

# A Strategy for Employment and Growth: and the Failure of Statism Welfarism & Free Markets

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The success of the West's economic system in postwar decades destabilized communism in Eastern Europe and dispelled economic nationalism in parts of the Third World. Some success goes on amid the present challenges. The investment opportunities posed by globalization in the flows of goods and capital have not been lost on Western firms. The new information technology is creating vast opportunity for the right talents. Perhaps never before have so many people found their work as exciting as now.

Yet, not altogether coincidentally, the West's system has developed a malfunction. The reward offered a fifth or more of working-age people for their work is now critically deficient. In the U.K. and the U.S., pay has fallen far too low for the self-support of most low-end workers;<sup>1</sup> and since the "pay" of welfare, family support and crime has not fallen, many have dropped out or become too demoralized to be employable (at incentive pay rates). In parts of the Continent, reduced pay is barred by law, as in France, or by wage-setting bodies, as in Italy; but that has the further effect of barring from a job in the formal economy those low-end workers who would still have been employable.<sup>2</sup>

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<sup>1</sup> The U. S. Earned Income Tax Credit offers most low-paid workers a supplement to wages. But it pays little to those who are not single parents and it helps least in absolute terms the worst-paid. The U.K. Family Credit is similar in that and other ways. So the breakdown of self-support among these lss-favored workers has not been adressed.

<sup>2</sup> See Juan Dolado et al. (1996). As that paper suggests, many economies do not fit that description.

The worst victims of this severe decline of opportunity are the low-wage workers themselves. To earn one's own way – to meet a decent living standard, afford children, and share in community life – is essential to one's sense of self-worth. To know the satisfactions of employment – its challenges and learning experiences, and the personal development that comes with mastering jobs – is also one of life's basic goods.<sup>3</sup> Such dependency and removal from the economic mainstream means a loss of integration with society, which is another basic need.

The rest of society is damaged in turn. The idleness, deprivations and disaffection of the victims lead to health problems, drug trafficking and crime rates. Countercultures spring up that put violence over law, drugs over hard work, family over career, being over doing. As a result, public safety is endangered, the upbringing of children is threatened. And taxpayers must pay for the tax revenues not generated, the health bills not paid and the outlays for damage control – without thereby solving the problem.

The roots of the malfunction are structural, not monetary. In most nations it became noticeable by the late 1970s and stopped worsening only in the early 1990s, before the monetary contractions connected with Maastricht.<sup>4</sup> The evidence points to an embarrassment of structural forces at work. Some global forces have operated (through labor demand) to reduce the relative wage and raise

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<sup>3</sup> Youth unemployment is less serious if economic independence and self-realization are only deferred.

<sup>4</sup> Possibly most or all of the sharp increase of joblessness in the mid-1990s in some countries can be attributed to the tight-money policies needed to bring inflation rates within the Maastricht target and to the transition effects of the expenditure cutbacks aimed at reducing the budgetary deficit to the Maastricht limit.

unemployment among low-end workers: there is the increased costliness of training owing both to the rising use of high-tech methods of production and the elevation of world real interest rates since 1981; and energy costs still play a lingering role. In most countries there are one or more domestic forces operating (through incentive-wage considerations or labor demand) to push up unemployment: an increase in welfare benefits to a very high level, onerous regulations on hiring and firing, a rise in tax rates on labor, and a slowdown of productivity (which raises the cost of capital and makes private assets pile up relative to wage rates).<sup>5</sup> Sensitivity to these shocks tends to be greater in high-welfare countries, <sup>6</sup> though G7 data show a broadly similar rise of unemployment within the highest-unemployment education category.<sup>7</sup>

If the problem is structural rather than monetary, the solutions must also be structural, if such exist. And if the damage is as widespread as suggested above, a sweeping political bargain to fix the malfunction would seem attainable. The scale the problem has attained makes feasible a radical solution in place of the diffuse and marginal reforms that, correctly or not, have seemed largely ineffectual so far.

But at this point the West's politicians seem stymied by an absence of vision. To piece together the needed package of reforms, I believe, politicians will have to understand more deeply than now the model on which the West's system

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<sup>5</sup> By now there are several studies with some of these themes and a look at the evidence. But see for example Phelps (1994) and Phelps and Zoega (1998). On firing regulations see Koedijk and Kremers (1996).

<sup>6</sup> See Layard, Nickell and Jackman (1991).

<sup>7</sup> See Phelps and Zoega (1996) on unemployment by education. A fixed-weight index of unemployment rates also shows smaller differences across countries than the average unemployment rate .

was originally based: how its parts worked and how they can be refitted to regain their capabilities.

#### THE THEORY OF THE SYSTEM

The core of that model was invented by a mostly Scottish team – notably Smith, Hume and Ferguson – in the 18th century liberation movement called the Enlightenment. The model sought to release people's enterprising spirit and clear the way for broad prosperity.

The first element was free enterprise. Anyone was to be free to start a private business, investing out of his own or other's private capital - without having to buy a license or win a charter from the state. And free to close or downsize it just as fast -- without paying an indemnity. The Scots understood well enough that this freedom of enterprise would stimulate innovation and discipline misguided ventures, thus creating jobs and expanding the national income far better than the heavy hand of the state ever could.<sup>8</sup>

The other element in the model was a mechanism for inclusion – open markets. Of course Smith was known for his point that markets, if kept open to competition, would be good for efficiency.<sup>9</sup> But the Enlightenment theorists were philosophers as well as economists, and viewed markets accordingly. For them it was a moral axiom that running the economy on the principle of free

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<sup>8</sup> As is well known, the classical era was hobbled by its attachment to the subsistence theory of wages and thus productivity so it would be problematic to say that the Scots saw in free enterprise a mechanism for more rapid economic growth (in the sense of productivity growth).

<sup>9</sup> Smith felt that firms having to operate in a competitive environment would be driven to get their costs down more forcefully than if each one was a temporary monopolist waiting for some

enterprise would lack legitimacy if the system left many people out. The Scots saw the moral imperative of extending free enterprise to the largest number possible, stamping out privilege and democratizing opportunity. No bars against new entrants to shield vested interests. No bail-outs or subsidies to prop up unprofitable activities of the politically powerful. With a level playing field, competition would dislodge the entrenched and help enfranchise the disadvantaged.

*Free-market doctrine contrasted*

This model, call it competitive capitalism, is not at all the "free market" of recent decades. Free-market advocates view any intervention in the market as a step on a slippery slope to stifling state control. They want markets not just open – no breaks for vested interests. They want markets free of all subsidies, all regulations, most taxes.<sup>10</sup>

In contrast, the Scots advocated circumscribed government intervention to help enterprise and broaden opportunity. Adam Smith endorsed myriad government functions, including subsidies for private education. They understood that a limited government did not mean one that was not activist in any way.

Recent research findings back the Enlightenment view far more than free-market doctrine. Free enterprise is unique in encouraging radically new ideas and

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new entrant to capture the market.

<sup>10</sup> It may be wondered whether this doctrine is coherent. If one asks how the economy is to function without taxes, perhaps with the exception of a lump-sum tax, the answer that would presumably be given is that those taxes necessary for boosting income per head – for wealth creation in the current jargon – are justified and only those. However, the subsidies and other government measures required for a reasonably inclusive economic system could also be viewed as necessary for average well-being – for public safety and various other goods, some of which are measured and some not measured in income. But let us go on.

in weeding out the ideas and the companies that are not working. State enterprises (with exceptions) are constrained by political accountability from much innovation and are subverted into a tool to dispense patronage and serve interest groups.

Some statistical studies measure the potential of capitalism to propel growth. A comparison of 40-some nations shows that where private ownership is broader, productivity growth is greater on that account.<sup>11</sup> A survey of Eastern European shows that private enterprises perform better; if they face product-market competition, better yet.<sup>12</sup> A study of 11 European nations has linked slow productivity growth to heavy government regulation of businesses.

Furthermore, studies have not found productivity growth very sensitive to tax rates and subsidies. Evidently economic success does not hinge on meeting the austere requirements of free-market doctrine. But it does hinge on extensive free enterprise.

#### THE PERVERSITIES OF TODAY'S CONTINENTAL MODEL

For two decades now the Western system has been failing. But I would argue that the decline of inclusion, and even some of the slowdown in economic growth, results from the neglect and infidelity shown the core model – not from adherence to the model beyond its time. If the genius of the West's economic system was the core model of the Enlightenment – free enterprise to achieve growth plus markets conditioned for the broadest participation – and if the West's values today have

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<sup>11</sup> Palia and Phelps (1997).

not drifted so far as to render that model inapplicable, then it is clear that economic policy on the European Continent has been profoundly misguided.

Policy from the '70s onward has been a double blunder: First, there was the gamble to bypass private capital and crimp its prerogatives--to make layoffs difficult, to prop up inefficient firms, to interfere with decisions that should be made by private business and to expand public-sector jobs--in the mistaken hope that to disempower enterprise would shore up employment and inclusion.

Second, there has been a fear of intervening with employment subsidies, hiring subsidies and similarly intended de-tax initiatives that would serve as incentive devices to channel the power of the market toward rebuilding inclusion. The heavy resort in some countries to government training programs might seem to be a counterexample, as they might be supposed to function like disguised subsidies to the employers who will have access to the persons trained. But there is a big difference between governmental provision of training programs and subsidies to employers to defray the costs they face in providing the range of training they want their new employees to receive.

The results of all this could have been predicted. The assault on private capital in the 1970s and 1980s has been followed by a long decline of employment in the private sector. The *first* dozen years from the first oil shock in late 1973 to 1985 were a time when private-sector employment fell relative to the labor force in the U.S. and the U.K. as well; but the decline in private-sector employment continued over the *past* dozen years in much of the Continent,

including France and Italy. In fact it seems doubtful that we can credit the anti-capital policies with any net aggregative lift to either pay or jobs; the rapid hiring in the public sector over the 1980s in Italy, for example, may have staved off only temporarily the rise of unemployment that finally began to emerge in the early 1990s. And these policies have been followed by a continuation of the markedly slower productivity growth – the sharpest in the West – that set in during the 1970s.<sup>13</sup> Finally, the government training programs seem also to have failed to raise the pay rates of their enrollees and there is suspicion that they have done nothing to lower the natural rate of unemployment.

#### THE RIGHT STRATEGY FOR EUROPE

The right policy mix is the reverse. First, the Continent must liberate its enterprises. This means broadening privatization. It also means dropping disruptive restrictions on private capital. Then productivity growth will pick up. And employment will not suffer – just as the restrictions on enterprise did nothing to create employment. Indeed, there is evidence that where the penalty for firing workers is low, private business takes the risk of hiring more of them.

But let's not pretend that free enterprise alone will shrink unemployment on the Continent to the levels of the early 1970s, when it was 2½ per cent in France and 3½ in Italy, or even those of 1980, when it was 6½ per cent in France and 4½ per cent in Italy. Nor will it deliver in the "Anglo-Saxon" countries the

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<sup>13</sup> See the cross-section analysis in Koedijk and Kremers (1996). It is hard to estimate what could have been expected, but it is plausible total factor productivity has slowed down more on the Continent than can easily be explained by catch-up with the U.S. and Japan; the Continent might reasonably have been predicted to go ahead.



prompt lift to low-end pay and low-end jobs that is needed so badly there; its help will be gradual and moderate.

Hence another bold reform is needed to fix the system's malfunction. This step is a market-friendly intervention to redirect market forces toward helping to integrate low-end workers. The best tool for a comprehensive raise of low-end employment and pay is low-wage employment subsidies – continuing across-the-board tax credits to enterprises for their continued employment of low-wage workers. In my *Rewarding Work* published in 1997, where I make a book-length case for these subsidies, I explain how they would operate to pull up both wages and employment.

The logic of the above strategy is that subsidy programs administered by bureaucracies are utterly unpromising for creating productivity growth, but serviceable for boosting low-end jobs and pay. Free enterprise, on the other hand, brilliantly creates growth, but, by itself, few low-end jobs in the new Information Age. This is why mandating private firms to preserve jobs and deploying subsidies to try to buy some growth is a recipe for neither growth nor employment, while the strategy advocated here promises good growth and high employment.

There appear now to be two obstacles to adoption, which must somehow be overcome: the left and the right. Those on the left prefer more education or more training or almost anything else as long as it is operated by the public sector. The error here is the same top-down mistake of the statist Continental model. It will be necessary to persuade the left that the essential functions of government

are to operate the legislative, judicial, fiscal and subsidy machinery – but not to operate the economy.

To those on the right the perceived drawback is that an employment subsidy runs counter to free-market doctrine. This doctrine seems to have gained strength everywhere, though it is far stronger in some countries, especially the U.S. and Germany, than in others. Apparently free-market proponents have gained from a coalition with advocates of social insurance and social assistances. "We'll vote for your social-security pensions, your medical insurance, and the rest if you support us in opposing subsidies and regulation."<sup>14</sup> Where this coalition has triumphed, where welfare outlays explode but the free market reigns, the social effects have been devastating: cities in desperate need of subsidies from the center to provide a decent home for culture, sciences with insufficient subsidies to fund much basic research, and low-end workers without the subsidies needed to help enable them to participate in society's business and support themselves through their work. And these effects will worsen if the countercultures of dependency and nonparticipation draw still more people from the values of civic responsibility and self-help.

But the right ought to be able to see the defects of its virtues. My hope is that it will yet be possible to persuade the right that subsidies are one of the few things that a limited government ought to be limited to. The spirit of competitive capitalism is not threatened by a constructive market intervention where there is a

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<sup>14</sup> How else to understand the lopsided votes for most social-welfare legislation? In the U.S. the most recent example is the consensus for the \$500 a child tax credit.

clear and present need.

The policy choices before the West are much richer than understood. It need not accept - as the price of free enterprise - the narrowing in recent decades of the opportunities originally promised (and for a long time delivered) by competitive capitalism and confine the state to social assistance for those left out. And it need not - as the price of inclusion - take the socialist route, giving up on growth and accepting a swollen public sector to warehouse the disguised unemployed. It can refit competitive capitalism for renewed pursuit of growth and the broadest opportunity, thus renewing the Enlightenment vision of what the West might be.



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