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GROWTH AND EMPLOYMENT IN THE EUROPEAN PERSPECTIVE

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The Western European debt deflation, which induced a severe reecession in 1992–93, is now giving way to a recovery for which both external and internal conditions appear favorable. The question remains, however, to know whether macroeconomic instability is not going to be more and more pronounced in the future. Faced with persistent unemployment, Western European countries ought not only to reduce rigidities in their economies but also to consider two medium-term policy proposals that were recently studied: a substantial selective decrease in the cost of unskilled labor and ambitious public investment programmes. The paper ends with a brief discussion of long-run challenges: the welfare state, European unification, the conditions for non-inflationary wage formation. (JEL J23, E32, E50, E60)

1. Introduction

Finland is not alone among the advanced market economies to have experienced the economic, social and psychological shock of an unforeseen depression in the early 1990s, although her experience has been, and still is, particularly severe. Even if we limit attention to Western Europe where unemployment is the main problem since almost two decades, the last three years challenge academic research as well as policy making. What has happened was not expected and is not yet so well understood. What should be done is very seriously debated, with fundamental disagreements between those concerned.

One aspect of the early 1990s, namely the end of the Nordic exception in Europe, will not be the main focus of attention in this paper, since it will be more competently discussed by other participants to the symposium. Neither shall I speculate about the economic revival in Central and Eastern Europe; my competence is too limited for me to do so. The concern will rather be the interruption of employment growth in the European Union, while there was still so much unemployment and while the medecine proposed to cure it had been accepted and, by and large, applied. It will belong to others to say by how much this failure of the economy of the Union affected Nordic countries, Finland in particular. But clearly the future in this part of the world will much depend on what will happen South West; similarly, the debate on the policy options at the OECD or in Brussels is relevant here.

Before we discuss the Western European policy reactions (part 3), we must diagnose which new trends matter for our region (part 2).

2. *New trends in the European economy*

Recovery of the world economy is under way. But it would be irresponsible to forget what recently happened and to neglect improving on our understanding of the 1992 recession, since it may contain significant lessons for the future. The last depression was not only a normal business cycle manifestation, since it was aggravated by private indebtedness, by burst of a bubble of asset overvaluation, by disorder in the currencies exchange markets and by inappropriate macroeconomic policies. The short-term prospects are rather good because most of these aggravating causes disappeared or were much weakened. But from a longer-term viewpoint it is disturbing to acknowledge that the world economy may be for long exposed to more instability than used to be the case, and that the still imperfectly understood structural employment problems of Western Europe remain.

2.1 The last depression

Over the four-year boom of the late 80's employment increased at the unprecedented annual growth rate of 1.4 percent in the EU, the rate of unemployment decreasing from 10.7 % in 1986 to 8.3 % in 1990. Unfortunately, by the end of 1989 one had to record an acceleration of inflation in every one of the twelve member countries. In order to check it, monetary authorities took restrictive measures raising nominal short-term interest rates.

The resulting slow-down in activity, also induced by the recession in the rest of the world, was first interpreted as likely to be temporary, so that a non-inflationary growth would soon resume. But this expectation did not take a proper account of perdurable troubles on the financial front. By the summer and fall of 1992, when activity sharply decreased, one had to realize that the recession had features of the »debt deflation» studied by Irving Fisher during the Great Depression and again last year by M. King in his European Economic Association Presidential Address given at Helsinki.

In 1992 businessmen and households had to revise their expectations: upward for real interest rates, downward for activity and real income. Debts, which had been increasing in previous years, were then perceived to have a large cost. The desired debt/capital and debt/income ratios were sharply reduced by this change in expectations. In order to put actual ratios in line with their desired values, private agents had to increase their savings and to delay their investments; many businessmen had to stop hirings.

Concern about indebtedness had affected for a decade a number of non-financial firms with only a temporary break at the end of the 80's when future prospects looked bright. Recently such a situation concerned still more financial institutions, which had earlier been protected by large capital gains, but were recording losses due to sudden sharp decreases in real estate prices. The normal reaction was a more restrained credit supply, which contributed to maintaining high interest rates and tightening credit rationing.

The high level of real interest rates had also to do with the large demand for funds to finance public-sector deficits, which had not been reduced enough during the boom years and had even increased in some countries. It had to do with the tensions on currencies exchange markets where clearly overvalued moneis, and even some others, were attacked until their devaluation. It then had to do with the resulting volatility of floating exchange rates, which implied large risk premia. It finally had to do with the policy of the Bundesbank, which long maintained a strict line, notwithstanding the force of the depression.

The Western European debt deflation had many points in common with the recession that occurred a few years earlier in the US: the burst of a speculative bubble, the difficulties of financial institutions, the credit crunch. The timing and severity of the depression was not exactly the same in various European countries. Part of the explanation is probably to be found in the dates of financial deregulation that opened new credit facilities, in particular to households: this meant a transitory shock to consumption demand as household debt was building up, but this impact had to come to an end. There was also, as is well realized in Finland, a different exposure to the disruption of activity in Eastern Europe.

2.2 *Short term prospects*

In this summer 1994, after two very difficult years for Western Europe, future prospects look definitely brighter than one dared to hope a year ago. Both external and internal conditions appear favorable.

In the US a sustained growth is under way, with hardly any visible inflationary pressure. The Japanese economy can resume only slow growth because in particular of a steady loss of price competitiveness, which will eventually lead to more sustainable real parities but in the mean time depresses demand. However, Western European exports have more to gain from a better competitiveness with respect to Japanese products than to loose from the sluggishness of markets in Japan.

The European macroeconomic policy mix is now being revised, with more reasonable monetary and fiscal policies. The short-term interest rates are today about neutral. Budgetary policies, which were neutral or expansionary in 1993, are now becoming more restrictive so as to stabilize in the medium run the ratios of public debt to GDP. Optimists can expect that these policies will accordingly be found credible by the financial markets, so that long-term interest rates will slightly decrease.

By the end of 1994 European business profitability should be restored. It deteriorated in 1993 much less than the force of the depression should have implied: quick adjustment of employment to output, decrease in prices of equipment goods and in long-term interest rates contributed to protect business conditions. Now, as output is growing again and risk premia are likely to be revised downward, the financial situation of most firms will appear more and more favorable.

All the more so as indebtedness of households and enterprises was stabilized or even decreased from 1990 on. Debt deflation operated as intended, with in particular an abnormal contracyclical evolution of household saving rates, which explained the duration and force of the slowdown but also solved some of the financial problems.

2.3 *A renewed instability?*

Whereas growth had been remarkably steady in Europe during the first decades after the war, business fluctuations became more important since the 70's. After a particularly strong depression one cannot but wonder whether macroeconomic instability is not going to be more and more pronounced in the future.

Those asking the question refer first and foremost to the new conditions created by the liberalization, extension and international globalization of financial markets. Should the characteristics of the last depression be considered as resulting from fairly exceptional circumstances or from the normal operation of an economy in which these markets play a large role?

The question is more easily posed than answered. One finds it difficult to exhibit convincing factual evidence because the international financial system has quite new features. To draw conclusion from past evolutions one must accept a framework of interpretation, that is, one must rely on theories about the functioning of the market system. But, whereas one has rather precise theories about the regular equilibria that can obtain within such a system, the study of properties out of equilibrium remains quite uncertain; even the formalization is debatable. The difficulty *a fortiori* applies if one pretends to rely only on abstract reasoning for finding an answer.

Bubbles in asset pricing have been observed in the past; but that does not say whether their frequency of occurrence will increase. Formal models exist and show how a sequence of temporary equilibria with rational expectations could lead to such bubbles; but these models are reduced to such bare essentials as to have little significance for many economists; in any case they do not seem to be appropriate for finding out which market institutions are most likely to lead to perverse evolutions.

Speaking in more general terms, one may say that the old question of the stability or instability of the capitalist economy has never been answered, except by very heuristic arguments, which were hardly more than acts of faith.

If the discussion has to remain heuristic for lack of a better alternative, one may perhaps come closer to facts by saying that the increasing role, generality and sophistication of financial markets amounts to giving more possibilities and flexibilities to real economic operations. One then understands how efficiency is likely to be so increased, but is stability likely to be also improved?

Some may argue that overshooting is a typical reaction in a competitive economy out of equilibrium, because too many agents, using too large own or borrowed funds, are eager to seize profitable opportunities as soon as they are clearly revealed, and because prices do not react enough to the consequences of yet uncompleted projects. If more flexibility means more overshooting, it should also mean more instability.

2.4 Persistent unemployment

The unemployment rate of the European Community had peaked at close to 11 percent in 1985, with wide intercountry differences (Germany 7, Spain 22). It declined to a minimum of 8.3 percent in 1990. It was then equal to 4.8 percent in Western Germany and to 7.0 percent in the UK. In these two countries in particular, tensions were then apparent, even in labor markets, and labor costs sharply increased. But unemployment was still high in Mediterranean countries with a rate of 9.0 in France, 10.0 in Italy and 16.1 in Spain; nevertheless in these countries also wage inflation was accelerating. For 1994 the EU unemployment rate is projected to amount to 11.2 percent, a little more than in 1985 (with rates varying from 8 in Germany to 22 in Spain). Even if one doubts that irrefragable forces cause an increasing trend in Western European unemployment, one must also recognize its persistence. The European excess labor supply drags a backlog that accumulated over the last two decades and that most of our countries did not manage to resorb enough during favorable periods.

The situation contrasts with that of the US and this deserves some attention. Since twenty years American unemployment fluctuates with the business cycle, but with no significant upward trend. On the contrary European countries seem to be increasingly unable to employ their full labor supply. Comparing the peak years 1972, 1979 and 1989 one sees just about the same level for the US unemployment rate (between 5 and 6 percent), but an increase of first 2.6, second 3.5 percent for the EC rate (9 percent in 1989). The difference appeared in the early seventies, when the world economy experienced a strong slowdown of the previously prevailing growth. In the US, the ratio of output to employment practically stopped moving for some years and later resumed a moderate increase (some 1 percent per year). In Western Europe, the upward trend of the same productivity ratio declined, but quite gradually, with an average annual drift of still 1.8 percent between 1979 and 1989. During the last few years the difference between the two sides of the Atlantic, as for the trend of this output/employment ratio, seems to have slightly decreased, but that may be due to a different phasing of the business cycle.

The poor performances of EC countries during the last two decades were studied many times, notably from the employment viewpoint. Particular reference may be given here to the European Unemployment Program, which covered the period up to 1986 (Drèze and Bean, 1990). This work devoted special attention to labor market rigidities, to which we shall turn in the second part of this paper. For the time being let us consider the loss of competitiveness, which resulted in a too slow output growth.

In 1987 at the beginning of rapid expansion it seemed that the European Community had restored its competitiveness after an important earlier deterioration, with even a large German foreign current surplus. But this account of the facts was misleading. It was based on the level and evolution of the current balance of payment surplus, which had reached 1 percent of GDP. It was then overlooking two facts. First, in the middle 80's European domestic demand had been depressed by the restrictive stance of macroeconomic policies. Second, improvement in the foreign surplus after 1985 was due to the initial impact of parity changes, in particular to the sharp devaluation of the dollar and to the resulting favorable effect on European terms of trade. But this impact had to be followed by unfavorable effects on market shares. Indeed, the share in the manufactured goods market (expressed in volume), which had hardly increased during the years of the strong dollar, quickly decreased from 1985 to 1988. Up to 1991, the fundamentals of European competitiveness, in particular labor costs corrected for parity changes, kept deteriorating in most countries.

Policies of competitive disinflation, devaluations of European currencies in the fall of 1992 and the progressive appreciation of the yen later led to an improvement in price competitiveness. Non-price competitiveness is more difficult to gauge. One may, however, diagnose from scattered indices that it improved as a result of the boom in industrial investment in the late 80's. The recent resistance of business profitability is a sign that European enterprises are likely to keep making determined efforts to take positions on markets abroad.

3. Policy guidelines

Two recent official documents directly concern the policies Western Europe should now follow. In december 1993 the European Commission published a White book on »Growth, competitivity, employment». In the spring 1994, OECD published a »Job Study», that had been requested by ministers in may 1992. Although the tones and some of the proposals somewhat differ, both documents agree in identifying the main source of deficiency : uneven and imperfect adaptation to change. Hence, both place a large emphasis in the restoration of flexibility. This is why it is proper here to start with the above guide-line, to recognize its validity, but also to suggest that it does not suffice. The following section will present two medium-term policy proposals. The paper will end with discussion of two long-term challenges.

3.1 Flexibity

In modern economies labor market institutions are notoriously complex to describe, since they involve (i) laws and regulations, (ii) formal agreements between employers and employees, often at the level of an industry or a nation, (iii) implicit norms of behavior that were built through time. For the present purpose a still wider definition is advisable, so as to cover the role of other institutions, concerning for instance housing, and also social barriers, such as the diversity of cultures and languages. All these institutions have effects on flexibilities or rigidities in the utilization of labor resources. The list would still be longer if we should consider all the adaptations that matter for competitiveness.

Unfortunately, our understanding of how the performance of a market economy depends on each dimension of flexibility is still quite low, after many years during which the subject was discussed. The results of some fairly precise but partial studies are available. Their general conclusion is that *the role of rigidities should not be overrated*: the effects, whose presence is assumed, are commonly found to be weak; even in some cases the direction of the effect is uncertain.

In other words, when we come to consider policy guidelines, we cannot hope that remedies intended to restore flexibility will automatically make other types of action useless. With this remark in mind, one is disturbed by the implications to be drawn of the two official documents. The White Book refuses »la fuite en avant économique» (literally »the economic forward escape», a clear reference to a policy of macroeconomic stimulation). For OECD macroeconomic regulation is not completely ruled out but *de facto* plaid down. However, the two documents were written while Western Europe was experiencing its deepest depression since the war and while it was becoming obvious that the lag in adapting monetary policies to the downturn seriously contributed to the evil.

In this summer 1994 one can only deplore that a manifest opportunity for safe macroeconomic regulation was so missed two years ago. But, since the present outlook is brighter, we may go back to what we know about some important rigidities on the Western European labor market.

The rules of *unemployment compensation* have been found to play some limited role on the level of unemployment and simultaneously, in the reverse direction, on the number of people being out of the labor force; but they seem to have very little or no direct role on the level of employment (OECD, 1993) (some indirect role seems to exist through the impact of the generosity of unemployment compensation on wage formation, particularly at the lower end of the wage scale; but I prefer to consider it separately). The fact is particularly significant for long-term unemployed, which are much fewer in the US than in Western Europe. Since many of these European unemployed would appear to be out of the labor force in the US (in a kind of »disguised unemployment»), there is a small bias on this account in the transatlantic comparison of unemployment rates.

Systems of unemployment compensation vary very much from one country to another, particularly so within the European Union. Moreover a synthetic measure of the degree of compensation is hard to define because systems vary in a number of respects: length of the work period required for entitlement to benefits, income replacement ratio, length of the period during which unemployment compensation is obtained, importance of side benefits granted to unemployed, severity of administrative controls on the exact employment status of beneficiaries. However, documentation gathered at OECD and calculations made there show that generosity varies a great deal, being higher on average in the EU than in the US, but also low in Greece, Italy and Portugal, and high in Belgium, France, Germany and the Netherlands. During the 80's there was a tendency to decrease the degree of compensation in some countries, particularly so in the UK, with a corresponding decline there in the number of long term unemployed, a decline also due to special efforts for offering jobs to these people.

Labor regulations that make lay-offs and disbandings costly have been much discussed on the public scene and in economic theory (with somewhat ambiguous conclusions for the latter). They have also been somewhat relaxed in the 80's, at least indirectly: the fast increase in the number of temporary jobs was tolerated, whereas regulations had at first aimed at preventing it. Intercountry differences are quite difficult to assess and, in any case, much less clear-cut than is sometimes claimed (disbandings are not easy and costless in the US; they are quite frequent and concern large numbers of workers for instance in France).

Perhaps still more important than any recent change in regulations, is the *change in public attitudes* as to what an employer must do in case of misfortune: rescuing the firm is now often seen as a better policy than trying to keep employees at all costs. These changes seem to translate into a faster adaptation of employment to fluctuations in output than was the case twenty years ago. I do not know of any econometric study that would have been made for the EC in order to test this idea. But simply looking at the aggregate time series suggests that adaptation of employment to downturns in output are now more speedy and that labor hoarding has decreased. For the EC as a whole, the respective decreases, in the percentage rate of growth of output and employment, were 7.2 and 2.7 from 1973 to 1975, 3.4 and 2.1 from 1979 to 1981, but 3.6 and 3.3 from 1990 to 1993.

A well recognized difficulty of the European adaptation to the change that occurred in the world economy around 1973 was *the behavior of real wage rates,* which tended to go on along the previous increasing trend. This was known as »The European wage gap». The nature of the phenomenon was well identified in the European Unemployment Program when data of two to three decades up to 1986 were analyzed. It appeared that, in Europe as against what happened in the US, measured productivity gains were incorporated quite rapidly in real wages; more generally real wages appeared to be particularly rigid (see also OECD, 1993). This made European economies particularly sensitive to inflation when their terms of trade deteriorated. This also led to a deep fall in profit rates, which threatened solvency of most firms and induced them to cut on their programs.

However, after the depression of the early eighties, wage settlements have been definitely more moderate. This was of course due in large part to the Phillips phenomenon, which seems to have been about as strong in Europe as in the US. But also restrictive income policies played some role and other factors that had been responsible for the wage gap appear to have weakened (indexation, union militancy, ...). So profit rates are now less depressed than ten years ago (the value of the profitability index, which had much improved from 1983 to 1989, hardly decreased up to 1992). The rigidity of the average real wage rate seems to have somewhat decreased.

On the other hand a serious problem remains because, in continental Western Europe but not in the English speaking countries, the structure of relative wages remains rigid, notwithstanding an increasing mismatch. The dispersion of wages much grew in the US during the 80's, to such an extent that unskilled workers experienced a substantial decrease in their real wages. In most European countries the wage scale was much more rigid. As was mentioned above, this may be explained by various factors, in particular the importance of unemployment compensation, to which some authors give a prominent role, and the level of the minimum wage.

Increased flexibility in adapting employment and wage levels plaid a significant role in explaining the force of the recent depresssion. On the other hand, it ought to stimulate a faster recovery than in the middle eighties, now as an upturn in business conditions is taking place.

3.2 Two proposals for the medium term

Aiming at medium-run growth of employment the White Book argues for two kinds of measures, which are also the central themes of a programme proposed in August 1993 at the annual meeting of the European Economic Association held in Helsinki (Drèze and Malinvaud, 1994). I shall refer to the latter programme in this presentation.

(i) Full employment of Western European *unskilled workers* is a serious challenge now and will remain so for many years, because the impact of competition from low wage countries concentrates on products of predominantly unskilled jobs. An important decrease in unskilled labor cost would mitigate the phenomenon, reduce the mismatch between the supply of and the demand for labor, finally permit a more balanced growth.

When unemployment persists over a long period, it is natural to record particularly high rates for unskillled workers, some of whom are displaced by more skilled workers. But there seems to be growing evidence of an additional, more structural phenomenon, namely an upgrading trend in the skill composition that goes faster for labor demand than for labor supply. At the same time, the relative cost of unskilled versus skilled labor seems to have been stable or even increasing in most European countries, at variance with the downward trend observed in the US.

Education and training are part of the answer to this mismatch; but new progress on this front meets with difficulty and can only have a very slow effect. One must also look for ways of slowing down the substitution of capital and skilled labor for unskilled labor, for ways of restoring the attractiveness of a number of cheap services, which have altogether disappeared in Western Europe but not in the US and which require little qualification from those providing the services. A selective decrease in the cost of unskilled labor would do precisely that. Indeed, as long as a general excess supply of unskilled labor will persist, the opportunity cost of this labor will be hardly more than the social net cost of putting an unemployed such person to work, far below the present private cost to employers.

It is proposed that, for lightening this private cost, minimum wages be altogether exempted from employers' social insurance contributions. For higher wages the exemption would be only partial and degressive; more precisely its rate could decrease linearly to zero at twice the minimum wage (by »minimum wage» we mean the lowest contractual wage earned by a young adult without seniority).

The financial implications of this proposal, if it is taken literally, will vary substantially from country to country. For the EU average, one may guestimate that the cost of exemptions will lie between 1 and 1.5 percent of GDP. This is substantial, but not prohibitive. The figure concerns the gross cost, whereas some budgetary gains would follow from additional employment. Substitute resources will of course have to be introduced for balancing the cost, and the final effect in terms of employment will depend on the choice of these resources. There is no need for uniformity among countries in this respect; some may wish to select a rise in VAT taxes, others an increase in the income tax; also, a European-level tax on emissions of carbon dioxide in under discussion; if used as substitute resource it would approximately cover the cost on average.

How large are the employment effects to be expected from this proposal? Clearly, they will require time since they will involve the organization and evolution of productive activities, as well as some restructuring of final demand (a long lag was indeed revealed by econometric studies of investment that estimated the effect of relative cost changes). Thus, the relevant question concerns the medium-term impact, after some five years, say, and beyond.

In order to evaluate this impact, one must consider first the cumulative sum of direct microeconomic effects, and second the positive or negative incidence of macroeconomic consequences and feedbacks. Uncertainties affect evaluation at both levels. The employment gains to be expected through the reappearance of low-paid service jobs are particularly difficult to estimate. For a good grasp on the slowdown of the substitution of capital and skilled labor for unskilled labor, one would need data bases providing the appropriate break-down between skill levels (what is called unskilled in this paper corresponds to only a small fraction of the skill distribution of workers, and this fraction is usually not isolated in the available data); today one must rely on very rough proxy estimates. Macroeconometric models should in principe indicate the macroeconomic consequences after the intervention of all main indirect links; but the now available models were not built for the kind of application discussed here.

Results of an exercise made at the European Commission are reported in J. Drèze and E. Malinvaud (1994). They lead to a crude estimate of an increase in aggregate employment amounting to some 2 to 3 percent after four years. They are sensitive to a number of assumptions, particularly to the value of the long-term elasticity of substitution, which may have been over-estimated.

So, reflection and computation indicate that no quick miracle should be hoped for. On the other hand, aggregate employment gains of such an order of magnitude should not be dismissed, since equivalently powerful alternative are not easy to engineer. Moreover, a selective action on unskilled employment will contribute to a better match on the labor market, hence to a more robust macroeconomic equilibrium. All this recommends rapid action, whereas the White Book speaks of a similar reduction in unskilled non-wage labor cost, but to be achieved by year 2000.

(2) The White Book put more emphasis on another main proposal, which was the core of the »growth initiative» adopted at the end of 1992 by EC heads of government meeting in Edinburgh. The proposal is strengthened and placed in the broad context of technological development. Since the time of Edinburgh, there was inadequate aggregate demand and little leeway for fiscal expansion beyond what automatic stabilizers implied. But a need was also perceived for building in the coming years modern trans-European infrastructures. The way out of these dilemmas was correctly identified by the European Commission, namely to find means of stimulating investment without falling back too much on national budgets for funding. The emphasis on public investment is natural when needs exist and unused productive capacities otherwise limit the immediate prospects for business investment.

Drèze and Malinvaud (1994) endorse this logic. They, however, argue that the Edinburgh initiative was insufficiently ambitious and could be meaningfully broadened in scope and scale, with more sharply targeted incentives. They do not precisely discuss the White Book, which was prepared after their paper. The Book is actually ambiguous about the size of the investment programme: large figures are quoted, but with priorities on a more modest scale. Decisions by the EU Council of Ministers have so far accepted just a small fraction of what is proposed by the Commission.

The argument for a broader scope starts from the observation that public investment have declined since twenty years (falling from 3.9 percent in 1970–73 to 2.8 percent since 1985 as a share of GDP) and that substantial unfilled needs exist. Besides modern trans-European infrastructures, one may list housing for low-income families, urban renewal and urban transportation. Of course, needs, meaningful projects and funding possibilities vary between countries. But there is scope for social and public investment on a scale commensurate with a genuine revival.

Last year already, the main argument for a large scale did not lie in the importance of the 1993 depression but in the macroeconomic prospect for the future expansion. It was then clear, it is now still clearer, that EU countries will have to take decisions on a discretionary fiscal contraction in order to reduce public deficits and government debts. The size is again uncertain, but a cumulated contraction of some 4 percent of the EU annual GDP to be achieved over four years is a likely order of magnitude. This would mean some ECU 250 billions over these years. It seems to us that the programme of social and public investments should have such an importance as to roughly compensate this fiscal contraction. So, neither will the medium-run expansion of demand be excessively restrained, nor will capital markets be strained.

As the main incentive for the contemplated investments we proposed employment subsidies, coupled with improved access to capital markets. On approved specific projects, or project areas, subsidies would be proportional to the labor content. In comparison to interest or capital subsidies, this proposal has the merit of reducing the wedge between the private and social cost of labor and of slowing down the wasteful substitution of capital for labor, so complementing our proposal in favor of unskilled labor.

Private lenders will of course be interested in financing some of these subsidized investments, either directly (as may be the case of banks) or through capital markets. But, for projects with long pay-back periods, such as those considered here, market imperfections remain significant. This is why banks experienced in public sector funding, such as the European Investment Bank, Credit National, IMI, and so on, should be given the responsibility of financing a good proportion of the specific investments.

3.3 Long-run challenges

When thinking about future growth and employment in Europe, one must wonder which main difficulties are likely to long stand across the way to a more satisfactory evolution than that experienced during the last two decades; one must then strive to define a policy strategy to cope with these difficulties. The Drèze–Malinvaud article does not go that far with respect to some long-run problems that it identifies; it rather argues for a fuller discussion of these problems by academic economists. Here, I shall briefly consider the same problems under two headings: the future of the Welfare State and the stability of growth in Europe.

(1) The Welfare State was an important objective in Europe throughout this century. People in our part of the world have ambivalent ideas about what was achieved and what should be done. On the one hand, they showed on many occasions during recent years their attachment to at least the hard core of social security and related institutions. On the other hand, we must recognize both elements of disenchantment with respect to the present performance of the Welfare State, and a trend toward an ever higher cost.

In this last respect, one must look carefully at the situation. According to presently available data, as given in OECD (1994b), the ratio of the aggregate value of social transfers to GDP seems to have reached a maximum around 1983 in most countries of Western Europe. Comparison between 1983 and 1991, the last year for which figures are available, show more cases of decrease than of increase in this ratio. But there are three reasons why this comparison should not be taken as a proof of a stabilization in the cost of social transfers as they were established up to 1980, say.

First, expenditures on social protection are of course contracyclical; 1983 was a recession year. For comparison, the year 1993 will be more appropriate than 1991 when the data will be available.

Second, some will argue that retreat of the Welfare State began during the 1980's, that this is how the previous increasing trend was stopped and that one should look at what happened behind the aggregate *ex post* figures. As a matter of principle the argument is correct; a number of cases exist in which risk coverage was reduced. Unfortunately, it is difficult to estimate what the global trend would have been under unchanged rules; the impact of particular cases should not be overestimated.

Third, the last decade does not seem to be appropriate for judging future trends, because of special circumstances that will not perdure. Demographic factors, which were rather favorable during that period, will become quite unfavorable at the beginning of the next century. As a simple indicator, the ratio of the number of people aged 15 to 64 to the total population increased in all European countries during the 1980's and is projected to decrease quickly after 2000 or a little later; specialists forecast either a small decrease or a moderate increase in the ratio of social transfers to GDP during the next few years, but are much more pessimistic on what is likely to happen at the beginning of the next century.

The prospect of an increasing cost must be taken seriously. Already now, public deficits and debts appear to be higher than desirable, or even sustainable; the upward trend of social transfers has already led to a reduction in public investment and creates a permanent concern for lowering public expenditures; the burden of taxes and social security contributions is perceived to be already too high because of its effects mainly on economic incentives, but also on equity in the face of tax exemptions and evasion. Confronted with such an arithmetic, government officials strongly oppose all proposals for increase in expenditure, even for temporary action. In such a context, all flexibility is removed from budgetary policy. Should then Europe forsake for long all possibilities of budgetary stimulation?

It is not the place here to go into the economics of the Welfare State, which has to consider different types of transfers and different aspects of the subject. The recent survey by Barr (1992) gives an account of modern reflection, which stresses the incentive problems generated by asymmetric information as studied by the economic theory of insurance. Whereas adverse selection gives argument in favor of public insurance, moral hazard has a large responsibility in excessive costs; the way out can be found only if one accepts some degree of co-insurance and of direct control over individual actions. Also, the redistributive function of the Welfare State ought to be reassessed and to concentrate on alleviating poverty. More generally, the spirit of the reform should not be to dismantle the Welfare State but to make it leaner and more efficient. This is such an important challenge that it requires a full reconsideration of our system of public finance, and this with the perspective of the first decades of the next century.

(2) The possibility of a high degree of instability in the future evolution of the world economy was evoked in the first part of this paper. There are also sources of instability within Western Europe, and they ought not to be neglected in any study of long-run policy challenges. Two such important sources can be identified.

The first one concerns the process of European integration; it is obvious enough after the difficulties of the two last years. Increased uncertainty may concern the building of institutions of the European Union and then depend more on politicians than economists. Before complete monetary unification it may also concern exchange rates between European currencies and interest rates in the various countries; this of course falls into our domain.

Intra-European exchange-rate changes in 1992 and 1993 can be traced in part to the undue confidence in the EMS that had developed earlier in government circles. Many analysts had stressed that freedom of international capital flows made it almost impossible for authorities to maintain parities when they were perceived as deviating from fundamentals, i.e. when operators could safely anticipate the direction of any future change in official parities. From January 1987, for the currencies of the then EMS, or from their date of joining for others, perceivable drifts in fundamentals had occurred; but the orderly revisions of central parities, which could have compensated for those drifts, were not made. At some point deviations appeared too large to be sustainable any longer.

This lesson must be remembered now, even after shrinkage of the set of EMS currencies and widening of the band around central parities, whose role has correlatively diminished. Moreover, coordination is still required in order to use properly the new degree of freedom given to short-term interest-rate management within Western Europe. Indeed, authorities must aim at cooling down intra-European exchange-rate volatility so that medium-term trends become more predictable and risk premia consequently decrease.

If the objective to be achieved is clear, the choice of the strategy is more delicate, because it must be credible (and even convincing) for the financial markets and because it must also ease the realization of monetary union. Some argue for a speeding up of the move to this union; others for accelerated implementation by a core group of countries; others still for a pause in open policy activism. Views also differ as to whether the strategy should give priority to interest rate stability or to exchange rate stability, when it happens that the two conflict with each other. Again a research area that should not be neglected.

(3) The second potential source of important instability within Western Europe lies in wage determination, which might push toward inflation and/or be too rigid. Here again the diagnosis is not wholly clear. Wage behavior has changed since the 1970's, as we saw in section 3.1. But it may still be a cause for concern.

In particular, the disturbing acceleration of inflation that occurred in 1989 is worth studying more closely. Indeed, if it had not occurred, monetary policies would not have been tightened so much and the resulting damage to debts and growth would have been less acute. This episode can be interpreted as implying that a non-inflationary decrease in unemployment can only be very slow, notwithstanding the high level of European unemployment.

What is involved here is probably not wage rigidity, although the situation in this respect seems to vary a good deal now from country to country. Indeed, where increases in wages initiated acceleration of inflation, like in the UK, tensions were real on the skilled labor market of some regions; later the depression induced a reversal of the trend. But it seems that, on the whole, negotiated wage settlements still tend to be too high as soon as governments relax their efforts for containing them.

Taking the wage drift into account, the Drèze–Malinvaud article concluded that for the years to come the reference ought to be to negotiated settlements at or near constant real wages. It then asks the question: is such a pattern acceptable and realistic until the unemployment rate is down at a more natural level? Recognizing the difficulty of the question, it goes on to consider the possible significance for wage developments of the relative tax burdens on capital and labor. Because of intercountry tax competition and capital mobility, interest incomes are in many cases now subject to little taxation. This situation appears unfair to labor, which is then not ready to listen to pleas for wage moderation.

A strong argument therefore exists for correcting the present fiscal imbalance and raising again the level of capital taxation, while using international cooperation to cope with capital mobility. A first solution consists in the organized reporting at EU level of all interest income of residents, which could then be subject to income tax in the home country. Alternatively a substantial withholding tax on all interest income of residents could be organized on a uniform basis at European level.

In the last parts of this paper I made frequent references to the Drèze–Malinvaud proposals because they may have relevance for the way out of the Finnish depression. If I used a somewhat different tone than we did a year ago, it is not only because the feeling of urgency has decreased as we saw signs of the business upturn; it is also because I wanted to recognize areas in which our knowledge is particularly deficient and in which research could therefore be valuable.

Those areas, among no doubt many others, might attract interest of the Yrjö Jahnsson Foundation, which did already so much for the progress of our discipline and will certainly go on doing so.

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