SWEDISH ECONOMIC POLICY REVIEW 1 (1994) 5–26

What Can Sweden Learn from the European Unemployment Experience? An Introduction

Lars Calmfors*

Summary

■ The twofold objective of this paper is to summarise the contributions to the volume and draw policy conclusions for Sweden. It is emphasised that there is a consensus regarding the importance of both structural (supply-side) and demand factors for the rise in Western European unemployment. The present labour market situation in Sweden is compared with that in Western Europe in the early 1980s. Although there are factors that speak in favour of a better employment development in Sweden than occurred in the rest of Europe, there is a very serious risk that high unemployment may become persistent in Sweden as well.

Another conclusion is that there is widespread agreement on the qualitative effects of various policies but great uncertainty about the quantitative magnitudes. This motivates a comprehensive package of employment-promoting measures: training and education, measures to activate the long-term unemployed, limits on the duration of unemployment benefits and participation in labour market programmes, deregulation in order to make labour markets more flexible, tax relief for various private services, focusing expenditure cuts on transfers to households rather than on public consumption and monetary policy that is not too restrictive. The need for fiscal consolidation would seem to increase the requirements on other sources of employment growth. ■

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During the 1980s Sweden stood out as a conspicuous exception to the high unemployment in most of Western Europe. Many came to regard Swedish employment policy as an example to follow. Recent years have, however, seen a dramatic change in this picture. From a trough of 1.2 percent in 1990, open unemployment rose to a peak of 8.9 percent in early 1994. The change in the labour market situation is even more drastic if the participants in labour market programmes are added to the openly unemployed: total unemployment measured this way rose from 2.0 percent in early 1990 to 14.4 percent in early 1994.

The Swedish unemployment crisis raises the same questions as have been debated in the rest of Western Europe for more than a decade. It is important to learn as much as possible from this discussion. To this end *the Economic Council of Sweden* has invited six contributions on the Western European unemployment problem from prominent foreign economists. The contributors are **Jørgen Elmeskov** (OECD), **Charles Wyplosz** (INSEAD), **Patrick Minford** (University of Liverpool), **Rudiger Dornbusch** (MIT), **Jacques Drèze** (Université Catholique de Louvain) and **Henri Sneessens** (Université Catholique de Louvain and Université Catholique de Lille), and **Richard Jackman** (London School of Economics).

The first two sections of this introduction summarise the main conclusions from the papers. Section 3 tries to judge the risk that the European experience of persistent unemployment will repeat itself in Sweden, while Section 4 discusses policy lessons. Section 5 points out a few crucial

* *I am grateful for comments from Susanne Ackum Agell, Anders Björklund, Jørgen Elmeskov, Harry Flam, Richard Jackman, Patrick Minford, Lars Svensson and Anders Vredin. The views expressed in the article are those of the author and are not attributable to the Economic Council as such.*

issues of policymaking where there is a great need for more research. Section 6 concludes.

1. The general theme

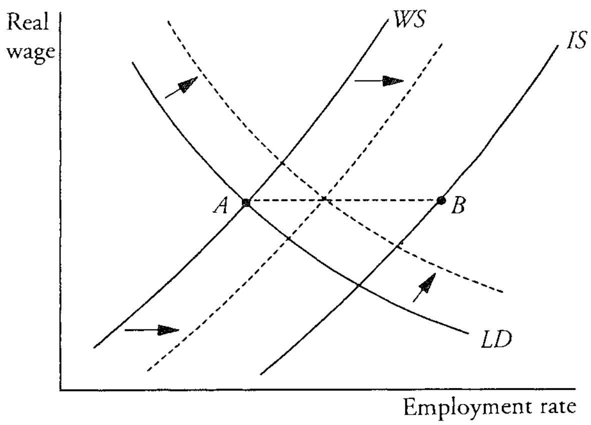
A central theme in all the papers – as well as in the ongoing policy discussion both in the rest of Europe and in Sweden – is the relative importance of *structural* and *demand* factors for unemployment. To which extent can Western European unemployment be explained by poorly functioning labour markets and to which extent by a shortfall of demand? This question is crucial for judging the risks of persistence of unemployment and for the choice of appropriate policy measures.

Although the views of the various authors differ in important respects, they all adhere to more or less the same basic theoretical framework, which has become a standard tool for the analysis of employment. It is illustrated in Figure 1. The *IS*-schedule shows how *individual labour supply* is related to the real wage. The *LD*-curve depicts *labour demand.* It can also be interpreted as a *price-setting relationship* which reflects that firms set higher prices relative to wage costs – that is, demand a lower real wage – the higher employment is. The *WS*-schedule is a *wage-setting relationship* indicating that higher employment tends to raise real wages. It may be seen as a *collective labour-supply curve* reflecting wage-setting behaviour.

In this framework the intersection of the wage-setting and labour-demand schedules at *A* determines the *equilibrium rate of employment* and the horizontal distance *AB* the *equilibrium rate of unemployment* (the *natural rate of unemployment*). Since the individual supply price of labour is lower than the collective price, equilibrium unemployment is involuntary on the part of individuals.

Variations in unemployment require shocks or policies that shift at least one of the three curves in the diagram, i.e., that change individual labour-supply, labour-demand or wage-setting behaviour. In the long run this can occur only if fundamental *structural* changes alter the incentives facing individual workers, price setters (employers) or wage setters. In the short and medium term, *demand policy* is important to the extent that there are nominal rigidities. For instance, if only nominal wages are sticky, policies that increase product demand and therefore also product prices automatically reduce the real wage – that is shift the wage-setting schedule in Figure 1 downwards – and thus raise employment by making

Figure 1. The standard labour-market model



WS = Wage-setting schedule
IS = Individual labour-supply schedule
LD = Labour-demand schedule (price-setting schedule)

the economy slide along the labour-demand schedule. One possible reason for such temporary deviations from equilibrium unemployment is inflationary surprises that have not been taken into account in long-term wage contracts fixing nominal wages.

2. The contributions to the volume

Jørgen Elmeskov's paper on "Nordic Unemployment in a European Perspective" is a broad survey of research on earlier unemployment experience in both the Nordic countries (defined here as Finland, Norway and Sweden) and the rest of Western Europe. A first part reviews evidence on the persistence of European unemployment. Although results differ depending on the methods used, the author concludes that the increases in actual unemployment rates in Western Europe are not likely to reflect equally large increases in equilibrium rates but are probably also the consequence of slow adjustments back to equilibrium.

The second part of Elmeskov's contribution builds explicitly on the analytical framework described above. There is a thorough discussion of factors that may have affected the three curves in Figure 1 in both the Nordic countries and the rest of Western Europe. The aim is to explain the earlier differences in unemployment developments. Although the difficulties of distilling "one Nordic and one EC story of unemployment" in the 1980s are stressed, a number of crucial differences are pointed to. One is a larger degree of real wage responsiveness to changes in unemployment in the Nordic countries. This may have been explained by the combination of centralised wage bargaining and high inflation in connection with exchange rate depreciations (with rapid price increases making high *nominal wage* growth consistent with *real wage* restraint). The contribution of the public sector to labour demand in the Nordic countries is also emphasised. Other factors may have been a slower adjustment of labour demand to shocks and a larger cyclical responsiveness of labour supply in the Nordic economies (the latter difference being important because labour force participation appears to exhibit less persistence than unemployment). An important conclusion is that the lower Nordic unemployment in the 1980s cannot be explained by a lower trend growth of the labour force (or developments toward shorter working hours).

As to the possibilities that Sweden (as well as Finland and Norway) will be able to avoid having the present high unemployment become persistent, Elmeskov is agnostic. He points both to remaining differences to other Western European countries and to worrying similarities. He ends by expressing the hope that the Nordic countries will now be in a better position to deal with unemployment than the rest of Europe was in the beginning of the 1980s because there has by now emerged a "widespread agreement that the cause of unemployment persistence in Europe to an important extent lies with structural features of European labour markets".

The title of **Charles Wyplosz**' contribution is "Demand and Structural Views of Europe's High Unemployment Trap". Like Elmeskov he uses the analytical framework illustrated in Figure 1. Although Wyplosz stresses the importance of *both* structural *and* demand factors, the main emphasis is on structural explanations here, too. A number of features of European labour markets that may contribute to unemployment are emphasised: collective bargaining and the collusion between employers and employed insiders in order to prevent underbidding from unemployed outsiders especially in newly started firms, minimum-wage and employment-protection legislation, restrictions on working time and high taxation of labour.

At the same time Wyplosz discusses how the phenomenon of hysteresis (persistence) tends to blur the distinction between demand and structural explanations of unemployment: if a temporary shortfall of demand sets off persistence mechanisms (disenfranchisement of unemployed outsiders, discouragement of long-term unemployed, etc.), long-run equilibrium unemployment may also rise because wage pressures increase at given rates of unemployment. Hence demand policies may play an important role in preventing structural problems from arising, although they may not be able to cure them once they have emerged. Here Wyplosz stresses the role of fiscal policy: by counteracting strong recessionary impulses at an early stage of a downswing, it may be possible to prevent a vicious circle of increasing unemployment, increasing costs for unemployment benefits and higher taxation on labour to pay for this, which only results in more unemployment, etc.

Wyplosz also emphasises the importance of looking at the flows in the labour market. He points to the surprising fact that increased inflows into unemployment in a recession seem to be matched (with only a short lag) by increased outflows. This raises the possibility of other mechanisms of hysteresis than have hitherto been analyzed, for instance that firms deliberately use recessions to upgrade their labour forces "by releasing less productive workers to replace them with a smaller number of more productive ones made available by other firms in difficulty". Such a process seems to be of obvious relevance in the Swedish case.

Wyplosz concludes that there is a long list of potential sources of the present European unemployment problem and a large amount of uncertainty as to the relative contributions of individual factors. In his view this motivates a comprehensive set of measures against unemployment. In a concluding section he discusses the political difficulties of launching such an across-the-board attack on unemployment. The problem arises because most supply-side reforms reduce the rents captured by various interest groups without any guarantees that the losers will receive the Paretian transfers that can compensate them. To overcome this problem Wyplosz suggests social contracts entailing "explicit promise that a payment will be forthcoming against the willingness to abandon a welfare-reducing rent".

Patrick Minford's topic is "Deregulation and Unemployment – The UK Experience". His paper analyses the causes of British unemployment on the basis of a small macro model of the type outlined in Figure 1.

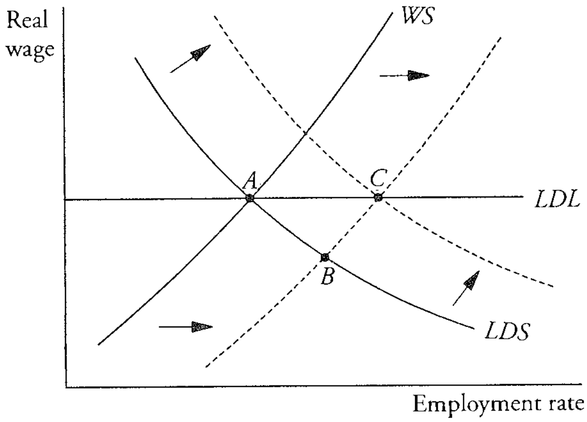
There are two special twists to Minford's analysis. First, changes in product demand will have an impact on employment apart from the inflationary-surprise effect to the extent that the real exchange rate (the relative price between domestic and foreign outputs) is altered. This is easy to understand from the earlier Figure 1, if the real wage is interpreted as the real consumption wage (the money wage deflated by the consumer price index). Since labour demand depends upon the real product wage (the money wage deflated by the domestic output price index), policies that increase domestic product demand and thus domestic prices relative to foreign ones (which is equivalent to a rise of the domestic output price relative to the consumer price index, that is, an appreciation of the real exchange rate) reduce the real product wage corresponding to a given real consumption wage.[1] Hence the labour-demand schedule in Figure 1 is shifted to the right and employment is increased. This will not mean an increase of *equilibrium* employment, however, since the increase of domestic aggregate demand together with the appreciation of the real exchange rate must lead to a deterioration of the trade balance, which is not sustainable in the long run (and which will therefore ultimately cause fiscal policy to be tightened again).

Second, Minford recognises that with international capital mobility, the domestic return to capital must in the long run conform to the capital cost determined in the world market. Structural changes in, for instance, the wage-setting process will therefore not receive their full impact on employment until the capital stock has adjusted fully. This is illustrated in Figure 2, which distinguishes between downward-sloping short-run labour-demand schedules (drawn for a given capital stock) and a horizontal long-run schedule (assuming capital to be endogenous). A simple case is if domestic and foreign outputs are perfect substitutes for each other, so that also the domestic output price can be taken as determined in the world market (and the real exchange rate becomes fixed at unity). Consider, for instance, a reduction of wage pressure, that is a downward shift of the wage-setting schedule. The new short-run equilibrium will be at *B* which will entail a higher return to capital than the world cost. This sets off a process in which the capital stock is gradually increased and which therefore implies successive shifts of the short-run labour-demand schedule to the right. The process goes on until the original real wage and thus also equality between the domestic return to capital and world cost has been restored at *C*.[2] If we in-

[1] Let W = the nominal wage, P = the domestic output price, P_f = the price of foreign (import) goods (in domestic currency), P_c = the consumer price index, w_c = the real consumption wage, w_p = the real product wage, and q = the real exchange rate. Letting all symbols denote logs we have $w_c = W - P_c$, $w_p = W - P$, $q = P - P_f$ and $P_c = \alpha P + (1-\alpha)P_f$, where α is the weight of domestic goods in the consumption basket. Then it holds that $w_p = w_c + P_c - P = w_c - (1-\alpha)(P - P_f) = w_c - (1-\alpha)q$.

[2] Let P = the output price, W = the nominal wage and R = the cost of capital. Under constant returns to scale, the long-run price equation once the capital stock has adjusted fully can be written $P = P(W,R)$, where P is linearly homogeneous in W and R. Hence we can write $1 = P(W/P, R/P)$. If both P and $R = (r + \delta)P_f$, where r = the real rate of interest and δ = the rate of depreciation, are exogenously given to the economy from the world market, so is R/P, which then determines a unique long-run real (product and consumption) wage W/P.

Figure 2. The labour-market model with capital-stock adjustment



LDS = Short-run labour-demand schedule
LDL = Long-run labour-demand schedule
WS = Wage-setting schedule

stead, like Minford, make the more realistic assumption that domestic and foreign outputs are imperfect substitutes for each other, so that their relative price (the real exchange rate) can change, the process will come to a halt at lower real (product and consumption) wages than the original ones. The implication is a real depreciation, which raises the cost of capital relative to the domestic price level.[3]

Minford argues that the Thatcher supply-side reforms of the early 1980s have reduced the equilibrium rate of unemployment in the UK dramatically. In his model this is attributed primarily to the strong fall of unionisation, which is interpreted as reducing wage pressure (shifting the wage-setting schedule downwards). There are also contributions from lower payroll taxes and productivity increases (the latter being taken to depend upon the various labour market deregulations). The high actual unemployment that has prevailed in the UK is instead explained by temporary restrictive demand policies (the disinflation in the early 1980s and the restrictive monetary policy implied by ERM membership in the early 1990s). As a consequence Minford is optimistic about future employment developments in Britain.

[3] If only *R*, but not *P*, is exogenous, it follows that a fall in *W/P* in footnote 2 is consistent with a rise in *R/P* (equivalent to a real exchange rate depreciation). The same qualitative conclusion holds if capital is assumed to be a composite good consisting of both domestic and foreign goods.

Minford's analysis leads him to the conclusion that low unemployment ultimately "depends on policies that permit wages to find a level equal to productivity, especially at the bottom of the pay scale where benefits and ideas of social justice put an artificial floor below them". From this point of view he regards the employment guarantee provided by Swedish active labour market programmes with scepticism. He does, however, recognise that supply-side reforms "take a long time to work" and that their positive effects can be swamped by unduly restrictive demand policies for long periods of time.

Although **Rudiger Dornbusch** in his paper on "Is There a Role for Demand Policy?" also points to the desirability of a balanced approach involving both supply-side reform and demand policy, he is the contributor who stresses the demand aspects the most. More jobs can be created "by lower wages and/or overhead costs and thus reduced prices or by any method who will shift out the demand curve for a country's products". He views overly restrictive demand policies as the main cause of the most recent increase in European unemployment and rejects clearly the notion that demand stimulation does not work.

Dornbusch discusses the potential of both fiscal and monetary policies. As to fiscal policy his conclusion is that it works in principle, but he concedes that the rising public debts of most Western European countries (with Sweden as a particularly difficult case) may rule out the use of this instrument. He argues instead for a strong dose of expansionary monetary policy implying exchange rate depreciation, especially if attempts at fiscal consolidation are made already at an early stage of the present upswing. Dornbusch builds his case on the US experience of easy monetary policy in 1992–93 with nearly one and a half years of zero short-term real interest rates preceding the recovery.

In the present depressed state of the European economy, Dornbusch sees small risks that expansionary monetary policy and accompanying exchange rate depreciations will trigger vicious inflationary spirals. At the same time he is worried about the predominance of the hard-money doctrine among European governments and central banks, according to which non-inflationary credibility must be achieved through tight monetary policy even in a deep recession. This leads him to recommend that the European periphery should take the lead and use competitive depreciations to force the centre (Germany and France) to adopt more expansionary monetary policies.

The contribution by **Jacques Drèze** and **Henri Sneessens** on "Technical Development, Competition from Low-Wage Economies and Low-Skilled Unemployment" adopts a somewhat different perspective than the earlier papers. It starts out from the notion in especially the recent US discussion that demand is shifting from unskilled to skilled labour, which in the European context of more rigid relative wages implies that unemployment becomes concentrated among the less skilled. Drèze and Sneessens address the policy dilemma that such a development means: is it possible to "reconcile labour costs low enough to promote employment of low-skilled workers with reasonable incomes for these workers"? Although the authors stress that "every effort should be made" to mitigate the trade-off through provision of more education and training, they do not believe such measures to be sufficient, at least not in the short run.

Drèze and Sneessens focus on two methods of handling the problem. The one they prefer is to reduce payroll taxes for low-wage earners (and perhaps also subsidise their employment). This is to be financed by increases in energy taxes or the VAT. Such an approach may be complemented by tax relief for so-called "proximity services" (services involving *local personal relationships*, such as assistance to elderly and disabled persons, child care, assistance to school children, home improvements, etc., which are not exposed to foreign competition from low-wage economies), where low-wage earners tend to be concentrated. The alternative approach is to reduce minimum wages as well as unemployment benefits in combination with tax cuts for the employed (earned income credit) or with general transfers independent of employment status in order not to give up equity goals. Drèze and Sneessens are sceptical of this latter avenue because of doubts that wages will in the end prove flexible enough.

In his paper on "What Can Active Labour Market Policy Do?" **Richard Jackman** has the same starting point as Drèze and Sneessens, namely that an important component of the European unemployment problem is the shift in demand from unskilled to skilled labour. He worries about the prospect that social protection of the unemployed "reduces the incentive to incur the costs and risks of occupational or geographical mobility". This is seen as a strong argument for using mobility-enhancing active labour market policy of the "old" Swedish type as an alternative to cash benefits for the unemployed.

Jackman stresses one aspect of active labour market policy that is often forgotten, namely the contribution it can make to reducing the moral-hazard problem of income protection for the unemployed. By making income support conditional on participation in labour market programmes, administrative criteria for the allocation of benefits can be replaced by self-selection: only those who are really searching for regular jobs will apply. Labour market programmes will fulfil this work-test function even when they are not very effective in improving the future job prospects of participants as is implied by some studies.

Jackman ends with the conclusion that "a partial retreat" from the welfare state may be necessary involving "an acceptance of greater wage inequality and of a less generous benefit regime ... particularly for countries like Sweden which have gone furthest in the opposite direction". However, he argues strongly against a removal of the guarantee in Sweden of a temporary job or a place in a training scheme to unemployed people whose benefits expire. The motivation is that without such a guarantee it would be necessary to provide some other form of income support which is likely to have more detrimental effects on job-searching incentives. To the extent that the mounting costs for the unemployed must be reduced, Jackman favours cuts in both unemployment benefits and payments to those on schemes as well as reduced provision of labour market programmes not specifically targeted on the unemployed.

3. The risk of persistently high unemployment in Sweden

A bottom line from the papers is the uncertainty about the exact relative contributions of various sources of unemployment. An equally important observation, however, is the agreement among the authors that there are *several* causes of the European unemployment problem and that both structural (supply-side) and demand factors have been important.

The above conclusions should not come as a surprise in view of the past unemployment developments in different countries. The general rise in unemployment throughout the OECD area in the second half of the 1970s was preceded by supply shocks (energy price rises, tax increases and a lower growth rate of total factor productivity), whereas the unemployment increases in continental Europe in the early 1980s occurred in connection with the disinflationary demand policies. Unemployment did not at all rise to the same extent during that period in the US and the Nordic countries (except Denmark) which adhered to more expansionary demand policies (fiscal policy in the US case, monetary policy with exchange rate depreciations in the Nordic cases). Inference is made difficult, however, by the fact that there are also crucial structural differences between the areas with different unemployment developments, with labour markets being much closer to the competitive model in the US than in continental Europe, and active labour market policies and centralisation of wage bargaining being important features of the Nordic economies.

The European development from the mid-1980s and onwards also points to the importance of both structural and demand factors. On the one hand unemployment fell relatively little during the strong demand expansion of the second half of the 1980s, which must reasonably be explained by structural problems. On the other hand there was again a substantial rise of unemployment in connection with the demand deflation in the early 1990s.

The uncertainty about the exact importance of various factors for explaining unemployment in continental Europe carries over to judgements of the risk that high unemployment will persist in Sweden. One way of assessing this risk is to look at differences and similarities between the present Swedish situation and the conditions that prevailed in continental Europe in the beginning of the 1980s when unemployment became entrenched in the system.

Looking first at factors that may motivate more favourable labour market developments in Sweden than occurred earlier in Western Europe, one important difference is the *absence of recent supply-side shocks* of the type that occurred in the 1970s. On the contrary, some of the supply-side policy reforms accomplished in Sweden should rather tend to raise employment: lower capital-income taxation should increase savings and the supply of capital to small and medium-sized firms. Lower marginal taxes and reduced sick pay should stimulate labour supply, which works in the direction of reducing wage pressure. (Note, however, that the tendency to increased labour supply, although it tends to raise *employment,* may also increase *unemployment* as a percentage of the labour force, as discussed in Calmfors, 1994.)

Another difference is the very substantial *depreciation of the real exchange* rate of the Swedish krona that has occurred mainly as a consequence of the nominal depreciation in 1992–93, but which was also helped by a cut in payroll taxes in 1992. There were no gains in international competitiveness of comparable magnitudes in the continental European countries where high unemployment became persistent in the 1980s.

Other positive factors are the *short duration of "passive" unemployment* benefits and the strong emphasis on *active labour market programmes.*

One would expect the positive employment effects of the latter to be the largest in a situation where they can be used to counteract tendencies to reductions of the effective labour force. (My guess is that these positive effects of labour market programmes have been more important in recent years with high unemployment than the negative wage-raising effects found in earlier Swedish studies applying to situations of low unemployment; see e.g. Calmfors, 1993.) Finally, it is, of course, an advantage that the rise of unemployment in Sweden has been so sudden that there still does not exist a large *stock of long-term unemployed.*

However, like Elmeskov, one can also make a list of disturbing similarities between the present Swedish situation and that in Western Europe in the early 1980s. *Unemployment benefits* are high in Sweden (indeed the replacement rate is higher for average wage earners than anywhere else in the OECD). The *guarantee of placement in a labour market programme* in the case of expiration of benefits also means in effect that income support for the unemployed at a fairly generous level is unlimited in time.[4] If programme placements come to be regarded mainly as an income guarantee, this obviously puts the efficiency of active labour market programmes at risk as a method of returning the unemployed to regular work, as seems to be indicated by a recent study (Regnér, 1993).

Swedish *employment protection legislation* seems to be fairly normal by European standards. Although there is no general consensus as to how this affects average unemployment over a normal business cycle (on the one hand there are fewer firings in downswings, on the other hand there are fewer hirings in the upswings because of higher expected costs for future layoffs; see e.g. Holmlund and Edin, 1993), there is agreement that such regulation increases the persistence of unemployment. This is a serious problem if one, as at present, finds oneself at the bottom of an unusually deep recession with high unemployment.

Furthermore, *wage distribution* in Sweden – like in continental Europe – is *compressed* relative to the US and Britain. In fact it appears somewhat *more* compressed in Sweden than in the rest of Western Europe (see Elmeskov's contribution). This is a serious drawback if the Drèze–Sneessens–Jackman hypothesis of an ongoing relative shift in demand from unskilled to skilled labour (which is not matched by a corresponding relative supply shift) is correct.

[4] The right to renew eligibility for unemployment benefits through participation in labour market programmes was restricted by the liberal-conservative government in 1994, but at the time of writing the new social democratic government has just proposed the elimination of these restrictions.

Finally, *real interest rates* are high at present just as they were in Western Europe in the beginning of the 1980s. An increase of the real interest rate means a higher capital cost and hence long-run equilibrium must entail a lower capital stock, a lower real wage and lower employment. (In Figure 2 the horizontal long-run labour-demand schedule shifts downwards.)

Unfortunately, there are also factors that can motivate why the present unemployment problem may be more severe in Sweden than in Western Europe. The *demand shocks* that the Swedish economy was exposed to in the first years of the 1990s are unprecedented among the OECD countries in the postwar period (Finland at the same time being the only exception): from 1990 to 1993 the private sector moved from financial dissavings of 7.0 percent of GDP to financial savings of 13.0 percent of GDP.

Another complicating factor is the present large *fiscal deficit* of the public sector in Sweden – 10.5 percent of GDP in 1994. It appears to confront policymakers with a dilemma that was not present in most of continental Europe in the 1980s. On the one hand, in the absence of fiscal consolidation, fears of mounting public debt are likely to cause high long-term interest rates which threaten to dampen the recovery. On the other hand, the direct demand-reducing effects of an early fiscal consolidation may in themselves counteract the upswing.

It is also possible that the turbulence of recent years means that firms in Sweden today perceive an unusually large amount of *uncertainty* which is likely to make them reluctant to "invest" in new hirings (as well as in physical capital). This argument is hard to evaluate, but many of the big corporations have more or less explicitly declared business strategies, according to which they seem deliberately to abstain from expanding production in order to be less vulnerable to future downswings of the business cycle.

To conclude whether Sweden is likely to end up with high persistent unemployment just as the rest of Western Europe did, it is necessary to assign weights to the various factors which are summarised in Table 1. This is necessarily a fairly subjective business. *My* judgement is that there is indeed a very serious risk. In view of the extreme seriousness of such a development, it seems wise to build policies on the assumption that the worst-case scenario will materialise unless drastic policy reforms are implemented.

Table 1. A comparison of factors generating unemployment persistence between Sweden today and Western Europe in the beginning of the 1980s

Differences in favour of lower Swedish unemployment
Absence of earlier supply-side shocks
Real exchange-rate depreciation
Short duration of passive unemployment benefits
Active labour market programmes
No stock of really long-term unemployed
Similarities
High unemployment benefits
Unlimited duration of participation in labour market programmes
Employment protection legislation
Compressed wage structure
High real interest rates
Differences in favour of higher Swedish unemployment
Earlier demand shocks
Fiscal deficits
Uncertainty

4. Policy lessons

Just as the various authors agree that there are a number of sources of the present unemployment in Europe, there is a consensus that a broad range of measures are required to deal with the problem. Although the relative emphasis again varies among the papers, it is not controversial that *both* supply-side reforms *and* macro policies that maintain an adequate level of demand are called for.

If one were to draw up a list of possible employment-raising measures on the basis of the – explicit or sometimes only implicit – suggestions in the six papers, it would look something like the following.

(i) Training and education to raise the marginal product of labour and to adjust labour supply to the structure of labour demand.

(ii) Targeting of active labour market programmes on those threatened by long-term unemployment and the otherwise-difficult-to-place in order to expose insiders in the labour market to more competition from outsiders. Basic counselling and job-search activities of the employment offices must not be crowded out by the administration of large training and job creation programmes.

(iii) Lower unemployment benefits and lower compensation in labour market programmes in order to strengthen incentives for individual job search as well as for wage restraint in collective bargaining.

(iv) Short duration of passive unemployment benefit to achieve the same aims as in (iii).

(v) Greater flexibility of real as well as relative wages for both various categories of workers and individuals in response to the unemployment situation.

(vi) More flexible working-time arrangements (for instance in order to increase operating times and thus the effective capital stock) and working practices in general.

(vii) Less stringent employment protection legislation in order to reduce the risk that expected future costs of layoffs hold down hirings in the recovery.

(viii) Deregulation in order to increase competition in markets for goods and services. This will tend to reduce the mark-up of prices on wage costs, that is, increase the real wage consistent with a given level of employment. In Figures 1 and 2 the consequence is an upward shift of the labour-demand (price-setting) relationship.

(ix) Shifts from payroll taxes on labour to taxes on other factors of production. Alternatively reductions of payroll taxes can be financed by reduced government transfers to households *or* by increased taxes on consumption and incomes.

(x) Shifts of taxation in favour of local personal services (child care, cleaning, home repairs, etc.) with high employment content and where less skilled labour tends to be concentrated.

(xi) Targeting necessary fiscal cuts on the public-sector expenditures that have the smallest employment content, that is, transfers to households rather than public consumption.

(xii) Investment in public infrastructure in order to raise marginal productivity of labour in the private sector.

(xiii) Monetary policy in order to hold down short-term interest rates.

The main motivation for a package approach to employment policy, involving at least a major subset of the list above, is the uncertainty about the magnitudes of each individual effect. This suggests a "balanced portfolio" of policy measures. An additional motivation is implicit in Wyplosz' discussion: if individual supply-side reforms reduce the rents of various interest groups, an across-the-board attack where specific losses for one group can be outweighed by the general benefits from the elimination of rents for other groups, may be necessary for political acceptance. This argument is close to the one that was used in the 1980s in many countries in favour of large-scale tax reforms instead of piecemeal ones. A problem in this context, however, is that many of the different measures suggested are likely to be perceived as having immediate negative consequences on organised labour (the insiders in the labour market), which for this group may create an unfavourable balance between perceived short-run costs and long-term benefits.

A related question concerns the possibilities of achieving greater flexibility of wages, working time and working arrangements in general. With the exception of minimum wages in some countries, governments do not *control* these parameters, although they are influenced by, for instance, the provision of unemployment benefits and employment protection legislation. But a crucial question is whether collective bargaining as it is now known in most European countries can deliver the flexibility desired or whether this presupposes deliberate measures to reduce the bargaining power and role of unions. Such changes may include restrictions on secondary actions, limitations on the right to strike in the public sector when the general public may be harmed, abolition of practices of extending collective agreements by law also to non-union firms, and legislation that makes it easier for the employees to bargain individually with employers about wages as well as to defend their interests as individuals (rather than as union members) in other conflicts with employers. This would be the Minford deregulation rather than the Wyplosz social-contract approach. A possible – but controversial – hypothesis might be that the latter method can work only if it has been preceded by a dose of the former (although it may not have to be as strong as in Britain).

5. Crucial issues

I conclude by pointing to a few crucial issues raised in the contributions where uncertainty is particularly great, but where it is still necessary for policymakers to take a stand.

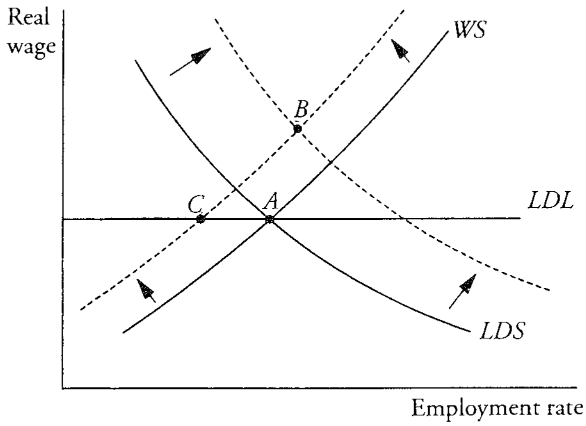
A *first* question concerns Jackman's endorsement of a *guarantee* of placement in labour market programmes – as currently exists in Sweden – as a superior alternative of income support for the long-term unemployed. Although such an approach may reduce the risks that the unemployed drop out of the labour force, it is likely to entail other problems. One is that programme participants have less time for active job search than the openly unemployed. Another risk is displacement effects, i.e., that both private and public employers substitute free (cheap) programme participants for regular hirings. Our knowledge of the trade-offs involved is very scant.

A *second* problem concerns the relative-demand shift from unskilled to skilled labour stressed by both Drèze–Sneessens and Jackman. It is still hard to judge the relevance of this issue in the European context, since most of the evidence is based on US experience. Although absolute differences between unemployment rates for different skill groups seem to have increased in Europe, as pointed to by Jackman, the ratios between unemployment rates in general have not (in Sweden they seem rather to have gone down during the last recession; see Edin and Holmlund, 1994). However, if we have disaggregated (un)employment goals for different groups and we attach higher marginal disutility to higher rates of unemployment, the increased absolute differences between unskilled and skilled labour do motivate a concern with the distribution of unemployment. This concern is even more motivated if social problems in connection with unemployment are more likely to emerge among the less skilled.

A *third* issue is the methods to use if one wants to stimulate especially the demand for less skilled labour. A drawback of the Drèze–Sneessens approach of reduced labour taxes is, as pointed out by Harry Flam in his comment, that incentives to acquire more human capital through training are weakened: the likely effect of a lower payroll tax for low-wage earners is a combination of higher employment and higher wages. Hence there is a goal conflict with the aim of strengthening incentives for training. This problem may not be there if the avenue of increasing wage flexibility is chosen instead: on the one hand unemployment differences between less skilled and skilled decrease, but on the other hand wage differentials increase.

Fourth, if the Drèze–Sneessens approach of stimulating relative labour demand for the less skilled is chosen, there is the question of whether this is best done by tax reductions for low-wage earners in general or by tax reductions for sectors where they tend to be concentrated. One might hypothesise that the risks of insiders capturing the rents are larger in the latter case, since unions tend to be organised along sectoral lines. There is, however, a strong optimal-taxation argument in favour of preferential tax treatment of many services involving personal relationships: because of the possibilities of substituting own work for services bought in the market, demand elasticities are likely to be larger than in other areas (see also Assar Lindbeck's comment on Wyplosz). Tax provisions of this sort can also be seen as a form of active labour market policy that overcomes the problem that socially valuable labour market programmes tend to give

Figure 3. An expansion of the public sector



LDS = Short-run labour-demand schedule
LDL = Long-run labour-demand schedule
WS = Wage-setting schedule

rise to strong displacement effects: since high tax wedges have to a large extent priced many "proximity services" out of the market, there are no regular jobs to be displaced, at the same time as there is likely to be a net social return from providing them.

A *fifth* issue is the effect of public-sector labour demand on total employment. In Figure 3, increased public employment shifts the short-run labour demand schedule to the right. If taxes are raised simultaneously to pay for this, the wage-setting schedule (with the before-tax wage on the vertical axis) is likely also to shift upwards as wage-earners try to compensate themselves. Hence the wage must rise in the short run, whereas the employment effect is uncertain. However, even if employment does increase (the economy moves from *A* to *B*), this does not represent a long-run equilibrium. The reason is that the higher real wage in *B* means a lower return to capital, which starts to decumulate (the short-run labour demand schedule begins to shift to the left). Unless there is a real appreciation of the exchange rate, this process goes on until the original wage has been restored (see the discussion in connection with Minford's paper in Section 2). In the diagram this will occur at a lower employment level than the original one (point *C*): employment falls more in the private sector than it rises in the public sector. This reasoning raises doubts about the employment-raising effects of a larger public sector. Instead, one would have to rely on other arguments. A relevant one might be that public-sector cuts in a situation of high unemployment might further exacerbate tendencies to hysteresis. In sum, however, we do not know enough about the role of the public sector for employment, although a recent Swedish study (Edin and Holmlund, 1994) is unable to find any long-run effects.

A *sixth* crucial question concerns the employment effects of the timing of the fiscal consolidation called for by the public-debt situation in most Western European countries, and not least in Sweden. This is an area of considerable uncertainty. The traditional Keynesian view is that such fiscal consolidation reduces demand and employment. The opposite view – which is often referred to as the German one – is that the effects are expansionary. One reason could be that the reduced uncertainty about the fiscal situation helps bring down the risk premia built into long-term interest rates. One might also argue that the later fiscal consolidation is, the more costly it will be: it will be less planned and more likely to involve cuts also of the most "productive" government expenditures and, to the extent that it involves tax increases, these will be more harmful if the distortions are non-linear in taxes (since taxes must be raised more to finance interest payments the more debt that has accumulated). It is difficult to judge these arguments. It is clear though that the direct negative demand effects of fiscal consolidation should be much smaller today than earlier because Ricardian equivalence has become more relevant: since credit markets have been deregulated, it is more likely that consumers will react to the reduction of the future tax burden implied by a cut in the fiscal deficit today by borrowing more in order to consume.

Finally, a *seventh* factor is the impact of monetary policy. How large is the risk that tighter monetary policy in the early phase of the upswing will impede the recovery as claimed by Dornbusch? Or will the main effect be a decrease in long-term interest rates because of reduced fears of inflation as suggested by his discussant Lars Svensson? To some extent the answer depends on what one believes about hysteresis effects. If easy monetary policy today reduces the equilibrium rate of unemployment, policymakers may have weaker incentives to create surprise inflation in the future in order to bring down unemployment. For this argument to hold, it must be possible to achive low short-term *real* interest rates without causing offsetting rises of *real* long-term rates. Needless to say, fiscal consolidation will make it easier to avoid raising short-term interest rates. At the same time this may be a necessary requirement for fiscal tightening not to be contractionary.

6. Conclusions

The basic conclusion from this volume, as well as from much of the discussion elsewhere, seems to be that the severity of the present unemployment problem requires a comprehensive set of policies. Different policies should be seen as complements rather than as substitutes to each other. Successful supply-side reform makes it easier to maintain a high level of demand without giving rise to inflation. At the same time the positive employment effects of such reform will take a long time to materialise if demand is too low.

What is the chance that supply-side changes will now prove politically feasible? The answer may depend upon whether two fundamental insights become generally appreciated. The first is that the need for fiscal consolidation increases the requirements on other sources of employment growth. The second crucial insight is that because of persistence mechanisms, the required structural reforms threaten to become more dramatic the longer they are postponed. On the basis of past experience one might doubt that these motivations for thoroughgoing reforms are strong enough.

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