

A comment on wage policy and the tradeoff between consumption and competitiveness in Europe

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This panel was asked several questions of which I will only address one: whether cutting wages to boost competitiveness or raising wages to boost consumption would lead to faster recovery. This is a dilemma that may probably never be fully resolved by empirical evidence, given the uncertainties of measurement and econometric analysis of macro-economic processes during a crisis. However - taking the advice we got from Christopher Pissarides in his lecture this morning - I would argue that this is one of those trade-offs that may be circumvented by turning to other policies.

In the short run, unemployment benefit and other welfare programmes can be used to increase consumption without jeopardising economic competitiveness. Wage setting then can be left to the market. In the long run, investment in human capital can improve the adaptability of European labour markets to fluctuations in the global economy and thus strengthen competitiveness without sacrificing consumption.

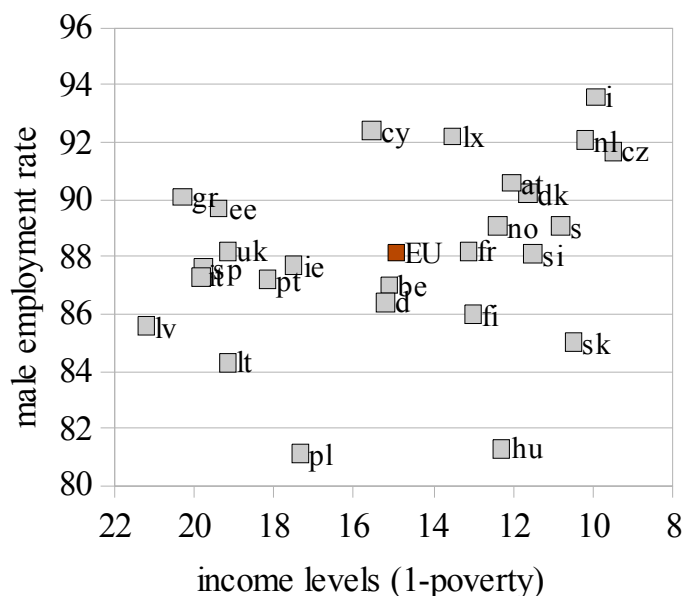
Neither of these solutions are new. Unemployment benefits have been long known and used as automatic stabilisers and more recently, life long learning has been promoted as an important part of governments' response to globalisation.¹ My argument here is not simply to use these tools, but that these are the areas that may yield efficiency gains for Europe. This is partly because welfare spending takes up a large part of public spending in Europe and partly because there is much variation in the efficiency of welfare and education systems across member states.

Spending more on welfare benefits and education obviously poses new challenges. Benefits are sustainable only if well targeted and their labour supply impact counterbalanced by well designed behavioural conditions. Spending on public education will only bear fruit if it reaches the most disadvantaged as well and develops the basic competencies children need in their adult life for coping with labour market change. Few countries in Europe have managed to meet both these challenges, but some have, which suggests that it is possible to circumvent the consumption-competitiveness tradeoff.

¹ Unemployment insurance benefits are well-targeted: they go to areas most hit by crisis, and the unemployed are also more likely to spend a high percentage of any additional income compared to wage earners. Auerbach and Feenberg (2000) show that the US unemployment benefit system is eight times as effective as the tax system in mitigating the impact of a recession on consumption. See also the recent federal extensions of state unemployment benefits in the US (Isaacs et al 2009).

As proposed by Sapir (2005), the employment rate is a crude but telling measure of the sustainability of a welfare system. Plotting the risk of poverty rate (as a measure of welfare provisions aimed at alleviating poverty) against the male employment rate in Figure 1 below we find considerable variation across the EU. Six member states (together with Iceland) managed to establish a generous but sustainable welfare system where poverty is lower and employment is higher than the EU average. Another six member states are close the EU average, while the others fall significantly behind on one or the other measure (three of them in both). The success of high achievers is relatively well documented and there are detailed EU and OECD guidelines to assist member states embarking on a reform to increase activation and flexibility while preserving security for job seekers.

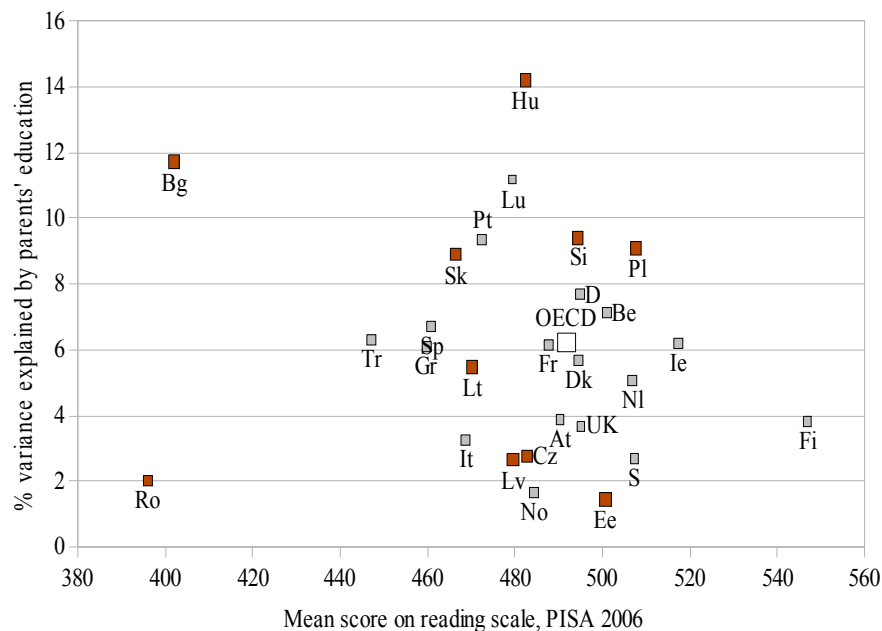
Figure 1 Efficiency and equity of European welfare systems



Source: Eurostat online database, 2007, LFS for the male employment rate and SILC for poverty levels

To improve the adaptive skills of the labour force would require not simply an increase of years spent in education, but a profound change in teaching methods, objectives and quality assurance (OECD 2004). However, Europe has been slow to take up this challenge. Figure 2 shows the performance of schools measured in two dimensions: the reading skills of 15 year olds and the ability to compensate for disadvantages in the students' family in the OECD PISA survey of 2006. Again, we see considerable variation across Europe and a large gap between exemplary Finland and the rest. The Netherlands and Sweden stand out as the two member states that feature above the average in all the dimensions of the above two figures. As with efficient welfare systems, the key elements of a successful education reform have been clearly identified (OECD 2004, McKinsey 2007). It is not so much the lack of sound policy advice but

the lack of political will that may impede reforms as potential gains from investment in education can be reaped only in the long run.



Source: OECD PISA 2006 database, tables T6.4.b and T6.1.c. 15 year olds.

The European Union may support its member states to improve their competitiveness on both of the above policy fronts in several ways. First, although the general directions are clear, there is a need for more research into precisely which policies work and in what conditions. The varied response of European governments to the recent global crisis (see table 1 below) in fact offers an opportunity to identify most efficient tools. Second, the EU may also help member states to improve the quality of policy making by providing fora for member states to share their experience, or directly supporting capacity building, especially in the new member states. Third, some reforms require substantial initial investments, to which the European Social Fund can provide partial funding. And finally, but not least importantly, pressure from the EU, however gentle, may ease some of the political constraints to reform that national governments – or their voters – are unmotivated or unable to tackle on their own.

To recapitulate my main arguments, I believe that there is great potential for improving Europe's competitiveness in reforming welfare systems. The consumption versus competition trade-off in wage policy can be circumvented by well designed welfare provisions – the challenge then is to improve the sustainability of welfare systems. The example of Holland or Sweden shows that this challenge can be met.

Table 1. Government response to the global crisis in the EU

	More than one measure	One measure	No measure
Training of employees and apprentices	Austria, Finland, France, Netherlands, UK	8 member states	Belgium, Czech Republic, Hungary, Italy, Luxemburg, Portugal
Income support	11 member states	Austria, Czech Republic, Italy, Slovakia	Denmark, Ireland, Luxemburg, Netherlands
Labour demand	12 member states	Austria, Denmark, Greece, Ireland, Italy, Netherlands, UK	–
Support job search and reemployment	14 member states	Belgium, Czech Republic, Slovakia	Hungary, Luxemburg

Source: Elek and Scharle (2010) based on OECD (2009), data for Jan-May 2009.

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