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by
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CAUSES AND CURES FOR UNEMPLOYMENT: ASSESSING THE MAINSTREAM VIEW

By: Stephanie Bell*

Almost two years ago, some of the most well known and well-respected economists in the world pooled their collective wisdom in an article entitled "An Economist's Manifesto on Unemployment in the European Union" (henceforth, "the manifesto").[1] When this group joined forces, the official unemployment rate in the European Union (EU) averaged eleven percent. Although the unemployment figures have improved since then, EU unemployment remains a serious problem in this region.[2] The authors of the manifesto considered the high rates of unemployment, which prevailed at the time they combined forces, to carry "damaging long run consequences, especially for the young that represent, in most countries, the bulk of the unemployment" (1998, p. 392). In addition, high levels of unemployment were considered "degrading and demeaning for the unemployed" (*ibid*.). Thus, their manifesto offered a number of policies designed to combat unemployment in the European Union. The purpose of this essay is threefold. First, given that the opinions contained in the manifesto derive from some of our discipline's most influential members, it is interesting to examine and assess the manner in which they propose to cope with unemployment. Second, it is intriguing to imagine how some of the great minds of the past (in particular Lerner, Keynes, and Minsky) might have approached the same problem. Finally, a host of alternative policies are proposed, and it is argued that a program of direct job creation is likely to be the most efficacious full employment policy.

A Cursory Look at the Manifesto's Stance on Unemployment

In assessing the manifesto, one might consider the *degree* to which the authors proposed to alleviate unemployment. Also, one might consider how *quickly* and at what "*cost*(s)" they were willing to

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pursue a reduction in unemployment. Although the authors claimed that they were proposing a "significant reduction" in unemployment, their plan actually called for *less than* a 50% decline in the average rate. Specifically, their goal was to "reduce unemployment by 4 or 5 percentage points" (*ibid*., p. 359). The objective, then, was not to combat unemployment in any meaningful sense (certainly not to eradicate it) but to bring it down to some *tolerable* level.

Thus, despite its social and economic costs, the authors proposed a reduction of only 4 or 5 percent points. Why not take a bolder stance? Why, for example, not eliminate involuntary unemployment altogether? It seems that, without explicitly stating it, the authors had some sort of a NAIRU in mind. Such a creature appears to be lurking in the background, for the authors repeatedly refer to a *cautious* pursuit of rising employment, lest the beast rear its ugly head. For example, the authors reassured the reader that their policies were designed to reduce unemployment "without compromising the recent gain in subduing inflation" (*ibid*.). They also said, somewhat cryptically, that "the *bulk* of European unemployment serves no useful purpose whatsoever" (*ibid*., p. 332). The implication, of course, is that *some* unemployment serves a "useful" purpose. Given its (stated) ill effects on social and economic well being, must we not conclude that its "usefulness" derives from its price-stabilizing effects? Perhaps the clearest evidence of a NAIRU can be found in their argument that unemployment is not a very potent instrument to control inflation when there is already plenty of slack [in the labor market]" (*ibid*., pp. 347-8). Again, the implication is that unemployment *is* a useful way to control inflation once the labor market begins to 'tighten' so that *some* slack in the labor market (i.e. some unemployment) will be useful in controlling further price increases. The ultimate goal, then, was to achieve an (average) rate of unemployment of 6 or 7 percent, but it was not to be done at the expense of rising prices.

But there is another troubling aspect to their proposal, namely how quickly were those lucky

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members of the 'project' for helpful comments.

enough to fall outside the reserve army of the "degraded and demeaned" supposed to secure employment? If adopted, the policies proposed in the "manifesto" were designed to reduce unemployment "significantly in a matter of a few years" (*ibid*., p. 328). So the overall objective appears to have been to bring the (average) rate of unemployment in the EU to its NAIRU in the next few years.

Combating unemployment, like combating any other economic ill, requires identifying the *cause(s)* of the problem and then eliminating or mitigating these causes. Viewing the problem from Minsky's perspective, this requires "understanding how a capitalist economy behaves," because its behavior "will give us knowledge that will enable us to control and change it so that its most perverse characteristics" can be controlled (1982, p. 32). They key, of course, is in the analysis of the working or behavior of the capitalist system, for the diagnosis reached at this stage will determine the cure to be applied in the next stage. Just as different medications will be prescribed to patients diagnosed with different illnesses, different policy prescriptions will follow from differing diagnoses. First, let us examine the manifesto's diagnosis and prescribed cures.

The Diagnosis

For the authors of the "manifesto," the diagnosis was clear: the patient suffered from high unemployment. The task, then, was to discover its cause(s) in order to prescribe a set of medications (policies) aimed at reducing it. The doctors ruled out a few potential causes in their preliminary analysis, concluding that the illness was not induced by:

- Insufficient skills
- Lack of motivation to seek jobs
- Burden of taxes
- Rapid technical progress

- Competition from low-wage countries
- A crisis (inherent) in capitalism

Having narrowed the list of potential ‘carriers,’ the doctors then searched for a healthy system in order to gain some insight into the proper blend of institutional diet and fiscal and monetary exercise. The UK and the Netherlands passed their physicals and were considered healthy benchmark economies. The doctors concluded that their good health was due, in part, to a healthy ‘diet,’ achieved through the elimination of labor market fat. Specifically, the proper diet called for: the restriction of strikes and secondary picketing, the decentralization of wage bargaining, the liberalization of hiring and firing restrictions, the reduction of the duration of unemployment benefits and tightening of eligibility requirements, and the abolition of minimum wage laws. Another important contributor to the stellar physical health of the UK, they concluded, was exercise. By ‘exercising’ its right not to join European Monetary Union (EMU), the UK was able to avoid the contagious effects of the convergence criteria, which the authors (rightly) blame for at least some of the unemployment. The ailing countries, the doctors concluded, were suffering from:

- Restrictive monetary and fiscal policy in order to prepare for the euro
- Minimum wages
- Job security legislation
- Work sharing and early retirement

Treating these, they argued, would heal the patient.

The Prescription

Demand-Side Policies

The authors lamented the European Union's focus on a supply side policy approach to unemployment and argued that much greater reliance on demand stimulus via fiscal and monetary policy was in order. Since the patient already failed to 'exercise' its right to opt out of monetary union, the doctors prescribed a *limited* exercise program, designed to put a bit more hop in the patient's step. Although some exercise was encouraged (e.g. countries should 'exercise' their collective will to alter budget deficit accounting practices so that investment in infrastructure, etc. is expensed according to the rules of a capital budget, rather than being written off in a single period), the doctors did not encourage them to seek complete freedom to run as fast and as far as they like (i.e. run massive deficits). Still, they concluded that the patient should do more exercise, so the following demand management policies were prescribed:

- Expand the rate of public sector investment through increased government (capital) investment, concentrating on "specific infrastructures capable of giving [competitive market] returns in the short-run" (Modigliani et al., p. 344)
- Increase private sector investment through central bank (ECB) lowering of interest rates

Thus, to get around the 3% deficit-to-GDP limitation imposed by the Treaty, countries were urged to call for a change of accounting practices so that they could increase capital investment while upholding their obligation to conform to the Maastricht criteria. This is surely a noble strategy, for numerous studies have shown that public capital expenditures yield positive feedbacks through increases in private sector productivity, profitability, investment and employment (see Aschauer, 1989a, 1989b; Erenburg, 1993; and Mundell, 1990). Thus, capital outlays sustain the secular growth path of the economy through their crowding-in effect on private investment and, through this impact, stimulate additional private sector employment. In general, then, the policy deserves support.

But there is no reason to restrict the government to some narrow efficiency criteria. Indeed, the government should evaluate individual projects on their respective merits and allow the overall budget outcome to emerge as a *residual*. This, of course, is consistent with Abba Lerner's approach to finance. Lerner dubbed his approach "functional finance" because it was the ends (as opposed to the means) that were considered relevant (Lerner, 1943). Minsky clearly agreed, arguing that economic efficiency should never be the *aim* of economic policy (1996, p. 10). Rather, he argued, "policy should strive to assure the civilized standards of an open and democratic society" (*ibid*.). Presumably, Keynes would have agreed - paying people to dig holes surely would have failed any requirement to undertake only those projects expected to yield a competitive market yield! The point is, the (indirect) stimulus from public sector investment is too important to allow arbitrary (and unnecessary) restrictions on public sector project yields to dictate their undertaking. Especially if the (indirect) stimulus from an interest rate reduction cannot be relied upon.

Now, it appears that the authors of the manifesto placed a great number of eggs in the European Central Bank's (ECB) demand-stimulus basket. Indeed, the authors claimed that the ECB would become the "only institution with substantial power to influence investments" (Modigliani, et al., p. 348). This power, they suggested, was to be wielded through the use of its "long acknowledged, classical tool of investment control," the rate of interest (*ibid*., p. 346).

But can monetary policy be relied upon to stimulate private sector investment and, thus, employment? Although the central bankers themselves argue that they wield little, if any power in this area, Modigliani et al., accuse them of underestimating their competence, arguing that their ability to influence investment derives from their ability to control prices. In short, their control over prices is supposed to give them control over demand and, thus, at least some control over investment.[3]

Lerner, like Keynes expressed concerns about the effectiveness of monetary policy as a stimulus to investment demand and, hence, employment. The effectiveness of monetary policy was also weakened by the capital critiques, which questioned the logical argument linking the interest rate (inversely) to investment demand. Moreover, Fazzari (1993) has shown (empirically) that there is no distinct link between these two variables. Despite these uncertainties, half of the demand stimulus policies[4] proposed in the manifesto relied on the (weak) link between interest rates and investment demand.

In sum, for those countries that have subjected themselves to monetary union, only *fiscally sound* 'exercise' was allowed, perhaps an occasional brisk walk. This sort of 'exercise' was encouraged in order to make the patient feel a bit better, but the types of activities that would really get its heart rate going were not prescribed. Ailing economies should feel better after a bit of 'exercise,' but were cautioned not to overexert themselves, for any injuries they might suffer would "burden future generations" (Modigliani, et al., p. 344) who would be forced to nurse them back to health. Thus, despite an *apparent* prescription for a heavy dose of *demand* 'exercise,' the patient was really asked to rely upon a more sensible 'diet' to *supply* it with the right mix of resources.[5]

Supply-Side Policies

With the diagnosis and the demand-side prescriptions firmly in hand, the doctors settled on a supply-side treatment: "we think that, in order to fight unemployment, it is necessary and feasible to introduce a substantially higher degree of flexibility in the European labor and product markets including, where necessary, a relaxation of job security legislation, a reduction in the coverage of collective bargaining agreements, and a reduction of barriers to entry of firms and of barriers to geographic mobility of labor" (*ibid*., p. 349). The policies were designed to give greater "incentives" to both employers (who are discouraged from hiring/firing at will) and prospective employees (who are too well cared for on the dole to be bothered to accept a job at a lower wage). The problem, the doctors maintained, was that workers have engaged in a number of unhealthy activities. Thus, unions, job security, and minimum wages, like alcohol, cigarettes, and sweets, may be tempting, but partake in them and you're sure to suffer health problems. The patient has been gluttonous, they agreed, so the solution was to improve its 'diet' by greatly reducing (if not eliminating) these fats. The result would be a healthier, leaner European Union.

The doctors prescribed a fistful of pills to treat the supply-side ailments:

- Encourage fixed-term and part-time jobs favoring women and the young
- Reform job security legislation - Make it easier (i.e. less costly) for firms to fire workers
- Adopt job-creation policies - Create jobs, either in the private or public sector
- Restructure minimum wage legislation - Devise a 'special' (sub-minimum) wage for the least employable
- Encourage search-promoting policies (e.g. Restart Program in UK)
- Promote policies to stimulate worker mobility (e.g. portable health insurance and pensions)
- Reform unemployment benefit programs – Provide incentives to take available jobs and aid when jobs are unavailable
- Allow conditional negative income taxes - An alternative to unemployment benefits
- Support a benefit transfer program - Take money that is currently spent on unemployment benefits and give it to firms as subsidies
- Auction off unemployment benefits and employment vouchers

For the authors of the manifesto, it was necessary to redesign the incentive structure in order to increase both the number of jobs offered and the number accepted. Minimum wage laws, they contended, were a "[potential] source of unemployment" and were "inspired by a lofty ideal that anyone who wishes to work should be able to secure a minimum decent living standard" (*ibid*., p. 336). They argued that these laws prevent (mainly young) people with no experience and little "human capital" who would be willing to work for a wage below the minimum wage from securing employment.

In evaluating the author's proposal, one must consider whether nominal wage reductions are really likely to improve the patient's health. Surely it is possible that a reduction in the nominal wage will reduce the money demand for consumption, which might cause firms to adjust their profit expectations and, hence, *reduce* their demand for labor. That is, there may be a positive relationship between changes in nominal wages and changes in employment. On the issue of job security legislation, the authors argued that firms will "eventually find it advantageous to shrink their labor force" and that it is inefficient to prevent them from doing so (*ibid*., p. 337). Consider, however, a firm that notices a decline in its sales revenue and decides to reduce its labor force. This firm will gain (or minimize its losses) only if other firms do not take similar action. If, however, other firms follow suit, the result could be a downward spiraling of aggregate demand. It is possible, then, that job security legislation may actually protect firms *from themselves* by preserving consumption demand.

For Lerner (1951), the pursuit of full employment would promote economic security, which was considered an important benefit in and of itself. Indeed, Lerner maintained that job security was an even more important benefit to full employment than the benefit from increased output. James Galbraith and Tom Ferguson would echo Lerner's concerns. They stress the importance of improving working conditions as well as solidifying people's grip on jobs, income and hours (Ferguson and Galbraith, 1998). Although Minsky would have agreed with a number of the supply-side policies promoted in the "manifesto," he, too, would have opposed any attempt to reduce economic security, for he argued that "capitalism can be successful only if economists and policymakers recognize that people have a limited tolerance for uncertainty and insecurity" (1996, p. 9).

Moreover, the manifesto's proposed cut in current outlays should, by its own logic, be unnecessary. That is, the proposed increase in capital outlays (what Argyrous (1998) calls 'autonomous' spending) is designed to feed back as a decrease in the quantity of current (or what he calls 'endogenous') outlays. Thus, tightening unemployment eligibility criteria, shortening the length of coverage, etc. should not be part of the "manifesto," as these forms of spending should automatically decline as 'autonomous' outlays increase. But as we have seen, the authors proposed restricting 'autonomous' outlays to those projects expected to yield a competitive market return. Because of these restrictions, the feedback mechanism may fail to stimulate sufficient private sector activity, leaving unemployment too high. This, of course, *strengthens* the argument to leave automatic stabilizers in place (in full force) so that incomes will be prevented from spiraling downward. Thus, if additional capital expenditures successfully stimulate private sector investment, transfer payments will decline; if they are unsuccessful, at least the entitlement program will help to mitigate the effects of depressed consumption demand.

Finally, the manifesto opposed work-sharing and early retirement on the grounds that "there is no justification for the government to provide incentives for people to work shorter hours or retire earlier" (Modigliani, et al., p. 388). Galbraith and Darity make a number of compelling justifications for government intervention, including positive social, psychological, physiological, and economic benefits from work-sharing and early retirement. Keynes certainly thought that a shortened workweek was possible. In *Economic Possibilities for Our Grandchildren*, he suggested that within "one hundred years" we would witness a different form of economic organization in which all would earn sufficiently high incomes while working a fifteen-hour week (1930 [1972], pp. 328-9).

Some (Further) Problems With the Proposed Policies?

The authors of the manifesto relied on three policies in order to stimulate employment. The first policy was to increase <u>public</u> sector investment as a *means* of increasing <u>private</u> sector investment in order to stimulate employment. The second policy was to encourage the central bank to lower the interest rate as a *means* to stimulate <u>private</u> sector investment in order to increase the demand for labor. The final policy (set of policies) was to increase work 'incentives' (to firms and workers) as a *means* of increasing employment. With regard to the second proposal, it should be noted that if firms are currently operating with substantial excess capacity (as they likely are), targeting employment via private sector investment may not be the best short-run strategy. This, as Minsky explains, is because investment decisions depend upon profit expectations over a longer time horizon. In order to induce private sector investment, then, something must be done to impact (favorably) long-run profit expectations. This, most likely, will require increasing *actual* or *realized* profits in the short-run, so that longer-run expectations will be revised upward.

From the Kalecki-Levy profit equation, we know that:

After Tax Profits = Investment - Non-Business Saving

Given that firms are normally operating with excess capacity, and that inducing new investment will require increasing *realized* profits in the short-run, the best short-run strategy is the one that boosts deficit spending (i.e. reduces non-business saving) and, hence, *actual* profits. Thus, of the two demand-side policies designed to increase employment, only the proposal to increase <u>public</u> sector investment (financed by deficit spending) is likely (through its impact on short-run profits) to induce additional hiring in the short-run. This, as Minsky explains, is because in the short-run, firms are motivated to increase output and employment "on the basis of the profits they expect to earn by using labour and the *existing* capital assets to produce and distribute consumption and investment output" (1982, p. 34; my emphasis). Thus, firms will hire more workers as their short-run profit expectations increase, but lower interest rates will not induce them to undertake new investment until some optimism has been generated. The latter will occur only after (realized) short-run profits cause an upward revision of long-run profit expectations.

Similarly, the set of 'incentive' policies are likely to succeed at inducing additional hiring in the short-run only to the extent that they improve firms' short-run profit expectations. If firms view the proposed subsidies, hiring and firing freedom, etc. as sufficiently large cost-reducing measures, they may indeed increase their demand for labor. But note that this depends entirely on the firm. Activist 'entrepreneurs' hire passive workers. The aggregate supply schedule for labor may not exist so that aggregate demand, alone, determines employment (Galbraith, 1997).

An Alternative Diagnosis

For Minsky, the patient would be diagnosed as suffering from a virus with recurring symptoms. Sometimes the patient looks and tests healthy, but this is *always* a transitory phase. Eventually, a sore throat followed by a fever and, possibly a full-blown flu will develop. In other words, the system itself is prone to generate periodic (and lasting) ills (e.g. unemployment). In order to keep the patient alive, Minsky would have written a prescription for a shot of carefully crafted institutional reform to be followed (as needed) by occasional shock therapy.

Again, Minsky's treatment would differ because his diagnosis would differ. Keynes, Lerner and Galbraith would, presumably, also write prescriptions that differ significantly from the one written by the authors of the manifesto. In part, this stems from their fundamentally different position regarding an individual's *right* to work. For the author's of the manifesto, it will be recalled, the belief that all who are ready, willing and able to work should be afforded a decent job at a decent wage derives from a "lofty ideal" that cannot possibly be accommodated. Lerner, Minsky and Galbraith agree with S. Jay Levy who argues that to deny a job to a person who is willing and able to work is a gross inequity (1998). As Minsky put it, "the economic and human costs of unemployment - to individuals and the nation - are too great to be tolerated in a society replete with unmet needs" (1996, p. 11).

Alternative Policies to Stimulate Employment:

Monetary Union is a creative (if flawed) institution. If, as the authors of the manifesto suggest, its adoption is largely responsible for the current state of unemployment in EMU countries, it is probably going to take some creative policies to successfully combat the problem. In other words, textbook supply- and demand-side policies may not suffice. Below are a handful of policies that might be considered in their stead.

- Government housing projects - This proposal is based on S.J. Levy's observation that "since 1990 in the EU the cost of shelter has increased twice as fast as the consumer price index in every major economy except the UK. The beneficiaries of this increase are the owners of rental property and the holders of mortgage loans, who realize gains without making any additional contributions to the production of goods and services and therefore to employment. Those who must spend more for their housing have less to spend in stores and their suppliers need fewer employees" (1998, p. 10).
- Wage and price floors - Deflation, rather than inflation, is the current threat to world economies. As Papadimitriou and Wray (1998) argue, deflation discourages investment because firms cannot be sure that their expenditures will be recovered in an environment of falling prices. Something similar to the New Deal wage and price controls, which set 'floors' to workers' and firms' incomes, could prevent EMU countries from sliding into a deep recession (or depression).

- Public investment - Spending on education and training (upgrade facilities, provide supplies, reduce class sizes, etc.), science and technology, and infrastructure should be increased.
- Private investment - Taxes and subsidies should be used to encourage individuals and firms to enhance productivity through training and upgrading of skills.
- Community development banks - They should be designed to increase investment in communities where needs are not being serviced by existing banks. Both the authors of the "manifesto" and Minsky (1992) proposed something similar to this.

- Encourage the production of consumption goods - Minsky suggested that policy emphasis should shift from the encouragement of growth through investment to the achievement of full employment through consumption production. This, of course, complements his Financial Instability Hypothesis, since a less capital-intensive economy will be less susceptible to financial instability.
- Direct job creation - Lerner argued that the maintenance of full employment, through its impact on business expectations and confidence, would help to impart stability. Of course for Lerner, as for Minsky, full employment did not mean unemployment at the non-accelerating inflation rate! Lerner viewed full employment as a fundamental macroeconomic goal and believed that it was the responsibility of the State to promote its attainment (Forstater, 1998). Both Lerner and Minsky supported a program of direct job creation in the form of public works in order to achieve true full employment (i.e. zero involuntary unemployment). Such a scheme, modeled on the WPA, NYA, and CCC, could be used as a prototype for a similar employment program in the EU. (See Wray, 1998.)

Conclusion

The proposal for direct job creation is, perhaps, the most promising solution to the unemployment problem in the Eurozone. That said, it is also true that under the current institutional framework, it would be impossible to implement such a program. This is because a variety of constraints – including those imposed by individual member states themselves, those imposed under the *Stability and Growth* Pact, and those imposed by financial markets - will serve to restrict deficit spending below the level that would be required to sustain a federal job assurance program. One way to resolve this fiscal constraint is for member states to unite politically (Kregel, 1999). In Wynne Godley's opinion, political unification is the most appropriate means by which to return fiscal freedom to the Eurozone (1992, p. 40). Another option might be the establishment of a European institution that would guarantee all bonds issued for the purpose of financing such a program (Berglund, 1999). Under current arrangements, member states must compete with other borrowers when they float bonds on the capital market. This subjects them to financial market discipline and leaves them unable to run the kinds of deficits that a federally funded job assurance program would require. Either way, something more must be done.

While the manifesto's authors recognize that EU unemployment is a problem, they do not propose the kinds of fundamental reforms that Lerner, Keynes or Minsky would have supported. The difference, of course, derives from their differing assessment of the problem. Moreover, the "prescriptions" that each group would write for these ailing economies differs according to their diagnoses. As economists, we must pay attention to history, institutions, culture, etc. If our diagnoses are flawed, we are likely to prescribe the wrong medication.

Notes

1. See Modigliani, et. al, *BNL Quarterly Review*, no. 206, pp. 327-61, 1998.

2. Using the revised unemployment rates from the OECD, the 1998 average rate of unemployment within the Eurozone was 8 percent, and the average rate in 1999 was 7.2 percent.

3. Ironically, this argument follows a previous concession that the ECB has “very little control over the price level” (p. 347).

4. If the interest rate-investment link proved sufficiently weak, fully half of the demand side policies would fail.

5. The manifesto could easily fool a reader into believing that demand side policies are far more important than they actually are. In fact, monetary policy is *the* key to the proposed demand side policies, and yet its *only* discussion occurred on page 348. The only other demand side policy was a c*onstrained* proposal to increase capital investment spending.

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