterly. If we compound them, they imply that about 30% of the temporary worker who are still employed one year later, will have a permanent contract. Similarly, Blanchard and Landier (2001), despite being very critical of marginal liberalizations, find 1-year transition rates from temporary to permanent contracts between 30 and 50 % for the less than 24-year old. This hardly sounds like a segregated labor market especially in light of the fact that it is natural for entry jobs to be short lived.

- It has also been argued (notably by Bentolila and Dolado (1994)) that temporary contracts increase wage pressure by reducing the exposure of insiders to job loss. The idea is that because firms use temporary workers to adjust their workforce, permanent workers are less likely to lose their jobs in a downturn. They can then safely ask for higher wages. Note that to harm employment, however, this effect should increase the cost of hiring the marginal worker, who is on a temporary contract. Otherwise, that effect is just increasing the rents of the inframarginal insiders. In the case of Spain, union-negotiated wages also apply to temporary workers; therefore, that assumption seems justified. The problem is that firms always keep the option to strategically increase the exposure of the insiders by hiring fewer temporary workers. If they choose not to do so, it means that the costs to them of greater wage pressure is lower than the benefits of lower employment protection at the margin. To put it otherwise, a reform which increases the options of firms must benefit them, because they can always ignore it —if they don't, they must be better-off. Furthermore, it can be proved that if there is free entry of firms, any reform which increases profitability must benefit the unemployed, by typically reducing unemployment duration.<sup>2</sup>
- Finally, temporary contracts may exert pressure on the unemployment benefit system, if temporary workers are eligible. The increase in job turnover may greatly increase the number of eligible claimants and impose financial strain on the unemployment benefit administration. Note however that the previous situation —a system which is sustainable because many unemployed workers are not eligible for benefits— is not very palatable from the point of view of insurance.

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<sup>2</sup> That does not mean that unemployment must increase. An increase in the job loss rate may more than offset the effect of lower unemployment duration. That is often the result that arises when one considers reductions in employment protection.

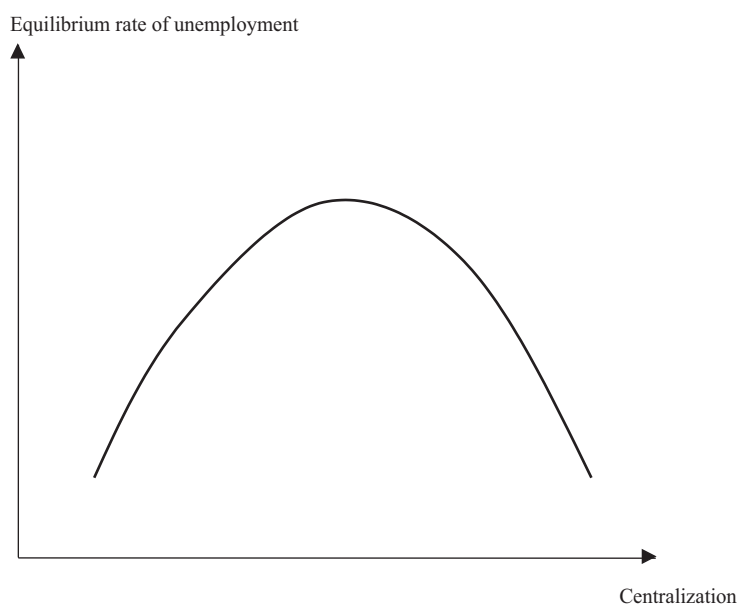


I tend to view these reforms in a positive light, in that they may be a transitional device to gradually build a political coalition in favor of an across-the-board liberalization of employment protection (Saint-Paul, 2000). Having a single, more flexible, employment contract is often advocated but very few governments have attempted to move toward such a contract for fear of political opposition. Marginal liberalizations themselves are not very easy to implement (Saint-Paul, 1996).

#### 4. Coordination of wage-setting

The success of Scandinavian countries in maintaining a low unemployment rate despite strong unions and rigid labor markets has long been celebrated. Two specific features of these markets that tend to be beneficial have been pointed out. One is the monitoring of the unemployed's job search activity, and more generally the importance of active labor market policies. This is discussed in the next section. Another is the nation-wide centralization of wage setting, which is thought to

FIGURE 1: THE CALMFORS-DRIFFILL CURVE



prompt unions to internalize the effect of higher wages in one sector on other sectors. This in turn leads to wage moderation and a lower equilibrium rate of unemployment.

This mechanism lies behind the famous “Calmfors-Driffill” curve, which relates the equilibrium rate of unemployment to the degree of centralization of wage-setting.

When wage negotiations are more decentralized, they take place at the level of a smaller economic unit—for example at the firm level. The lower that unit, the more it faces competition, which makes its labor demand more elastic, thus building-in wage moderation. At one extreme, that level is the individual and the elasticity becomes infinite, because he can be replaced with another worker willing to work at the going equilibrium wage. On the other hand, higher wages in one sector tend to increase the price of the corresponding goods, which reduce living standards for workers in other sectors. This in turn induces them to ask for higher wages. Thus, wage bargaining in one sector exerts a negative externality on wage settlements in other sectors. The higher the level of bargaining, the higher the share of the price of the goods for which wages are set in the consumption basket of the unions, and the greater the extent to which unions internalize the externality. As a result, greater centralization of wage-setting breeds wage moderation. When wage formation is entirely centralized, the effects on consumer prices are entirely internalized. If, in addition, the unions represent the unemployed in addition to the employed, they will tend to replicate the full employment, walrasian outcome.

This argument implies that if the level of centralization of wage bargains is high and if unions are encompassing, then a highly unionized economy can achieve low unemployment rates. Countries with highly decentralized wage-setting achieve a low unemployment rate because wage-setters face a lot of competition. The worst possible case is for a country to have an intermediate degree of centralization, which puts it at the top of the Calmfors-Driffill curve. Unions then face a relatively inelastic demand for labor, and at the same time do not take into account the adverse reactions of other unions to their own wage pushes.

While centralized wage setting has thus been considered as an asset, this system has gradually eroded over time. The reason is that it is difficult to coordinate wages at a central level while not setting the same wage, or the same rate of wage increase, throughout the economy. This in turn reduces the flexibility of relative wages. As a result, the economy can only adjust to asymmetric sectoral shocks through unemployment. That is why the traditional “Scandinavian model” embodied active involvement by

the state in the process of labor reallocation, through training programmes and other active labor market policies: The rigidity of relative wages made it impossible for market wages to drive this reallocation process. Furthermore, if labor markets are segmented, wage compression can in fact lead to excess reallocation from the least productive to the more productive firms and sectors, with the economy paying too much in terms of adjustment costs. It is documented (see for example Davis and Henrekson, 2003), that solidaristic wage setting in Sweden has been harmful to small businesses and favored large firms. Furthermore, the country suffered a chronic problem of low productivity growth during the period when centralized bargaining prevailed, which led to a rampant fall in its living standards relative to the rest of the world (See the Lindbeck (1994) report).

The employers' organization desire to get a greater dispersion of wages in several dimensions eventually led to the demise of the Swedish centralized bargaining system in 1983. Since then, wages are set at the firm and/or sector level. Yet, the unemployment rate in Sweden remains quite low. This suggests that centralization may not be such an important factor after all, and that even if it ensures a low level of unemployment, it imposes other kinds of costs to the economy.

## 5. Flexicurity

A currently popular approach to reducing unemployment is “flexicurity”, which is inspired by the Danish experience.

The starting observation is that employment protection and unemployment benefits are “substitutes” in that both can be used to protect workers against job loss. However, employment protection gives workers a right to keep their current job, while unemployment benefits compensate them for not working. Each of these institutions distorts the labor market. Employment protection reduces hirings and separations and creates wage pressure by raising the insiders' bargaining power. Unemployment benefits reduce the unemployed's search intensity and also create wage pressure by raising the insiders' opportunity cost of working. However, given the overall level of protection enjoyed by workers, unemployment benefits may seem a better idea because, unlike employment protection, they do not prevent labor reallocation and therefore do not distort the structure of employment in favour of old, unproductive jobs. Thus, having less employment protection and more unemployment benefits seem to be a good idea in that it makes the economy more adaptable while

still protecting workers. Furthermore, it is argued that unemployment benefits can be generous and that unemployment can be low at the same time. The idea is to “force” the unemployed to look for a job by making them report their search activity and impose sanctions on them if they turn down a suitable job offer or if they fail to apply to enough vacancies. That is what the Scandinavian countries have long been doing.

To many, this sounds like the best possible world, however, there are a number of shortcomings.

- First, monitoring the unemployed requires resources. In particular, if unemployment rises sharply, one is faced with a dilemma. Either one increases the number of workers at the public employment service proportionally, which can be very costly. Or, one lets the number of unemployed per social worker goes up, in which case the monitoring intensity falls. With generous benefits, the unemployed will then reduce their search activity and the economy may end up stuck at a permanently higher level of unemployment. In other words, this strategy may be economical when unemployment is low but not when it is high. More fundamentally, it is always possible to offset an economic distortion which harm a certain kind of activity (in our case job search) by spending resources which stimulates that activity (in our case the social workers who are supposed to monitor the unemployed). This does not solve the problem but merely shifts the nature of its costs: The taxpayer spends less in passive unemployment support but more in active policies. The unemployed spend less time idle but one has to pay people who monitor them, and who could otherwise build bridges, be teachers, electricians, nurses, and so on.
- Convincing social workers to impose sanctions on the unemployed and to recognize that they have turned down a suitable job offer may be quite difficult. First, it may be easier for them to “shirk” on their bosses rather than resist pressure from an unemployed worker. Second, the social workers may be biased by some egalitarian ideology which induced them to be a social worker in the first place, and be reluctant to impose sanction on somebody they may (perhaps rightly) see as more needy than the rest of the people. Third, as a bureaucracy, the employment service is managed by people whose objective is more likely to be its level of activity than social welfare. They have an interest in maintaining their own clientele and may suffer if too many unemployed find jobs.

- The political feasibility argument applies again. Increasing competition from outsiders harms the rents of the insiders. Unions will want to reduce the efficiency of the monitoring scheme in order to dampen such competition (See Saint-Paul, 1998). That may be especially easy if, as in many countries, they are actively involved in the management of the public employment service and the unemployment benefit system. For example, in 1999, the French employers' association managed to negotiate with a fraction of the unions a reform of the unemployment benefit system along these lines. Eventually, however, to get support from the (then left-wing) legislature and the other unions, the scheme had to be amended; in particular, the commitment asked from the unemployed worker evolved towards a bona fide pledge for job search, while at the same time the declining pattern of unemployment benefits with time was abolished. It is not clear at all, then, whether the positive effects (on unemployment) of more intense job search will dominate the negative effects of the fact that benefits are no longer decreasing with time. If it is difficult for the government to make sure that workers at the employment agency adequately monitor job search, then it is preferable, if one wants to increase search intensity, to reduce benefits rather than implementing an inefficient monitoring scheme. In the end, the feasibility of flexicurity depends on people's propensity to cheat, and therefore on social attitudes. What works in a Scandinavian country may fail in a Latin country where people behave in a more opportunistic way. (Algan and Cahuc (2005) have provided evidence on that).
- From an empirical perspective, there is fairly robust econometric evidence that the duration and level of unemployment benefits have an adverse effect on the equilibrium rate of unemployment. In contrast, the evidence for the role of employment protection is much weaker. That evidence is in line with theoretical models, that all predict an adverse effects of unemployment benefits, while the effects of employment protection are more complex and model-dependent (See Box 1). Therefore, it seems uncautious to trade more unemployment benefits for less employment protection. Furthermore, the Danish example seems overblown. While it is true that sanctions on the unemployed for lack of job search are tougher than in the past, Denmark has also implement numerous reforms. Ironically, employment protection has been largely untouched, while unemployment benefits have been cut both in duration and levels.

### The complex effects of employment protection<sup>3</sup>

The effects of employment protection on unemployment result from a variety of mechanisms. Furthermore, they depend on which kind of employment protection is considered, and what assumptions are made about its effects on wage bargaining. Economists typically distinguish *severance payments*, that are a pure transfer to the worker, from a *firing tax*, which includes all the monetary and nonmonetary costs of a dismissal that are either dissipated (loss of time, inefficient retention of productive workers, inefficient reinstatement of dismissed workers in their jobs following a court decision...) or paid to third parties (lawyers, courts, the administration, and so on).

*Severance payments* are typically thought to have *no distortionary effects* on the dismissal decisions, because they can be offset by bargaining between firms and workers. Suppose the worker's marginal product in his current job falls below his opportunity cost of work. Then it is efficient for the match to dissolve. The firm will never offer a wage higher than the marginal product of labor, and it is then optimal for the worker to leave voluntarily and forfeit the severance payment. Separation outcomes would also remain efficient if the severance payment had to be paid upon a voluntary quit. The firm is then willing to keep the worker at any wage lower than the sum of his marginal product and the severance payment, but at that wage the worker remains better-off leaving the firm, since he then gets the severance payment plus his opportunity cost of work. The argument breaks down if wages cannot be freely set by bargaining between firms and worker, for example in the case where there is a binding minimum wage. Then, if the following inequality holds:

$$m < w_{alt} < w_{min} < m+s,$$

where  $m$  = the worker's marginal product,  $s$  = the mandated severance payment,  $w_{alt}$  = the opportunity cost of work, and  $w_{min}$  = the minimum wage, the worker will inefficiently continue in his current job. The minimum wage law compels the firm to offer more than its maximum

<sup>3</sup> For references, See Lazear (1990), Bentolila and Bertola (1990), Hopenhayn and Rogerson (1993), Bertola (1994), Bentolila and Saint-Paul (1994) and Saint-Paul (1995)

profitable wage,  $m$ , but the loss made by the firm is lower than the severance payment. If the opportunity cost of labor is larger than the worker's productivity but lower than the minimum wage, the job inefficiently continues. More generally, any mechanism which prevents the wage offered by the firm from falling below some minimum will make severance payments non neutral.

*Firing taxes* clearly distort separation decisions in the direction of maintaining people in unproductive jobs, regardless of how wages are set. The overall impact on employment flows is two-fold. First, there are less hirings, both because the firing tax reduces the value of the firm, which leads to lower entry, and because existing firms are more reluctant to hire workers for whom they might have to pay the firing tax in the future. Thus, the flow of job creation is reduced. At the same time, firms will inefficiently keep some workers despite that they have become unprofitable. Hence, the flow of job destruction is also reduced. The net effect on unemployment, in steady state, is ambiguous: fewer people find jobs but also fewer people lose their jobs. The net effect on unemployment *duration* is unambiguous: it goes up. Finally, the economy's overall productivity is harmed as the distribution of employment is inefficient. If moving labor from old to new sector is key to the growth process, the economy's growth potential may also be reduced.

This analysis suggests that while employment protection imposes a number of costs on the economy, the unemployment rate is the indicator which is the least likely to reflect these costs.

### Direct interventions on the cost of labor

One policy that has been constantly pursued is to try and reduce the cost of labor, in particular by reducing payroll taxes. This policy consists in undoing with one hand what the State has done with the other hand. They seem to have been relatively efficient in creating jobs over a medium-run horizon. Nevertheless, I believe that they are eventually problematic for a number of reasons.

First, payroll taxes are supposed to finance something. An overall reduction in payroll taxes must be met by an increase on taxes elsewhere. Increasing taxes on capital is likely to be counterproductive because capital is mobile. An alternative is an increase in VAT. That probably helps but the effects are bound to be limited: The increase in the VAT brings about a

reduction in the purchasing power of the take-home pay. Workers will try to offset that by asking for higher wages. That in turn tends to offset the direct effect of the measure on the cost of labor. The only effect that remains is due to the fact that the non-employed also pay the VAT, so its rate needs to increase less than the fall in social security contributions. Note that the measure has non trivial effects on the distribution of income between workers and non-workers (in particular, retirees).

Second, one may try, as has been done repeatedly in France, to use these measures to redistribute the burden of taxation away from groups of workers who suffer high unemployment, shifting the burden to workers with low unemployment risk. That is what the French government has been doing since the early 1990s. Social security contributions have been gradually reduced at the level of the minimum wage, while they have continued to increase at higher wage levels. As a result the profile of social security contributions is becoming more progressive: they sharply rise when wages rise from the minimum wage to 1.5 times the minimum wage. This progressivity has a number of drawbacks. An increasing mass of workers are paid exactly the minimum wage, despite differences in job content, education, experience etc. It becomes quite costly for firms to give their workers a raise, which is harmful for incentives and morale. The net wage differential between skilled and unskilled workers is being compressed, which reduces the incentive to acquire human capital and stimulate the “brain drain”, which is increasingly a matter of concern. Overall, policies of redistributing the tax burden of social security contributions only have small effects on employment: one improves the labor market for some categories of workers but at the same time it worsens for some other. Furthermore, politicians seem to regularly use the margin of manoeuvre created by these cuts to increase the minimum wage rather than employment.

Third, these policies do not directly act on labor market rigidities and may have little impact, if any, on the natural rate of unemployment in the long-run. In the short-run, reducing labor taxes creates jobs because workers are cheaper to hire. However the attempt by firms to hire more workers generates greater wage pressure. That is, the reason why unemployment falls in the short run is that the cut in taxes allows for an increase in the take-home pay for the same gross cost of labor, which induces more people to work. To the extent that unemployment benefits (and other components of the alternative wage: assistance, pre-retirement benefits, etc...) are indexed on wages, they will also rise and this will fuel the wage pressure. Unemployment will rise again and one can show that



under the “standard” model it will go back to the same equilibrium level as before. The reason is that the equilibrium rate is tightly linked to the terms of trade between working and not working. If the value of not working is proportional to the wage, these terms of trade do not depend on the wage but just on the replacement ratios. An increase in the take-home pay does not reduce unemployment because unemployment benefits increase in the same proportion. While unemployment is unchanged, however, employment may go up as it is now more attractive relative to non-participation.

## 6. Reforming goods markets instead of labor markets

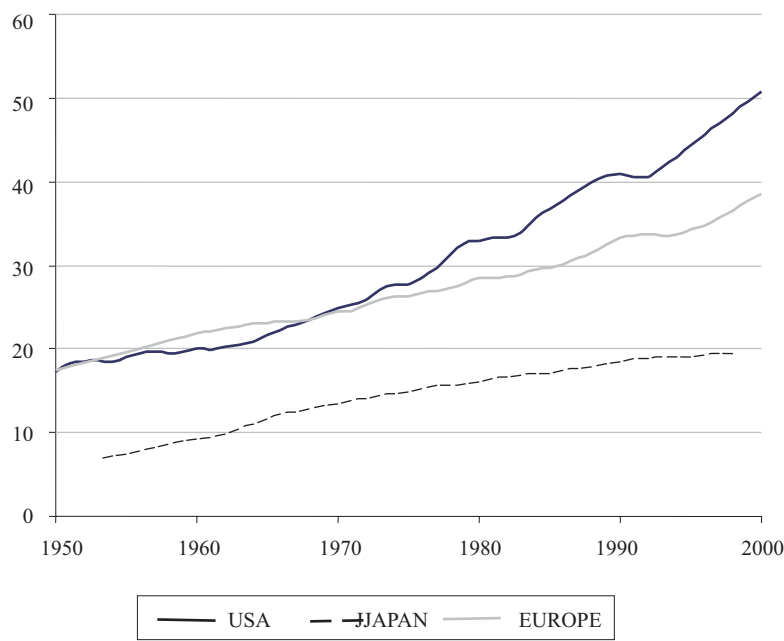
A similar “ersatz” of labor market reform would consist in reducing barriers to competition in the goods markets. There is ample evidence in many continental European countries that goods markets are hampered by entry barriers and costly regulations. Common sense suggests that the economy would be more efficient, and living standards higher, if these barriers were removed. However, another popular argument is that many jobs would be created if goods and services were deregulated, and therefore that such policies can also be worth using to fight the unemployment problem.

There are three arguments supporting the view that deregulating goods markets may help to cure unemployment: the “naïve” one, the “less naïve” one, and the “sophisticated one”. Of these three, only the sophisticated one is firmly grounded in economic analysis, and it is not clear what its quantitative effects are.

The *naïve argument* views some sectors —such as e.g. retail trade— as a “reservoir” of jobs that cannot be tapped because of harmful regulation. An influential report by the McKinsey Global institute (1994) showed that retail trade in the US has been a substantial source of job growth, while it has been stagnant in Europe at best (Figure 2). The McKinsey report shows that a much greater fraction of the working age population is employed in retail services in the United States than in Europe (Table 4)

Furthermore, poor employment performance in Europe seems associated with regulation that reduce entry and competition in the service sector. Most continental European countries have regulations that limit the opening of large stores. One may cite the “Royer law” in France, which imposes a local authorization to open new stores larger than 1,000 m<sup>2</sup>, the

FIGURE 2: SERVICE EMPLOYMENT GROWTH IN THE US, JAPAN AND EUROPE.  
(Millions of persons employed in commercial services)



Source: Verspagen (2203).

TABLE 4: RETAIL TRADE EMPLOYMENT IN EUROPE, JAPAN AND THE US.

Country	Retail employment per thousand working age population (1991)
France	25.1
Germany	32.8
Italy	32.0
Japan	41.9
Spain	25.4
United States	49.6

Source: McKinsey (1994).

“bebaunungspläne und baunutzungsverordnung” in Germany, which allows only small, local stores in residential and service zones and requires local authorization for stores larger than 1,500 m<sup>2</sup>, and the Italian commercial law which requires regional authorization for shopping centers, department stores and hypermarkets. Thus, the argument goes, if these restrictions were lifted, Europe would enjoy a similar service sector employment as the United States and unemployment would substantially fall. Say, if France were to add 20 retail employee per thousand working age population, with an average employment rate of 80% and another 10% unemployed this would reduce the unemployment rate by  $20/80/90 \times 100 = 2.8$  percentage points.

The problem with that naïve argument is that it totally ignores the determinants of equilibrium employment. It is true that if the service sector were deregulated, the demand for service jobs would go up, but that does not mean that the overall unemployment rate would fall. Instead, the structure of employment will be reallocated away from other activities, into service jobs. As the service sector starts recruiting, wage pressure and labor market tensions would go up, thus reducing employment in other sectors. This crowding-out would eliminate most of the gains in terms of job creation. Furthermore, that strategy might not be such a great idea if the jobs that are destroyed are in the industry and generate more value added than retail jobs<sup>4</sup>. Furthermore, deregulation need not have the effect of boosting employment. Instead, it may increase productivity and—to the extent that there is sufficient complementarity between the service sector and other sectors—reduce employment. That would happen, for example, if large shops are allowed to enter cities and displace small shops. Indeed, Japan has one of the most stringent regulations on retail trade, yet its retail employment rate—made of a large number of poorly efficient small shops—mimicks that of the United States. The willingness to hire by the service sector depends on the cost of labor. In France and Germany, services have opted for capital-intensive technologies and a tight use of their human resources, while U.S. services employ a large number of cheap employees. There is no reason for deregulation to change these strategies, because it will have no impact on labor market institutions, and therefore on the relative cost of labor.

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<sup>4</sup> For example, in the third quarter of 2006 France grew at 0 % while continue to create jobs. It appears that most of the jobs are created in the construction and service sectors, while industry continues to shed labor at a rapid pace.

The *less naïve* argument is that deregulation in goods markets increases competition, thus lowering mark-ups. This in turn allows for higher take-home pay, everything else equal, which increases the incentives to work and reduces equilibrium unemployment. That is, its effect on the unemployment rate is similar to that of a fall in labor taxes, discussed above, or for that matter an increase in productivity. Equilibrium unemployment falls only if the take-home pay rises by more than the alternative wage. While that may well happen in the short-run, in the long-run we expect the alternative wage to be indexed on the wage, so that the equilibrium rate of unemployment is unchanged.

That does not mean, of course, that these deregulations are not desirable. They remove distortions and barriers to economic freedom. And by raising wages they will raise employment and labor market participation. But (barring the effects discussed below) they are unrelated to the well-functioning of the labor market, therefore, we do not expect this labor market to function better by any appropriate measure.

However, further analysis may suggest that (some) goods markets deregulation may have a lasting effect on the equilibrium rate of unemployment after all. That is because many regulations harms the prospects for unemployed people to relocate to another sector by starting their own business and becoming self-employed —the *sophisticated argument*. One case in point is the regulation of taxis. The number of taxis in Paris has not increased since the 1920's despite large growth in the city's population. To be a taxi driver one needs a licence and no new licenses have been issued for a long time. The market price of a licence is above 150,000 Euros. Many other regulations make it difficult to open a butcher store, a pharmacy, and so on. This kind of regulation makes it impossible for an unemployed to enter another sector as a self-employed. If they were lifted, intersectorial labor mobility would increase, which would reduce "mismatch" and boost competition by outsiders. We thus expect the equilibrium rate of unemployment to fall, but the reason is rather subtle. It is that self-employment is a way to get around labor regulations (mostly employment protection and work rules), so that entry barriers are also a barrier for competition between insiders and outsiders. If the self-employed faced the same labor regulations as larger firms, their incentives to enter a sector would not be greater than the larger firm's incentives to hire them, and entry regulation would have little impact on equilibrium unemployment.

## 7. Conclusion

In the face of the political difficulties in implementing a “Big Bang” strategy, European countries have devised a number of alternative approaches. Its of these approaches have their merits and drawbacks. While their net gains may often be positive, none of them – with the half exception of the “flexicurity model” — really solves the fundamental problem of the labor market, which is the impossibility for outsiders to compete on equal terms with insiders. As long as this problem remains, European labor markets will be plagued by distortions and inefficiencies, which show up not only in the form of high unemployment, but also high unemployment duration, misallocation of employment across sectors, resources wasted on “active labor market policies” that could be spent more productively, and so on.

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