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SOME POLITICAL ASPECTS OF UNEMPLOYMENT

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ABSTRACT

Some Political Aspects of Unemployment*

We study a number of mechanisms through which an economy can be stuck at a high unemployment equilibrium because a poor labour market is associated with support for poor policy. These mechanisms are consistent with the relative scarcity of measures that have been undertaken to cure unemployment. The message of the paper is that curing the European unemployment problem is a difficult task because a lot of skill is required to avoid political pitfalls.

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Keywords: unemployment, labour market flexibility, political reform, firing costs, protection, fiscal conservatism, exclusion

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NON-TECHNICAL SUMMARY

On 1 March 1994 the French labour unions and left-wing parties called for mass mobilization against a government project to lower the minimum wage for young workers. The project was aimed at reducing unemployment for the young which currently stands at a level of some 25%. The cautious, two-tier approach to this reform was designed to protect the interests of those already employed. Yet this reform is facing considerable hostility from trade unions and left-wing parties which, despite having lost most of their support in the 1980s and 1990s respectively, have found in the reform an opportunity to restore their cohesion and rebuild their political support among the work-force.

The episode is illustrative that political considerations are an important explanatory factor for the level and persistence of European unemployment. Political constraints, rather than technical obstacles or uncertainty about the outcome explain why little has been done to fight unemployment despite its magnitude. The rigidities that plague European labour markets are often blamed for unemployment. It is often argued that these rigidities are motivated by a greater emphasis on equity, social insurance and protection of individuals in European societies. An alternative view, however, is that they simply benefit politically powerful groups and organized interests at the expense of the rest of society.

This paper is concerned with studying how 'politico-economic complementarities' may lead to a vicious circle of high unemployment and perverse decision making. The term 'politico-economic complementarity' is used to mean an economic situation which leads voters and lobbyists to political (non-) decisions likely to reinforce that situation. More concretely, I focus on three examples that I believe are relevant mechanisms to explain the level of European unemployment.

In the first example, analysed in more detail in Saint-Paul (1993) the labour market is characterized by high firing costs. The government tries to change this situation by lowering firing costs. This will tend to increase firings but also increase hirings, thus making the unemployed better-off. If the reform is well designed it may also benefit the employed. It can be shown that this is more likely to happen if the employed are highly exposed to unemployment. But if firing costs are very high, this will not be the case so that reform is impossible. Low turnover in the labour market (an economic variable) leads to no support for lowering firing costs (a political decision), thus ensuring that turnover will be low.

In the second example, the long-term unemployed can invest resources to find a new job. The more resources they invest, the higher their probability of finding a job. To finance these expenses, they cannot borrow, for obvious moral hazard reasons, against their future income. Cash transfers may therefore reduce

unemployment by allowing them to search harder. But when unemployment is higher, these transfers are likely to be lower. This is for two reasons: the tax base shrinks, and, more interestingly, the tax rate itself may shrink because a larger underclass leads the median voter to more fiscal conservatism in so far as he is not a member of this underclass.

In the third example, high unemployment lowers the probability for workers in declining industries to find a job in a new sector. As a result there will be more incentives to vote or lobby for subsidies for the industry. In general equilibrium these subsidies for declining industries put a drain on new sectors, thus lowering labour demand and increasing unemployment.

SOME POLITICAL ASPECTS OF UNEMPLOYMENT

Gilles Saint-Paul[1]

CERAS, DELTA, et CEPR

1. Introduction

On March 1 1994 the French labor unions and left-wing parties called for mass mobilization against a government project to lower the minimum wage for young workers. The project was aimed at reducing unemployment for the youth which currently stands at a level of some 25 %. The cautious, two-tier approach to this reform was designed to protect the interest of those already employed. Yet this reform is facing considerable hostility from trade unions and left-wing parties which, despite having lost most of their support in the eighties and nineties respectively, have found in that reform an opportunity to restore their cohesion and rebuild their political support among the work force.

The episode is illustrative that political considerations are an important explanatory factor for the level and persistence of European unemployment. Political constraints, rather than technical obstacles or uncertainty about the outcome, explain why little has been done to fight unemployment despite its magnitude. The rigidities that plague European labor markets are often blamed for unemployment; it is often argued that these rigidities are motivated by a greater emphasis on equity, social insurance and protection of individuals in European societies. An

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alternative view, however, is that they simply benefit politically powerful groups and organized interests at the expense of the rest of society.[2]

This paper is interested in studying how "politico-economic complementarities" may lead to a vicious circle of high unemployment and perverse decision making. By "politico-economic complementarity" I mean an economic situation which leads voters and lobbyers to political (non-) decisions likely to reinforce that situation.

More concretely, I focus on three examples that I believe are relevant mechanisms to explain European unemployment.

In the first example, analyzed in more detail in Saint-Paul (1993) the labor market is characterized by high firing costs. The government tries to change this situation by lowering firing costs. This will tend to increase firings but also hirings, thus making the unemployed better-off. If the reform is well designed it may also benefit the employed. It can be shown that this is more likely to happen if the employed are highly exposed to unemployment. But if firing costs are very high, this will not be the case so that reform is impossible. Low turnover in the labor market (an economic variable) leads to no support for lowering firing costs (a political decision), thus ensuring that turnover will be low indeed.

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[2] This view is developed in Saint-Paul (1994a).

to be lower. This for two reasons: the tax base shrinks, and, more interestingly, the tax rate itself may shrink because a larger underclass leads the median voter to more fiscal conservatism insofar as he is not a member of this underclass.

In the third example, high unemployment lowers the probability for workers in declining industries to find a job in a new sector. As a result there will be more incentives to vote or lobby for subsidies to the industry. In general equilibrium these subsidies to declining industries put a drain on new sectors, thus lowering labor demand and increasing unemployment.

2. The Political Economy of labor market flexibility

Increasing "labor market flexibility" is typically presented as the panacea for curing unemployment. For example, one should reduce firing costs. Yet the steps that have been taken in that direction are modest. This is not that surprising, since firing costs (and other kinds of rigidities) presumably benefit the employed by lowering their probability of losing their job and increasing their bargaining power in wage determination. Since the employed, even at high unemployment rates, are much more numerous than the unemployed, it is evident that policy is determined by the interests of the employed rather than those of the unemployed.

Does this mean that increasing labor market flexibility is impossible ? Fortunately not. It is possible to get out of this dilemma by liberalizing *at the margin*. For example one can specify that employers will be able to hire new workers under more flexible terms than existing labor contracts. Indeed, it is mostly under these two-tier, marginal schemes that some progress has been made in increasing the flexibility of

European labor markets. One spectacular example is the introduction of determined duration contracts (DDC) in Spain, after which 95 % of new hires were under (DDC). These contracts exist in other European countries, but have been less of a success. Lowering the minimum wage for the young, as discussed in the introduction, is another example of two-tier, marginal liberalization.

The attractive aspect of the two-tier system is that it can generate *consensus* over the reform between the employed and the unemployed. The unemployed like it to the extent that it increases the likelihood that they find a job. The employed like it because it does not increase their exposure to unemployment (since they keep their old contracts), but know that in the event of losing their jobs, they will gain from a higher probability of finding a new job.

One can already see, however, that it is only because of their exposure to unemployment that the employed will support it. The lower their probability of ending unemployed, the less they gain from the change. This would not be too much of a problem, however, if the government could commit on the path of policy following the reform. Even though those employed at the time of the reform would gain very little, they would not lose if one could guarantee that no attempt will be made at further reform in the future. The rigid sector would then gradually disappear as "rigid workers" get retired or change jobs, to be replaced by the emerging flexible sector.

The problem is that in the absence of a commitment device for future policy, the emergence of the flexible sector will affect the balance of power for future decision making. Flexible workers do not have a vested interest in maintaining rigid workers' privileges. They probably lose from these privileges to the extent that (i) enforcing labor market regulation is costly to the tax payer and (ii) they expect to be preferentially fired if they co-exist with rigid workers within the same firm. As the flexible sector develops, the political support for a complete reform of the labor market will increase. After some critical time t^* the government will be able to implement a full reform of the labor market by relying on a coalition of flexible workers and unemployed people.

Those who hold rigid contracts will of course recognize that when asked to vote for a two-tier system. The reform now entails not only benefits for them, but also costs. The costs now come from the fact that rigid contracts will be converted into flexible ones after $t=t^*$ As argued above, if their jobs are very well protected, they benefit very little from the reform, since it is unlikely that they will experience unemployment in the future. If the employed have little initial exposure to unemployment then there may be no two-tier reform such that the benefits outweigh the costs.

This generates a situation of politico-economic complementarity. If the labor market is very rigid to start with, there will be very little support for the reform, and the economy will be locked in a trap where reducing firing costs is politically impossible, even through a two-tier system. If rigidity is not too big, then there will be more support for the reform and further increases in flexibility are politically viable.

3. The Political Economy of Exclusion and Fiscal Conservatism

Let us now turn to the second example. One of the most fascinating trends in the eighties and nineties is the general rise in inequality in almost all major industrialized countries. At the same time, there has been a rise in fiscal conservatism in the sense that most countries have engaged in programs of deficit and expenditure revisions, often at the expense of redistribution in favour of the poor and disenfranchised. A concern has risen about the emergence of a two-tier society and the associated potential conflicts.

The joint development of inequality and fiscal conservatism is somewhat of a puzzle for economic theory. The general view among economists is that an increase in inequality is associated with more redistributive taxation.[3] This is based on the following line of reasoning: (i) voting theory suggests that the tax rate will be higher when the median voter is poorer relative to the mean; (ii) in most countries, income distribution is skewed to the right, so that the median voter is poorer than the mean; (iii) when inequality increases the median income is therefore likely to fall relative to the mean. Hence one should expect a higher tax rate.

However, the third part of this argument is not that general. The fact that the median is poorer than the mean does not imply that it will get farther from the mean for any mean preserving spread in the distribution of income. Indeed, if the increase in inequality is due to a larger share of the underclass, or more generally if it is due to an impoverishment of the *bottom* of income distribution, it is quite possible that the median will get *closer* to the mean and vote for a lower tax rate.[4] That is, the rise of the underclass will tend to lower aggregate income, but it hardly lowers median income provided the median voter is not, or does not expect to become, a member of the underclass.[5]

This theory is therefore able, in principle, to explain why the rise

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[3] This view is, for example, exemplified in Persson and Tabellini (1994) or Alesina and Rodrik (1991).

[4] This is recognized by Perotti (1993), who does not however derive the dynamic implications of this observation.

[5] A formal analysis of this argument is developed in Saint-Paul (1994b).

in inequality has been accompanied by more, rather than less fiscal conservatism. As far as the evidence is concerned, it is not quite true that the median/mean ratio has increased. It is however true that it has fallen much less than, say, the share of the bottom quintile. Furthermore, the appropriate notion of the median/mean ratio which is relevant for the political equilibrium is highly dependent on the tax structure. By "mean" we do not necessarily mean per capita income but some *non-linear* aggregate of individual incomes, where the non-linearity is linked to the progressivity of taxes and transfers.[6] Given that transfers are highly progressive, it is likely that the aggregate will give a much heavier weight to poor incomes than will GDP per capita. The rise of the underclass is likely to generate a fall in this aggregate relative to the median income, thus generating more fiscal conservatism.

Is fiscal conservatism associated with a politico-economic complementarity? That is, would fiscal conservatism lead to a expansion or a shrinkage of the underclass ? In the first case there are politico-economic complementarities. Fiscal conservatism and exclusion reinforce each other; multiple long-run steady states may co-exist. In the second case fiscal conservatism and exclusion are mutually defeating and the economy will converge to a unique, stable steady state.

The answer to that question crucially depends on the functioning of financial markets. Assume the poor can invest resources into activities (job search, human capital accumulation) that increase their chances of

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[6] If the tax rate is flat and transfers are lump-sum, the tax rate preferred by the median voter will be an decreasing function of the median income/mean income ratio. If taxes are progressive, then the mean income has to be replaced with some aggregate which gives a higher weight to high incomes. If transfers are progressive in the sense that they sharply decline with income, then the mean income has to be replaced with an aggregate which gives more weight to low incomes. Given that transfers are more progressive than taxes, the latter effect is likely to dominate.

taking off. Fiscal conservatism then increases the return to that investment. One could therefore expect it to lead to a reduction in the underclass, which in turn will lead to less conservatism in the future...until the economy converges to a steady state. However, one should keep in mind that this logic will only prevail if the poor are not preventeded from borrowing in order to finance their investment. If imperfections in financial markets impose liquidity constraints on them, then their investment in search or training is bounded by their current income, implying that lower transfers will lead to less, rather than more investment. The economy then ends in a vicious circle with more poor generating more conservatism, and vice-versa. A transitory shock such as a recession, a war or an oil shock may shift the economy from a redistributive/egalitarian situation to a conservative/unequal situation.

To what extent can we rely on this argument to explain European unemployment? At face value, it is suggestive that the European care for equity and redistribution may actually be good for employment by allowing the unemployed to use their benefits to fund their search activity. If this is true, one should expect that all else equal, countries with more generous unemployment benefits will have less unemployment. Unfortunately, if there is one variable which is robust in explaining unemployment and its persistence in a cross-section of countries it is precisely the level and duration of unemployment compensation.[7] In that respect, the model is not that relevant because job search is not a very cash-intensive activity.

On the other hand, whenever getting out of long-term unemployment is associated with an investment in retraining or relocation, fiscal

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[7] See Layard et al. (1989)

conservatism may be a serious obstacle. This may be particularly relevant if (as in England for example) unemployment is concentrated in depressed regions and/or sectors. In that case the complementarity between exclusion and conservatism may raise a concern for the prospects for building a political support to reduce this form of unemployment.

4. The Political Economy of Unemployment and Subsidies to Declining Industries.

The last example we shall consider is based on the following idea: in a society with low job creation there will be more political support for subsidies to declining industries because the alternative - relocating labor to new industries - looks bleak (a similar argument would apply for other forms of job protection such as firing costs). To the extent that these subsidies generate inefficiencies - e.g if they are financed by taxes on the new productive sectors - they will have an adverse impact on labor demand and therefore validate the low rate of job creation. This is again an example of politico-economic complementarities, which may lead to the coexistence of a low turnover/high subsidy equilibrium and a high turnover/low subsidy equilibrium. Unemployment may, but need not be higher in the former equilibrium, since both job creation and job destruction are higher.[8]

Under what assumptions is this intuition valid ? Let us assume that the job reallocation process takes place according to a matching function (see Pissarides (1990)) $h = m(u,v)$ where h is the hiring flow, u unemployment and v vacancies. Assume that each sector is either in a productive state or a declining state. We shall consider two alternative

[8] This is formalized in Saint-Paul (1994c).

political systems. In the first case, people vote on a subsidy rate for all declining sectors. The subsidy is financed, say, by a flat tax rate on the income of productive sectors. In the second case, each declining sector lobbies individually for subsidies by putting resources into the production function for rent-seeking (See Becker (1980)).

Let us start from the case where people vote on the subsidy rate and there are constant returns to the matching function. In that case, people will internalize the effects of subsidies on labor demand when deciding what to vote for. Furthermore, because of constant returns in the matching function, the initial stock of unemployment will have no effect on the equilibrium probability of finding a job (See Pissarides (1990)). Therefore, there will be a single equilibrium subsidy rate which will be independent of the initial level of unemployment. In that case there are no politico-economic complementarities.

Let us now consider the case where people vote, but there are congestion effects in the labor market, i.e. decreasing returns in the matching function. Then a higher initial unemployment rate will be associated with a lower rate of job finding. This will lead voter to support a higher subsidy rate, which will further lower labor demand and the job finding rate. Although there will not be a coordination failure, there will be politico-economic complementarities.

What happens now if instead of being determined by voting, the subsidy rate is determined by lobbying ? This introduces a coordination failure which reinforces complementarities. If I expect other sectors to invest heavily in lobbying for subsidies, I expect labor demand to be low tomorrow. The resulting low rate of job finding will induce me to devote more resources to get subsidies for myself.

5. Conclusion

We have studied a number of mechanisms through which an economy can be stuck at a high unemployment equilibrium because a poor labor market is associated with support for poor policy. These mechanisms are consistent with the scarcity of measures that have been undertaken to cure unemployment. The message of the paper is that curing the European unemployment problem is a difficult task because a lot of skills are required to avoid political pitfalls.

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