Commentary: The Role of Demand Management Policies in Reducing Unemployment

Welfare State Unemployment: A Comment

Allan H. *Meltzer*

Charles Bean has written an informative discussion of unemployment that brings to a larger audience some parts of his comprehensive discussion of European unemployment (Bean, 1994).

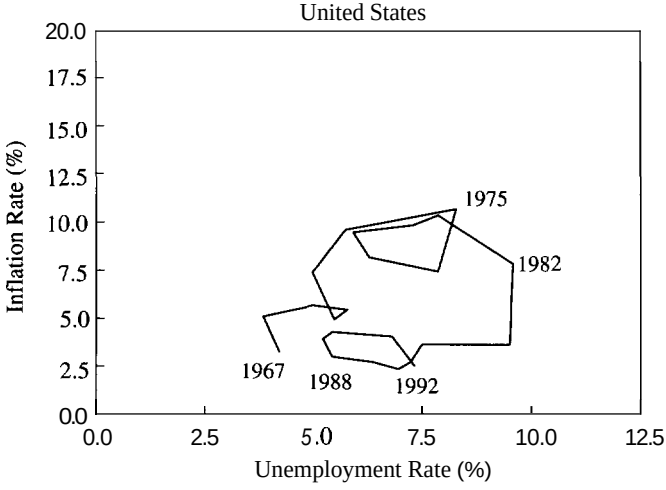
His current paper also discusses the role that policy might take to reduce unemployment. I will put policy issues aside initially to concentrate on the causes of unemployment. I begin by stating and commenting on four main points about the causes of unemployment that I draw from his work, particularly his survey paper.

Why European unemployment rose

First, most of the increase in unemployment within the European Union is on the supply side. Chart 1 in Bean's conference paper, and his earlier survey paper (1994, Figure 2), show that the steady-state unemployment rate rose from less than 2½ percent in the late 1960s to about 10 percent twenty years later. Bean's chart, reproduced as Chart 1, shows that the unemployment rate at any rate of inflation is higher in all countries but, outside the European Community (EC), the increases are modest. The rise in the EC is almost a constant rate of increase over a fifteen-year period. Since the rise in the unemployment

Chart 1
Unemployment and Inflation

Bean: European Unemployment: A Survey



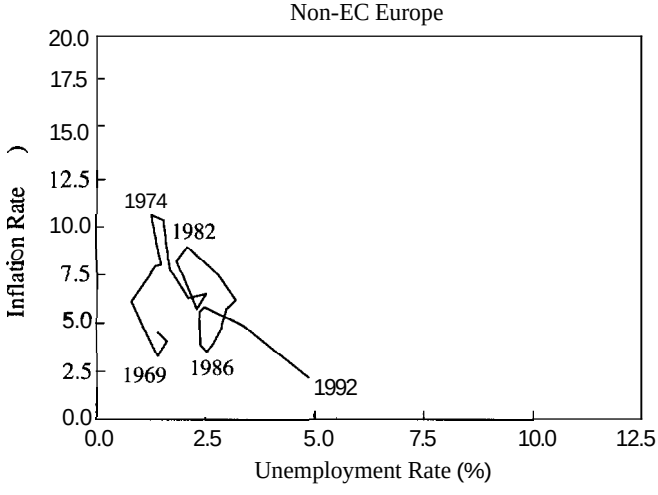
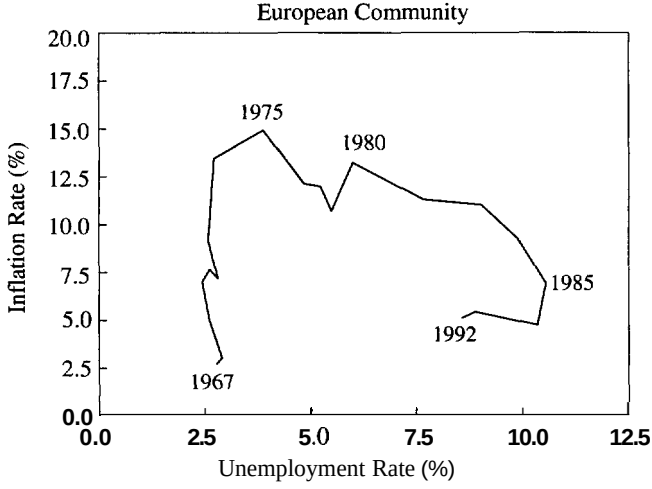
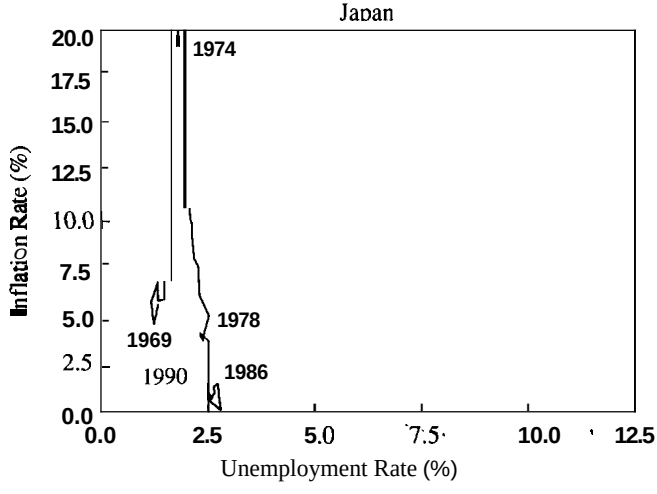


Chart 1
Unemployment and Inflation
continued

Bean: European Unemployment: A Survey





rate is mainly on the supply side, it is not "Keynesian unemployment." I suggest that a better name is "welfare state unemployment."

A distinguishing difference between welfare state and Keynesian unemployment is that the former, unlike the latter, cannot be reduced ***permanently*** by policies that increase aggregate demand. Welfare state unemployment raises the natural rate of unemployment. Bean's (1994, p. 575) survey suggests that the natural rate has increased in the last twenty years in the United States, Europe outside the EC, Japan, and in the EC. The increase in the rate for the EC, however, is orders of magnitude greater than in the other regions. I concentrate on this long-term rise.

Second, cyclical fluctuations in aggregate demand play a much smaller role. Bean's data suggest that, at its worst in the mid-1980s, cyclical unemployment was 2½ percent, so the unemployment rate, in the EC or European Union (EU), would have been less than 5 percent instead of more than 10 percent had welfare state or supply-side unemployment remained at the late 1960s level.

Third, Bean concludes that there is no accepted explanation of the rise in European unemployment. His survey suggests that economists have worked hard investigating many plausible explanations without reaching a firm conclusion. The explanations include the oil price shocks, changes in the terms of trade, slower productivity growth, higher and longer-lasting unemployment benefits, and minimum wages. Some of these explanations are incomplete as they stand. The lasting effects of productivity growth, oil shocks, and changes in the terms of trade should be on real wages, not unemployment, and any effect of the oil shocks should have reversed when real oil prices fell.

Other, more inventive economists, have proposed fanciful explanations of persistence or, as some prefer, hysteresis. In one popular version, workers are said to lose their skills when they remain unemployed. Such explanations neglect some facts. Much of the rise in unemployment is not the result of employed workers losing jobs. Unemployment in the EU is heavily concentrated among new entrants. In Bean's words (1994, p. 576): "The high levels of unemployment in

the European Community are thus associated primarily with the reduction in the probability of finding a job, rather than an increased likelihood of losing one." Further, to reach the remarkably low unemployment rates of the 1950s and 1960s, the labor force absorbed the generation that experienced the depression of the 1930s and the war in the 1940s. This generation had no problem finding and keeping jobs in the 1950s and 1960s despite a lengthy absence from the labor force.

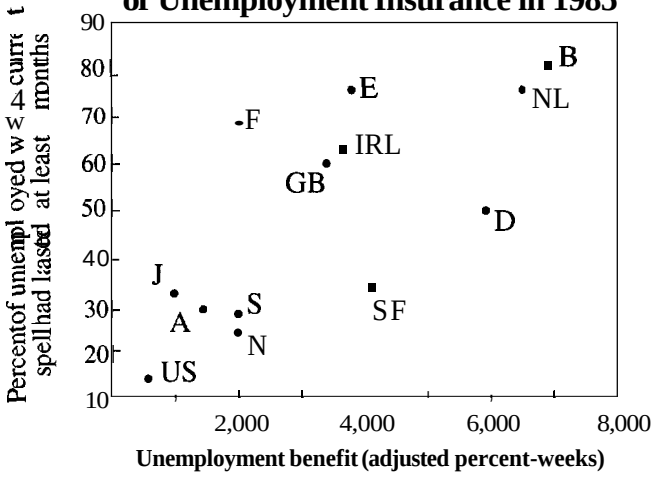
Fourth, Bean's (1994) survey suggests that most of the research on the role of the welfare state has concentrated on unemployment benefits and taxation. He dismisses these policies as an explanation of an increased steady-state unemployment rate.

Bean recognizes (1994, pp. 592 and 602) that the duration of unemployment benefits is indefinitely long in several EC countries that now have high unemployment rates, whereas the duration of benefits is limited in the Nordic countries (and the United States) where unemployment rates rose much less in the 1980s.[1] He dismisses any long-term effect of taxes and permanent benefits by arguing that the two should be offsetting on an individual's choice of labor and leisure. His argument is that leisure depends on permanent income. Higher taxes reduce permanent income but the higher benefits restore the loss. In Bean's model, the permanent effects on unemployment cancel (1994, p. 589).

I believe that the error in this argument is the fallacy of aggregation. Taxes on earned income or labor income (whether assessed on employers or employees) are paid by those who work. Unemployment benefits are paid to those who are idle. Hence work or effort is discouraged and leisure or idleness is encouraged. Or, workers move into the underground economy. Permanent benefits that cannot be taken away (to use a now familiar phrase) have a double effect on the unemployment rate if paid for by taxes on earned or labor income. Far from canceling, the two effects are reinforcing.

Burda (1988, p. 407) studied the relation between the duration of unemployment benefits and the proportion of the unemployed out of work for six months or longer. Chart 2 reproduces his data. The correlation between long-term unemployment and duration of benefits

Chart 2
Long-term Unemployment Rates and the Level of Unemployment Insurance in 1985



Note: A = Austria, B = Belgium, D = West Germany, E = Spain, F = France, GB = Great Britain, IRL = Ireland, J = Japan, N = Norway, NL = Netherlands, S = Sweden, SF = Finland, US = United States

is 0.75 for 1985 based on across-section of Organization for Economic Cooperation and Development (OECD) countries. At the time, duration of benefits was unlimited in the United Kingdom, Belgium, the Netherlands, Germany, and Spain, and two and one-half years in France, compared to twenty-one and one-half weeks in Switzerland, thirty weeks in Austria, and thirty-four weeks in the United States. These differences help to explain the differences in unemployment rates and the duration of unemployment in the EC compared to non-EC Europe and the United States.

Permanent unemployment benefits and taxes on labor income are not the whole story. They are only one of the contributions of the welfare state to unemployment.

Role of the welfare state

Three features of the welfare state are important for the steady-state unemployment rate. To have a significant effect on measured unemployment, benefits must be (1) comprehensive, (2) independent of the

amount of work performed, and **(3)** permanent or of long duration. Not all benefits are of this kind, so correlations of tax rates or transfer payments are not likely to be relevant or revealing.

At least since Burda's (1988) study, the duration of benefits has been recognized as important in the analysis of unemployment compensation. Bean's survey brings this work up to date. Duration of benefits explains part of the difference in measured unemployment rates within Europe or between the EC and the United States. Less attention has been paid to other aspects of the welfare state. Many studies of the response of unemployment to the welfare state concentrate on the effect of taxes. Taxes distort the individual's labor-leisure tradeoff and increase the measured unemployment rate. This effect is one of many distortions but, if benefits are not comprehensive and permanent, the effect appears to be relatively small.

Analysis of the effect of a negative income tax and in-kind benefits suggests why the permanent, comprehensive benefits of modern welfare states distort labor-leisure choices and increase measured unemployment rates (Meltzer and Richard, 1985). Decisions to work are less affected if benefits are not comprehensive. For example, giving food stamps, housing allowances, or other in-kind transfers reduces employment less than an equivalent payment of cash. Beneficiaries must work to purchase the goods and services not provided by the welfare state. A cash equivalent payment, therefore, reduces the incentive to work. The more comprehensive and durable the benefits, and the more they are independent of labor force participation, the larger is the reduction in employment. The extreme case is a cash transfer, or negative income tax, paid permanently as an entitlement. The effect is diluted if benefits can be sold, but housing allowances, health care, and education are difficult to sell.

The United States has housing allowances, food stamps, and some medical care, but cash payments for welfare recipients are small relative to the average wage, and unemployment benefits are not permanent. In countries with permanent unemployment benefits that are a large share of the average wage, the unemployed also receive a variety of in-kind transfers independent of their work history. Health care, housing allowances, and schooling for children supplement the