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Comments on André Sapir, "Structural Reforms and Economic Growth in the EU: Is Lisbon the Right Agenda?"

One particularly effective way of thinking about the future of structural reforms and economic growth in the European Union is to consider the assignment of policy instruments to policy goals. It is also a useful way of evaluating the proposals of the *Sapir Report,* which has justifiably received wide acclaim for developing a policy agenda for the future of the European Union.

In macroeconomics, the traditional conception is to have monetary policy determined at the Community level (by the European Central Bank), whereas fiscal policy remains in the hands of the national governments. In microeconomics, analogously, the deregulation of product and capital markets was governed by Community policy, while structural reforms in labor markets are the responsibility of the EU Member States.

The past few years, however, have shown that the above-mentioned division of policy responsibility was not sustainable on the macroeconomic plane. EU-wide monetary policy has been supplemented

by the Stability and Growth Pact (SGP). Since various Member States have not maintained budget balance over the business cycle, the deficits generated in times of recession have made the deficit constraint of the SGP binding. Thus, fiscal policy was not longer under the exclusive discretion of national governments, but came under the influence of Community rules. This of course holds true not only of countries complying with the SGP, but also of those breaking it, on account of the inevitable political pressures that such rule-breaking entails.

It is no doubt true that *if* the Member States ensured budget balance over the cycle, then the likelihood of a binding SGP deficit constraint would be small. Yet given the existing political incentives, framed in part by the SGP, such behavior has turned out to be unrealistic. Thereby the strict division of responsibility for monetary and fiscal policy in the EU has broken down. It is also worth noting that, had Member States responded to the SGP by adopting a medium-term balanced budget, then the macro division of policy responsibility would have given way as well in the medium run, rather than in the short run.

Against this background, I would like to ask whether the division of policy responsibility on the microeconomic level can be maintained. The *Sapir Report* argues persuasively that EU policy needs to give priority to economic growth. As the population ageing raises the dependency ratios, as technological change and globalization change the mix of skills demanded in labor markets, and as enlargement raises EU income differentials, it becomes essential to achieve higher growth to raise living standards and maintain social cohesion. The Report stresses that this goal will require greater mobility of employees within and between countries, higher education, and other fundamental labor market adjustments. Nevertheless, the Report broadly accepts the traditional division of policy responsibility: "Although the main responsibility in this area lies with, and will continue to be with, Member States, the EU can act as a facilitator" (p. 160). It then proceeds to recommend targeted assistance and permits to enhance labor mobility, as well as grants to promote excellence in higher education.

Over the past decade, economists have made much progress in understanding how important human capital accumulation is for economic growth. The most highly skilled people are the ones who are best equipped to work with the most productive physical capital and to implement the organizational changes appropriate for the new technologies. We also have a much clearer understanding of how important employment is for human capital accumulation. Prolonged periods of unemployment cause skill attrition, which leads to even longer periods of unemployment. In short, we have come to understand that the functioning of labor markets is central to a country's ability to achieve high growth rates.

Can higher growth be achieved EU-wide without greater Community involvement in EU labor markets? To assess this issue, let us begin by asking ourselves some straightforward questions: Why does the EU Community, through the European Commission, not practice greater surveillance of competitive-

ness in national labor markets and the corresponding surveillance of national labor market policies? Why promote competitiveness in EU product markets, but not EU labor markets? Why break up price cartels, but not wage cartels?

The reason is that anti-competitive behavior in the labor market is often seen as a way of promoting job security and equalizing the distribution of income. Anti-competitive labor market activity is commonly seen as a way of promoting social cohesion. On this account, job security legislation, centralized wage bargaining, wide coverage of wage agreements, and many other anti-competitive practices go largely unchallenged at the Community level.

It is important to face this political reality: our equity objectives often lead us to turn a blind eye to anti-competitive labor market behavior. Recognizing this fact, we can then proceed to the crucial question: Is this anti-competitive behavior the most efficient way of promoting social cohesion? The answer to this question depends on the institutional underpinning of the labor market. When the institutional setting does not give people much latitude in finding new jobs, retraining, and buffering themselves against risk of income loss, it can make good sense to rely on restrictive labor market practices to gain some modicum of job security and income security. In the land of the blind, it can make good sense to follow the one-eyed child.

In many European labor markets, people live in a world where the present value of their expected future income is significantly higher if they retain their current jobs than if they take the next best ones that come along. Under these circumstances, stringent job security legislation is likely to be an effective way of achieving income security. Wide coverage of wage bargaining agreements is likely to help as well. The job security legislation of course helps raise the probability that current employees are retained, relative to the probability that they could find a new job with comparable remuneration; in other words, it lengthens job tenure and unemployment

duration at the same time. In this context, unemployment becomes a more serious social problem, since it is more difficult to escape. Consequently, it makes sense to support generous unemployment benefits and related welfare state entitlements for those who are trapped in the unemployment pool. The unemployment support of course discourages job search, because when an unemployed person does find a job, the state withdraws much, if not all, of this support and starts imposing taxes. Furthermore, many Europeans live in a world where tertiary education is either free or heavily subsidized, and generally provided right after they leave high school. Only minuscule amounts, relatively speaking, are available for re-education and retraining later in life, in response to the rapidly changing nature of jobs. In this setting, job security legislation, unemployment support, and wide coverage of wage

agreements become even more important in the quest for income security.

In short, sclerotic labor market institutions make people reliant to uncompetitive practices to protect themselves against adverse economic shocks; these uncompetitive practices lead to even more sclerotic labor market institutions; and so on, in an unremitting vicious cycle. Once this cycle has played itself out, it becomes difficult to implement reforms that promote labor market competition. Eliminating any particular anti-competitive labor market practice would put substantial segments of the voting population at risk of facing prolonged periods of low income and precarious livelihoods. It is not surprising, then, that these people will use their votes to block the reforms.

So the question we need to ask is: What institutional changes do we require in order to make it politically worthwhile to reap the gains of increased competition in labor markets? To address this question, it is useful to compare the state of our labor markets with the state of our financial markets. Over the past thirty years, our financial markets have changed out of recognition. We have developed a plethora of financial instruments that allows us to protect ourselves from risk and change its structure in countless flexible ways. We have created financial institutions that are able to bundle and modify these instruments to suit our ever-changing business needs. In comparison, European labor markets have remained relatively untouched. Although we have come to place more reliance of active labor market policies at the expense of passive ones and wage bargaining has become somewhat more decentralized, the general institutional landscape – trade unions, employers confederations, wage bargaining agreements with extensive coverage, severance pay, notice periods, unemployment benefits, incapacity benefits, etc. – remains easily recognizable since the early postwar period.

How would our financial and product markets have fared

– if companies were not allowed to hold bank accounts,
– if bonds, equities, futures, and options were not available, and
– if, instead, firms were given a generous subsidy if they went bust (say, 40–70% of their earnings in good times, followed by somewhat more modest assistance indefinitely thereafter)?

These are in fact the conditions under which our labor markets operate. Given that we are far better able to protect ourselves against risk in financial and product markets than in the labor markets, is it any wonder that we are far more audacious in pursuing competition in the former markets?

So, in thinking about institutional labor market reform, it is reasonable to look to our financial markets as a potential source of ideas for what might one day be achievable in our labor markets. In this vein, I believe the European Community can play a useful role in facilitating the creation of new financial instruments that would permit the establishment of the two individualized labor market accounts: (i) unemployment accounts and (ii) skills accounts.

These accounts could represent a way for Member States to help their citizens manage labor market risks more efficiently and flexibly than through current forms of welfare

support. Each working-age adult could be given each of these accounts. Instead of paying taxes to finance the existing unemployment benefit systems and state-sponsored training and post-high school education, people would make ongoing, mandatory contributions to these accounts. When they become unemployed, they would make withdrawals from their unemployment account instead of claiming the existing unemployment benefits. When they acquire skills, they could draw on their human capital account instead of receiving current government grants, subsidies, and loans for education and training. The minimum contribution rates to the accounts and the maximum withdrawal rates would depend on income and age.

The balances in the unemployment account could be used in various ways. Most simply, they could take the form of forced savings, used to tide people over periods of transitory unemployment. Beyond that, they could be used to purchase newly-created financial instruments whose value fluctuates inversely with the unemployment rates in the individuals' chosen sectors and occupations. Since these unemployment rates could not be influenced by any particular individual, these financial instruments would not give rise to moral hazard or adverse selection.

The balances in the skills account could buy new "human capital bonds and stocks," whereby people would receive money to finance skill acquisition and pay interest or dividends later. In particular, human capital bonds would enable individuals to borrow money for the purposes of further education and training, paying back a proportion of the interest and principal, the proportion depending on their future incomes. Analogously, human capital stocks would give individuals the possibility of issuing equities on the expected present value of their future expected incomes, and the dividends per share would rise with income.

The lowest income groups would receive transfers from the government into their labor market accounts. The greater the income, the lower the transfers. At higher in-

come levels, the transfers would give way to taxes. These redistributions would have to be of the balanced-budget variety: economy-wide taxes on each of the skill accounts would be equal to total transfers into each of these accounts, and the same for the unemployment accounts.

People could transfer funds between accounts, but if their balances on all welfare accounts fell to zero, the government would make the specified deposits. Government transfers to able-bodied people of working age would be conditional on their availability for work.

At the end of their working lives, people could transfer the remaining balances in their unemployment and skills accounts into their pension accounts.

How could the private sector be encouraged to contribute more to education and training? The private sector gains the incentive to contrib-

ute significantly to the welfare system only if the institutional structure of this system makes it impossible for the government to use the tax-and-transfer system to drive the private providers out of business. Under the proposed account system, the government would have two budgetary systems: one for non-welfare expenditures and existing taxes, and another system in which labor market services are financed through payments from the labor market accounts. Thus, the government could not use its general tax receipts to fund education and training and thus drive down the prices of these services, and thereby keep private providers from entering these sectors. Instead, the public and private sectors would then be able to provide education and training services on an equal footing, competing of the account holders.[1]

While this reform could replicate the amount of redistribution in our current system, it would create a revolutionary change in people's incentives. The longer a person remains unemployed, the lower will be the unemployment account balance and consequently the smaller the funds available for the pension account at a later date. People would use their skills accounts to improve their skills only if they believed that this would raise their future incomes sufficiently.

Due to the improved incentives, the account contributions necessary to finance a particular level of welfare provision would turn out to be significantly lower than the taxes necessary to finance the same level of support under the current system. In sum, these proposals would enable our labor markets to take a step towards catching up with our financial markets. They would enable people to reduce their labor market risk in efficient ways, and give them greater flexibility in transferring purchasing power across their lives. Thus, they would make people less reliant on existing unemployment benefit systems and state-provided education and training systems, which often make our labor markets rigid and prone to unemployment and recurring skill shortages. The European Community could play an important role as facilitator of these developments. ❧

[1] *For a related welfare reform proposal, see Orszag, J. M. and D. J. Snower. 1997. Expanding the Welfare System. In: European Economy 4. 101–118.*