Unemployment in Europe: Some American Suggestions

JAMES K. GALBRAITH

Hurricane Katrina and the destruction of New Orleans have exposed for Europeans the folly of the »American model« as commonly understood. Having abandoned planned public capital investment – not merely under George Bush but over 30 years – the United States finds itself unprotected from a well-predicted natural disaster, unable to stage an effective urban evacuation, and with impaired capacity to plan and execute reconstruction. Meanwhile, fiscal federalism in the stricken region leads to public sector bankruptcy and a collapse of services, to the point where local authorities cannot even detain, let alone prosecute, thieves, murderers, and rapists. As this is being written, evacuees find themselves stranded in hotels and shelters across the country, their homes ruined, their finances in tatters, and their futures in doubt.

To the extent that the drive for labor market reform in Europe is predicated on shallow comparison with the United States, these developments should signal a profound re-examination of assumptions. Do free and flexible labor markets imply, in part, the abandonment of cherished national and regional construction projects? Given the obvious linkage between wage rates and tax revenues, clearly they do: impoverished workers cannot easily support expensive public works. But public works are integral to the identity and even to the survival of Europe. Should the game of labor market reform require defunding the SNCF (La Société Nationale des Chemins de Fer) or the Dutch levees, few Europeans would consider it worth the candle.

Nevertheless, Europeans would be mistaken to swing to the view that America's experience has nothing to offer in the way of useful ideas against mass unemployment. For it was only five years ago that the United States did achieve full employment – with a high labor force participation rate, measured unemployment rates below four percent for three years in a row, and unemployment and poverty among ethnic minorities at record lows. America did achieve this, and with negligible price inflation. The question is, how?

The answer *cannot* be found in the hypothesis of »labor market flexibility.« This hypothesis holds that wages adjusted to equate marginal productivity to pay. It implies that in the run-up to full employment, the United States should have experienced increasing inequality in the structure of earnings or pay. Yet this was not the case. Although *income* inequality rose, that was due (practically speaking, *entirely*) to the rise in *capital* incomes – to the cash-flow immanent in the technology boom. *Pay* inequalities – relevant to the labor market – *declined*, as I have documented elsewhere. In general, periods of high employment in the United States have, since 1947, always accompanied declining inequalities of pay (Galbraith and Garza-Cantù 1999). And indeed Garcilazo and I have shown (Galbraith and Garcilazo 2004) that the same principle holds across Europe in cross-section: regions with lower inequality in their pay structures exhibit systematically lower rates of unemployment. More broadly, we show that much of the variation of European unemployment can be accounted for by inequalities within and between regions, by differential growth rates, and by the share of youth in total population. Much of the remainder is due to variations common to all European regions, prima facie evidence of the importance of continental macroeconomic control. In a forthcoming work, we show that as unemployment declined across Europe in the late 1990s inequality also declined (Galbraith and Garcilazo forthcoming).

The implications for the general design of unemployment policy are straightforward. Differences in national institutions, including labor market institutions – with minor exceptions involving Spain, Holland, and the UK – are virtually unimportant in the larger countries. Anything that will *reduce* the inequality of European wages will help reduce chronic unemployment. So will targeted measures that provide *pre-labor market* opportunities for young people, enabling them to time their entry into paid employment so as to escape being tarred as long-term unemployed.

But what would accomplish these goals? Would, for example, raising the minimum wage in Germany to a higher fraction of the average be an effective way to reduce inequalities (and therefore unemployment) in Europe? It would not. For the inter-sectoral differences within the labor markets of the German Länder are not among the most significant in Europe. In fact, they are already among Europe's lowest inequalities.

Pay inequality in Europe today is notoriously of a different kind. Within individual European regions, it is highest where middle class jobs, usually associated with manufacturing industry and robust service employment at good wage rates, are scarce or absent. It is in Europe's dualistic economies, with a handful of good jobs and many undesirable ones, that structural unemployment festers. These exist mainly on the European periphery, and of course very extensively among the accession countries. And an even larger source of overall inequality in Europe is *between* these regions and the rich regions of the European center. The notion of Europe as an egalitarian continent is an illusion, based on the fact that Europe's statistics do not yet consider the continent as an integrated entity (as America's do), and therefore overlook this source of inequality. But raising minimum wages in Germany does nothing to relieve the difference separating average wage levels in Germany from those of Spain.

It follows that an egalitarian growth policy – with directed measures to raise overall growth rates absolutely and relative growth rates in the poorer regions of Europe – would be the single most powerful medium-term measure for the reduction of European unemployment. The difficulty with this idea is that new instruments are required to put it into effect. The readily-available macroeconomic policy instruments are now reduced in Europe to a single measure: a lower interest rate. There is no very practical way to target this policy to the European periphery, and no guarantee that lower interest rates – if they worked at all – would in fact foment aggregate income convergence. If monetary stimulus were to help the rich countries of Europe more than the poor, producing a bubble, unemployment could rise.

The practical steps that would generate convergence within Europe are therefore precisely those redistributive measures most despised by common discourse. The European Union has left social welfare policies to Member States, and the inequalities in their economic positions are perpetuated by this decision. This is the problem that policy innovation must now begin to address. *Interregional* income convergence is the key to fuller employment in Europe. The efficient way to achieve it is quite direct. It is by contriving to raise the incomes of Europe's poor – correctly measured on the continental scale and largely consisting of the residents of low-income regions – more rapidly than the incomes of Europe's rich.

This is an old story in the United States. In this country, the Deep South, the old Confederacy, was until very recent times much poorer than any other region and marked by much deeper unemployment. Periodic crises, such as the Dust Bowl of the 1930s, sparked mass migration – of Okies and Arkies[1] to California, of blacks from Mississippi and Alabama to Chicago and Detroit. This eventually spurred a project of national economic convergence.

And so in the 1930s the United States began the process of federalizing the welfare state. Social Security and a continental minimum wage came already in the 1930s. A national industrial development policy grew out of deliberate federal investment decisions in the wartime mobilization of the 1940s. A national transportation network was built in the 1950s. In the 1960s we achieved federally-funded health care for the elderly and the poor (Medicare and Medicaid). Even Richard Nixon's administration contributed General Revenue Sharing – though this program alone did not survive the Reagan counter-revolution of the 1980s, and no further progress has been made since that time. Nevertheless, today the *continental integration* of social welfare policy in the United States is much farther along than in Europe (and the Deep South is no longer especially poor). It is this, and not flexible labor markets, that accounts for America's relative success against entrenched *structural* unemployment.

As economic integration now encompasses all of Europe, the European Union needs to follow that earlier American example. Not only a more social democracy, but a *more unified* social democracy, is the answer to European unemployment. It remains necessary to identify specific measures, and to prove out the model with bold experiments.

One useful, practical step, entirely consonant with economic justice, would be the creation of a »European Pension Union,« to move toward convergence in the base incomes of the elderly. There is no just reason, in a unified Europe, why the retired elderly of the poor countries should be paid on the income standard of their own nation, and suffer the indignity of poverty in old age compared to fellow Europeans who worked no harder than themselves. Minimum pensions should be set on a standard, governed by the average productivity of Europe as a whole, and the differentials paid directly to individuals by direct transfer through the European Union.

In a similar vein, there is no just reason why unskilled pay differentials across Europe should be allowed to remain as large as they are. The street sweepers and news vendors of Portugal are not less productive than those of Germany (except by virtue of inferior capital equipment). The European Union could inaugurate a »topping up« scheme for low-wage

1. Editor's note: Dust Bowl migrants from Oklahoma and Arkansas

employees in the poor regions, along the lines of the American Earned Income Tax Credit. This too would slow economic dislocation and reduce the incentive to migration.

No one would wish Europe to emulate American rates of military enlistment or incarceration. But our rates of enrollment in higher education – now up to about half of high school graduates (and higher in some places, such as California) – are another matter. The investment required to improve European performance in this area would mobilize resources in the lower-income areas, while sharply reducing the incidence of youth joblessness by converting the unemployed, as we do, *into students*. Let Europe, therefore, fund and build *European* universities, on a scale and of a quality to rival these institutions in the United States. It is an area where Europe lags badly, not because of a lack of talent, but only a lack of will and imagination. Therefore let Prague, Warsaw, and Budapest – not to mention Berlin – become true magnets of world learning. Let the same happen in Lisbon, Salonika, Palermo – and any number of cities throughout Spain. (Istanbul and Ankara will surely follow, one day.)

The economic burden of these measures needs to be understood carefully. It need not be, as many suppose, a matter of taxing Germans to support Portuguese. Rather, as there exist unemployed human capital assets in Portugal, the appropriate step is to create a liability that will permit their employment. A pension supplement scheme, placing purchasing power in the hands of the elderly in Portugal, will mobilize latent resources in Portugal. It has no other important economic effects. There is no need to tax the Germans to do it. A euro deficit run at the European level is perfectly justifiable, so long as overall unemployment exists at intolerable levels. The interest on that deficit can be paid, in effect, from the eventual increase in national income in Portugal. The burden will be light if the benefit is realized.

Beyond these examples of effective redistributive policy (which could be multiplied, particularly by better understanding the role of the nonprofit sector in US job creation), there is a need to address the larger problem of relative growth rates. This is substantially a macroeconomic problem and accordingly there needs to be a new and uncompromisingly Keynesian understanding of what it might take to achieve aggregate income convergence.

One may begin with a bit of good news. It seems the euro worked for the periphery of Europe, at least at first. The remarkable decline in unemployment in Spain over the transition (from 20 to 10 percent) may owe something to counting trickery. But it is also reasonably clear that it owes much to the disappearance of exchange rate risk and to the resulting interest rate convergence. In principle, this reduces a common distortion in favor of manufacturing activity in peripheral countries and absorbs the unemployed into better-paid services jobs, which now become creditworthy in ways they were not before. To the extent that this happened in Spain, it could be similar in a small way to the late 1990s American experience. In the US at that time, millions of new jobs were created – not by lowering wages but simply by making credit available for next to nothing.

Overall, however, income convergence of the poorer members of the EU has largely stopped. The new countries to the East are so far not enjoying the credit and service-employment expansion that has occurred in Spain. Getting convergence started again is first of all a matter of making this a declared priority of the Union. Europe needs income convergence targets more than it needs deficit targets or even growth targets. What otherwise is the point, exactly, for poorer countries of remaining in the European Union?

An effective targeted, growth-producing fiscal policy is required. How might the Stability and Growth Pact be revised to achieve it? The best way would be to set convergence targets instead of deficit targets and to give them priority over less important goals. And then, let the Union itself be permitted to run fiscal deficits, and to issue Euro bonds, sufficient to return the Union as a whole to full employment. This is what America usually does, or tries to do, in practice, in a slump. However, such a radical change presupposes a development of European federalism on a scale that is not presently on the cards.

Still, the same effect could be achieved in other ways. An alternative might be to rewrite the Stability and Growth Pact to permit *any* country of the EU to run deficits greater than three percent – the current limit excepting only in deep recessions – so long as unemployment *on average* in Europe is higher than a threshold value. The point here is that it does not matter *which* country in Europe runs deficits and provides stimulus. Since the European economies are integrated, the resource-using effects will be felt everywhere. And if the Germans, say, do not want to create full employment in Europe by absorbing first their own unemployed and then attracting immigrants from Spain or Poland? Well then, let the Spaniards or the Poles do it, and let Germans (or the ECB) hold the resulting bonds. Could German money build a great university in Greece? Of course it could.

The threshold average value for unemployment in this scheme need not be close to full employment. Any figure well below the present European averages – for instance, six percent – would do. For it is a near-certainty that once unemployment in Europe starts decisively on a downward path, the private sector's demand for credit (and its perceived creditworthiness by financial institutions) would rise. Before long, the resulting growth of *private* deficits and debt would reduce the deficits of the public sector. The problem for the authorities would then be merely to manage the flow of funds, guarding against the emergence of bubbles and Ponzi schemes that would make the expansion difficult or impossible to sustain.

Such, in any event, was the experience of the United States in the late 1990s. It was a happy time, while it lasted. And it contains a plethora of useful, unexpected, and unexploited lessons for Europe. These are lessons, moreover, which Europe, which has not plunged itself into needless wars nor grossly neglected its public capital formation, is very well positioned to exploit. They are just not the lessons that most Europeans, casting a highly conditioned glance in the American direction, usually expect to find. And they will not find them until they come to understand our actual circumstances far better than the conventional economics has taught them to do.

References

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