ELSEVIER European Economic Review 38 (1994) 489–504

EUROPEAN ECONOMIC REVIEW

Growth and employment: The scope of a European initiative

Jacques H. Drèze[a]*, Edmond Malinvaud[b]

[a] *CORE, Université Catholique de Louvain, 34 Voie du Roman Pays, 1348 Louvain-la-Neuve, Belgium*

[b] *Institut National de la Statistique, Paris, France*

Abstract

This paper is an abridged version of a policy initiative paper, prepared with a dozen colleagues in Louvain-la-Neuve and Paris. We propose a set of policies to cope with Europe's persistent unemployment, including two medium-term programs: a drastic reduction of the indirect cost of unskilled labour and an ambitious stimulation of targeted investments. The bottom line is that policies addressing meaninfully Europe's unemployment problem must be pursued on a bolder scale than currently contemplated.

Key words: Growth; Employment; Policy initiative

JEL classification: E61

1. Unemployment: A challenge for economists

Since almost twenty years now, European unemployment has been a major social problem and the sign of underutilisation of resources at a time of unfilled needs. According to current forecasts, *the slack in the labour market will still prevail over this decade. Faced with such a prospect, European economists*

* Corresponding author. This is a condensed version of a position paper prepared collectively at the initiative of Jacques Drèze and Edmond Malinvaud, who invited a few colleagues, Paul De Grauwe, Louis Gevers, Alexander Italianer, Olivier Lefebvre, Maurice Marchand, Henri Sneessens, Alfred Steinherr and Paul Champsaur, Jean-Michel Charpin, Jean-Paul Fitoussi, Guy Laroque, to meet with them, respectively in Louvain-la-Neuve and Paris, in order to consider the terms of a meaningful growth initiative in Europe. The full text is available from the authors. All the authors participated in a personal capacity; the views expressed here are their responsibility, and should not be ascribed to the institutions with which they are affiliated. The authors invite reactions, criticisms and suggestions from fellow economists. The theme will be taken up again at the 1994 Congress of the European Economic Association.

0014-2921/94/$07.00 © 1994 Elsevier Science B.V. All rights reserved
SSDI 0014-2921(93)E0128-8

cannot remain silent. We think that *independent academic economists have a specific role to play.* We present here the outcome of a brain-storming exercise, and we invite our colleagues to join in the exercise, by reacting to our views and promoting their discussion.

With that objective in mind, and within the limitations of the genre which preclude major data manipulation, we focus on the persistence of unemployment, and try to appraise the scope for a European growth initiative. Indeed, we believe that Europe (EC12), as a major integrated and relatively closed economic area, must identify and pursue cooperative policies to cope with its problem. External (worldwide) cooperation can help, but should not be relied upon to provide the solution. Similarly, internal cooperation is much needed, as individual member countries can do very little on their own. We review macroeconomic policies, i.e. monetary, fiscal and incomes policies, proceeding from the short to the medium and long term. The specificity of our standpoint resides in advocating two medium-term programs – a drastic reduction of the indirect cost of unskilled labour and an ambitious stimulation of targeted investments. Both measures have been endorsed or even decided, but on a much smaller scale. *Our bottom line message is that policies addressing meaningfully Europe's unemployment problem must be pursued on a scale different from that of currently decided or contemplated programs.*

2. Recent trends

Over the four year period 1987–90, real GDP increased by 13% and employment by over 5.5% for EC12. That is, an average growth rate of output of some 3.4% was accompanied by an unprecedented growth rate of employment of 1.4%, with annual productivity gains of some 2%. According to the Eurostat definition, unemployment declined from 10.7% in 1986 to 8.3% in 1990. These favourable developments fed hopes that a gradual abatement of unemployment was at last under way. Such hopes were short-lived, unfortunately. With the benefit of hindsight, one can detect two clear deficiencies in that growth revival; they concern *inflation* and *public finances.*

By the end of 1989, one had to record an acceleration of *inflation* in every one of the twelve member countries, with the rate of increase of the average EC consumption deflator rising from 3.8% in 1988 to 4.9% in 1989. This acceleration of inflation was essentially synchronous with peaks in capacity utilisation rates in manufacturing, reached mostly in 1989. It was soon followed by acceleration of nominal wage increases, which rose to 7.5% per year in 1990 and 1991, up from 5.8% in 1988 and 1989. Acceleration of inflation when unemployment was still high in most countries is very disturbing, because it suggests that in Europe inflationary pressures appear as soon as the rate of growth exceeds the level required to stabilise

unemployment. Such was clearly the assessment by monetary authorities, which took restrictive measures in 1989.

The second detectable deficiency concerns *public finances.* Here, the disturbing fact is that the faster growth in the years 1987–90 did not lead to noticeable improvement. The net public deficits (borrowing requirements) amounted to 4% of EC12 GDP in both 1987 and 1990; the debt/GDP ratio declined only slightly, from 60.6% to 59%. Not surprisingly, when growth slowed down in 1991, the presence of automatic stabilisers and the persistently high interest rates resulted in growing deficits (4.6% in 1991, 5.3% in 1992 and 6% or more in 1993) and a rising debt/GDP ratio (63% in 1992, expected to reach 68% or more in 1993).

The upshot of these developments is that the European economies entered a recessionary phase in the middle of 1990 with the combination of at least three unfavourable circumstances: significant inflation, restrictive monetary policies and rising deficits. It is not surprising that current prospects look bleak. The *Annual Economic Report* of the EEC for 1993 states: 'even if in 1995–96 growth were to return to rates of about 3%, unemployment could still be as high as 10 to 11%'.

The prospect of an unemployment rate in excess of 10% for EC12 over the coming five years is our main concern here. We are looking for policies that would speed up the return to a growth rate of the order of 3.5% and that would make it sustainable over the medium run.

In the pursuit of that goal, we must draw the lessons from the 1987–90 upswing. On the one hand, every effort must be made to avoid inflationary tensions. We deal with wage moderation in Section 8. On the other hand, it is imperative that a return to higher growth be conducive to a genuine consolidation of public budgets, going beyond the working of automatic stabilisers. We take up that issue in Section 7. Prior to that, we review briefly the short-run policy mix in Section 3 and present in Sections 4 and 5 two proposals for strengthening progressively the supply and demand sides of European economies over the years to come.

3. Short-term macroeconomic policy

The current deepening of budgetary deficits, through the working of automatic stabilisers, is carrying all the European economies away from the Maastricht ceiling of 3%, which is currently respected only by Denmark, Ireland and Luxembourg. It is thus implicitly recognised by most countries that a deficit ratio cannot be interpreted without reference to economic conditions. Whereas a 3% deficit at full employment is a meaningful norm, attempting to enforce the same norm against the tide of a recession would be procyclical. It is natural for most European economies, i.e. those not plagued

with an excessive debt, to aim for an *unchanged fiscal stance*, that is to let the automatic stabilisers work, without attempting to be more restrictive, and without relying on discretionary budgetary stimulation at this juncture.

Thus we endorse the prevailing short-run fiscal stance, arguing for monetary stimulation through a strong decrease of nominal short-term interest rates, and propose the reference level of *zero real short-term rates.*

The impact of lower short-term interest rates on activity and employment should of course not be overestimated. But it is not negligible. Firms finance a substantial part of their operations by short-term credits so that the cost of their outstanding debt reacts to changes in short-term rates. Also high short-run rates militate towards postponing physical investments, whether in plant and equipment or in housing. Directly or indirectly the rates applied to quite a few longer-term loans also depend on these rates. Moreover low short-term rates will significantly help European price competitiveness by lowering the exchange rates of our moneys, at least in comparison to what they might otherwise be. Finally, lower short rates will help easing the burden of debt service by governments, especially those with a significant short debt.

The expansionary stimulus must, however, be carefully managed, so as to act favourably on expectations. Public opinion must be confident in the ability of governments to counteract the recession without leading to inflation. What is to be gained with lower short-term interest rates must not be lost because of higher long-term rates. Whereas inflation has been a primary concern in Germany and in the Mediterranean countries, it stands currently at record-low levels in France, Benelux, Denmark and the British Isles. Our recommendation is particularly addressed to these countries, where it may be hoped that the decrease of short-term rates will somewhat spill over to longer term rates. Of course, this must be seen as coupled with a long-term policy of structural budgetary adjustments. And it must be understood as a temporary stimulus, in response to the current situation. Short rates might rise again as soon as we shall observe clear indications that a recovery is under way. Hopefully, more effective monetary cooperation may by then have been restored in Europe.

4. For the unskilled unemployed

4.1. *The skill mismatch*

When high rates of unemployment persist over long periods, an important specific feature attracts attention: *high unemployment is heavily concentrated among unskilled workers.* That feature could result from displacement of unskilled workers by more skilled ones. That explanation makes sense in a cyclical perspective. But there seems to be growing evidence of an additional, more structural phenomenon, namely *a trend in the skill composition of*

labour demand, meaning that, at any given system of wages and wage differentials, the demand for labour calls for a declining proportion of unskilled jobs.[1] At the same time, the relative cost of unskilled versus skilled (but perhaps not highly skilled) labour seems to have been stable or even increasing in most European countries, at variance with the downwards trend observed in the US and to a lesser extent also in the UK. Thus, *persistent disequilibrium on the labour market is concentrated on the market for unskilled labour*, and should be tackled there. Education and training are part of the answer. We believe that relative prices are an essential part as well.

4.2. The wedge between private and social labour costs

The problem of mobilising wasted resources of unskilled labour towards meeting unfilled needs is linked to the enormous wedge between the private cost to employers of new hirings and the real opportunity cost of these hirings. The nature and extent of the distortion must be properly understood. At times of full employment, the opportunity cost of labour to one firm is the productivity of labour in other firms, and there is no distortionary wedge. At *times of underemployment*, the opportunity cost of an unskilled worker is simply that of putting an unemployed person to work.

A rough measure of the wedge is given by the share in the private labour costs of social insurance contributions (SIC) and income taxes possibly augmented by unemployment benefits (or a fraction thereof, to reflect the fact that only a fraction of new jobs go to unemployed – a fraction typically of the order of 1/2). The share of SIC and income taxes in labour costs ranges between 30 and 50% in Europe. Thus, the single most important price in the economy is distorted by a factor of the order of 40%!

A more refined calculation would recognise that, when a non-employed person is hired, that person typically gains entitlement to additional social benefits (pensions, ...) so that only a fraction of the SIC should be deducted from the private labour cost. If, as a crude approximation, earners of minimum wages enjoy entitlements roughly comparable to those of non-employed persons, then only the SIC applicable to minimum wages should be deducted. Yet one would ideally like to bring private costs in line with social costs at all levels of wages. This would require that private costs remain unchanged for fully employed skills. If one identified these with high wage occupations, one would opt for SIC collections at a progressive rate.

4.3. A proposal to reduce the private cost of unskilled labour

Our proposal is to exempt minimum wages from *employers*' social

[1] See the Appendix of the full-length paper for a documentation of this assertion.

insurance contributions (ESIC) altogether. This exemption is *degressive* and decreases linearly to zero at twice the minimum wage. Substitute resources are appropriated to the social security. (By 'minimum wages', we mean the lowest contractual wage earned by a young adult without seniority.)

A particular, specific merit of this measure consists in reducing the private cost of employing unskilled labour, *relative to* the cost of employing skilled labour. Such a reduction seems needed to counteract somewhat the changed skill structure of labour demand. By reducing significantly the private cost of employing unskilled labour, the measure would also restore the attractiveness of a number of low-paid jobs which have altogether disappeared in Western Europe *but not in the US.*[2] It would reduce sharply the incentives for underground employment. And it would hopefully slow down the wasteful substitution of capital for unskilled labour.

4.4. Cost and financing

The financial implications of our proposal would vary substantially from country to country. ESIC rates are zero in Denmark, around 10–12% in the UK, Ireland and the Netherlands, but higher than 40% in Belgium, France and Italy. Also the exact cost of our proposal depends upon the wage distributions. For an EC12 average – unrepresentative as that average may be – we guesstimate a cost lying between 1% and 1.5% of GDP. This is substantial, but not prohibitive. (We note for comparison purposes that government receipts in EC12 in 1992 averaged 13.4% of GDP for indirect taxes, 12.5% for direct taxes and 15.6% for SIC.)

Our figure concerns gross costs. What matters ultimately is net costs, net of the budgetary gains associated with additional employment. The final effect in terms of employment is also influenced by the nature of the measures yielding substitute resources. There is no need for uniformity here. Each country should privilege the substitute sources of revenues which are least detrimental to employment or otherwise most attractive. Also, a European-level tax on CO_2 is under discussion and could be used as a substitute resource. It would cover approximately the cost of our degressive exemption, on the average.

4.5. Potential impact

In Denmark, ESIC are nil, yet the unemployment rate is close to the EC-

[2] That attractiveness would be further enhanced if the exemption from ESIC were accompanied with an administrative simplification, enabling households or the self-employed to hire unskilled labour with minimal formalities.

average. It would thus be difficult to clain that our proposal will do wonders – whatever its logical appeal may be. Econometric simulations have been conducted in France and Belgium to assess the potential impact of lower ESIC. The substitute resources came from direct taxes in France, from indirect taxes in Belgium. In both cases, alternative models have been used, with sometimes major differences in results. Proportional reductions of ESIC by 1% led to estimated net employment gains between 0.5% and 1.5% in France, between 0.6% and 1.2% in Belgium.

The estimates are thus imprecise. Also, they are subject to major biases – which fortunately work in opposite direction. First a proportional reduction applied uniformly at all wage levels ignores altogether the induced modification of the relative cost of unskilled versus skilled labour. Some crude simulations suggest that our proposal might be several times more effective than proportional reductions entailing the same total cost. Second, country models simulate the effects of a policy shock in the home country, assuming unchanged policies in other countries. Accordingly, they associate with ESIC reductions gains in export competitiveness. In case of simultaneous reductions in several countries, these gains would vanish. On the other hand, export demand would be sustained by the additional imports of expanding partners.

What should be concluded beyond the obvious imprecision of the results? First, no miracle should be hoped for. But second, definite gains in employment are in sight, *at no budgetary cost*, if simulations are to be trusted. Employment gains of one or more percentage points are not easy to engineer, and should definitely not be overlooked – even if reshuffling public revenue to the tune of 1–1.5% of GDP is involved. A third conclusion is that employment stimulation through relative prices is a medium-run proposal. The effects build up more or less linearly over time. Such measures make sense in a situation, like today, where excessive unemployment is bound to prevail for several years to come.

4.6. About minimum wages

There is of course an alternative approach to reducing the private cost of unskilled labour, both absolutely and relatively to skilled labour; namely, to reduce outright the wages of unskilled workers. Whether or not such a measure is advisable depends upon the level of these wages, and upon equity considerations. Levels and adequacy of minimum wages vary from country to country. Three remarks are in order on that score.

– Where desired, wage reductions for unskilled workers should be considered as a complement, not a substitute, to the measures advocated here.
– There is a limit to what can be achieved through wage reductions. In

contrast, exempting minimal wages from ESIC provides a substantial margin, of the order of 20%.
– A margin of incentives must be maintained between minimum wages and replacement income.

5. Targeted investment projects

5.1. The Edinburgh logic

What has been proposed here for the unskilled would contribute to the growth of employment but would still not be sufficient, even long after recovery from the present recession. Accordingly, we propose additional measures to promote *labour-intensive investments with adequate social returns.* This would serve the twin purposes of mobilising idle resources towards meeting unfilled needs, while contributing to sustain aggregate demand. The measures best susceptible of achieving that goal consist in subsidising the labour inputs while improving the institutional access to funding. This would enhance the private or local profitability and feasibility of these investments.

These guidelines are closely related to those underlying the growth initiative defined in Edinburgh and strengthened in Copenhagen. The crux of the matter is a situation of inadequate aggregate demand, at a time when there does not seem to exist any leeway for fiscal expansion. The way out of this dilemma has been correctly identified by the EC Commission, namely to find ways of *stimulating investment without falling back too much on national budgets for funding.* The emphasis on social and public investment is natural at a time when unused capacities limit the immediate prospects for business investment (which moreover would be labour-saving). We shall argue however that the Edinburgh initiative is insufficiently ambitious and can be meaningfully broadened in scope and scale, with more sharply targeted incentives.

5.2. Shortfalls in public investment and construction

For EC12, the share of public investment in GDP has fallen from 3.9% in 1970–73 to 3.2% in 1974 to 2.8% from 1985 onwards. Public investment remained on a declining trend throughout the 1986–90 upswing, whereas private investment was then recovering, rising from 16.2% of GDP to 18%. Given the recent emphasis on the contribution of public investment to the growth potential of the economy, restoring the share of public investment to its pre-1974 level looks like a reasonable target. Quantitatively, an annual investment effort amounting to 1% of GDP is at stake.

Turning to the dynamics of construction in EC12, we note that the pre-

1974 growth rate of 3.5% turned negative (−1.3%) over the decade 1974–84. The development during the 1986–90 upswing was dramatic, with an average growth rate of 4.7%. But we are now back to zero or negative growth. Yet, there remain substantial needs of urban renewal and of better housing for low-income families. Quantitatively, returning to a growth rate of 3.5% (equal to the hoped-for aggregate growth of GDP), would entail an annual investment effort of 0.4% of GDP.

5.3. Some well-defined investment needs

Of course, needs, meaningful projects and funding possibilities vary as between countries. But there is scope for social and public investments on a scale commensurate with a genuine revival. Many of these investments need not require long planning periods and could thus be implemented well before the current and expected levels of unemployment are eliminated.

(i) There are major needs in the field of private housing, especially housing for low-income families. This is also an area where investment projects are relatively labour intensive, and where unskilled labour *can be mobilised*, if the costs of on-the-job-training of unskilled workers are duly subsidised. Recourse to initially unskilled workers could also be important since one wishes to avoid inflationary pressures on building costs.

(ii) Many European cities are in need of 'renewal' – upgrading of run-down areas, transformation of unused urban factories into dwellings... Programs combining urban renewal with provision of low-income housing are doubly attractive.

(iii) Another important area, where living conditions for both city dwellers and commuters could be improved, has to do with urban transportation. Also, environmental concerns call for discouraging the use of private cars and developing public transportation. Investment in urban transportation is furthermore a natural outlet for excess capacities in defence and other industries. Again, we have an example of unfilled needs in the face of underutilised resources.

(iv) Investment in 'Trans-European Networks' concerns high-speed trains, turnpikes and telecommunications. This is the area where the advisability of a European initiative is most obvious. There is, of course, a pricing dimension – in particular in the case of turnpikes. Proper pricing is requried to draw in private investors, but also to assess correctly the social value of the projects.[3]

[3] The social value of an investment project depends upon the rate of use of the facilities, which in turn depends upon the pricing policy.

5.4. *The Edinburgh package falls short of what is needed*

In order to promote economic recovery in Europe, some actions were approved in Edinburgh last December, which according to the Conclusions of the Presidency 'could provide Community support for investment in the public and private sectors of the Member States amounting to more than 30 billion ECU's (30 becu) over the next few years'.

This seems to fall very much short of the potential action. An amount of 30 becu is roughly 0.5% of EC annual GDP. Of course, some technical data collection is needed to assess the potential of our own proposal for investment in housing, urban renewal and transportation, and Trans-European Networks. But one may be confident that the amount will be found to be much larger than 30 becu.

Taking the question from the macroeconomic side, a natural target would be to attempt offsetting the discretionary fiscal contraction that EC countries will have to decide as soon as the recession will end, in order to reduce public deficits and debt. A cumulated contraction of some 4% of the EC annual GDP to be achieved over four years is a likely order of magnitude. This would mean some 250 becu over these years. In Section 5.2., we have referred to an annual investment effort of 1.4% of GDP, or roughly 80 becu. This also means 240 becu after 3 years. The figure shows why the Edinburgh package is not sufficient and why one must be more ambitious. It also shows that our proposal would not strain the capital markets, if budgetary adjustments are implemented. Still, the funding prospects must be considered.

5.5. *Employment subsidies and institutional funding*

The main incentive that we propose for the contemplated investments is in the form of employment subsidies, coupled with improved access to capital markets. The principle of employment subsidies is to approve specific projects, or project areas, and to grant a subsidy proportional to the labour content of those projects. In comparison to interest or capital subsidies, our proposal has the merit of reducing further the wedge between the private and social cost of labour, and of slowing down the wasteful substitution of capital for labour. Subsidising specifically approved projects entails some administrative costs. But such an approach seems necessary if one wishes to concentrate the subsidies on projects which would not otherwise have been undertaken, and which yield adequate social returns. Possibly, the administrative efficiency could be enhanced by relying upon the accumulated experience of the European Investment Bank which might also help on the funding side (see below). There is a positive counterpart to these administrative costs, however. It comes from the opportunity to speed up administratively the

implementation of the approved projects. For instance, in the area of urban renewal, there is definite scope for speeding up administrative planning.

In light of what has been said in Section 4, a subsidy bridging the gap between the private and social cost of unskilled labour might amount to the sum of the SIC, the income tax and a fraction of the unemployment benefits applicable to such labour. If a program of ESIC exemptions were to be introduced progressively, it could be anticipated for approved investments. On the other hand, if such exemptions were in place, labour subsidies on approved investments might correspond to 50% of unemployment benefits (possibly 100% for hiring of registered unemployed). Many details remain to be worked out (criteria for approval of projects, definition of their labour content, level and modalities of the subsidy...). But the nature and direction of the proposed incentives should be clear.

Private lenders will of course be interested in financing some of these subsidised investments, either directly (as may be the cases for banks) or through capital markets. But for projects with long pay-back periods, market imperfections remain significant. Banks experienced in public sector funding (the European Investment Bank and national long-term credit institutions, such as Crédit National, KfW, IMI, etc...), should finance a good proportion of the specific investments. In the case of the European Investment Bank, a first step should be to extend its mission, so as to encompass private housing, and possibly other aspects of the program. Larger possibilities will be open when the European Investment Fund approved in Edinburgh will operate and when the EC structural funds (social fund, regional fund, cohesion fund) will also be available after the decision taken in Copenhagen. If this is not enough a European Growth Fund, similar in nature to the European Investment Fund but with a larger base and wider function, could be created; or, more naturally perhaps, the European Investment Fund itself could be extended.

6. Reducing monetary uncertainties

The present recession was made worse by new uncertainties about European economic unification. One had long realised that unification could not be achieved quickly. But since the middle 80s and until 1991 it was perceived as progressing. More recently, this evolution was blocked by a conjunction of related circumstances: problems with ratification of the Maastricht Treaty, lack of coordination of macroeconomic policies, finally the exchange rates turbulence in the fall of 1992 and summer of 1993, leading also to some interest rates turbulence.

Limiting ourselves to basic principles, we note the detrimental incidence of the prevailing uncertainty about some inflation, interest and exchange rates,

but also about institutional developments in the monetary area – including the recurring temptations of competitive devaluations. We do not opt for a specific political program. But we stress that reducing institutional monetary uncertainties is an important goal in its own rights. It should be pursued actively, to put monetary Europe on a track more promising for employment than a return to floating exchange rates between the currencies of relatively small economies closely integrated through trade.

7. Public finance and the Welfare State

In most countries *public deficits and debts appear to be higher than desirable, or sometimes even sustainable, in the long run*; 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 on economic incentives, but also on equity in the face of tax exemptions or evasion. Confronted with such an arithmetic, government officials strongly oppose all proposals for increases in expenditures, even for temporary periods. In such a context all flexibility is removed from budgetary policy. The strongest argument nowadays against the idea of a fiscal stimulus is indeed that the expansion of the 1987–1990 period did so little to ease public budgets. Should Europe foresake for long all possibilities of budgetary stimulation? This is a serious structural problem, that should be frankly faced.

The concept of 'Welfare State', explicitly or implicitly adhered to by most Western European countries since World War II, combines decentralised free markets with a high degree of income protection and social insurance, organised and funded by the state. The basic justification for this concept is twofold:

(i) Market mechanisms at their best yield efficiency, but not necessarily equity; the state is the only instance which can deal with equity issues globally, i.e. from the viewpoint of all citizens. Given the near impossibility of implementing non-distortive lump-sum transfers, an equity–efficiency trade-off is unavoidable when redistributing welfare across individuals.

(ii) Real-world market economies do not deliver all the promises of idealised frictionless models; some parts of the Welfare-State program aim at alleviating the inefficiencies resulting from market failures.[4]

---

[4] Thus, minimum wages cum unemployment benefits have a second-best justification, in the absence of forward or contingent labour contracts; mandatory health insurance obviates some of the adverse selection problems encountered in private contracts, a.s.o.

Of course, the real-world implementation of the Welfare-State programs is not itself without defects. The second-best improvements aimed at do not come free, and they represent at best a compromise among alternative types of distortions. There is thus scope for improving the operating efficiency of our Welfare-State economies and for attempting to reduce the vulnerability of social protection to lasting underemployment. But the basic justification outlined above remains persuasive. Both the current recession in Europe and the observable consequences of the relative neglect of social protection in the US reinforce that justification. *The agenda should be to make the Welfare State leaner and more efficient, not to dismantle it.* There are many hardships which the current Welfare State has proved unable to eradicate. The progressive elimination of today's appalling unemployment is also an essential element to remedy many of those shortcomings.

Faced with such challenges, our countries have to reconsider their whole system of public finance and to do so with the perspectives of the first decades of the next century. Priorities among conflicting objectives must be assessed anew or at least made clearer. A realistic balance must be found between on the one hand the laws and other rules implying public transfers, on the other hand the concern for giving enough incentives to private enterprise and reducing inefficiencies in public management. The balance must be such as to leave room for temporary appeal to public expenditures above their normal course.

Spelling out the implications of these readily accepted principles is a major task, extending far beyond the scope of this document as well as beyond our competence. Fortunately, many economists are already engaged in one or another aspect of the task, and there are strong incentives to intensify the effort, which should be assigned an ambitious target.

In several European countries, the share of social transfers in GDP needs to be reduced and the protection of the least endowed strengthened. This is needed to restore budgetary flexibility, to facilitate ESIC exemptions and to permit targeted investments at no strain on capital markets. Yet situations vary from country to country. In the UK, social transfers fall substantially short of the levels prevailing in comparable countries, to which our recommendations are primarily addressed. In other countries still, managerial efficiency is a prime concern. But the advisability of an ambitious overhaul is felt everywhere. Otherwise, the long-run viability of the Welfare State would be in danger as, under present circumstances, costs are forecast to explode in such areas as health care or pensions.

8. Wage moderation

The aim of a European Growth Initiative is to help bringing about a

period of sustained growth in output and employment, with priority given to employment relative to real wages. A realistic pattern combines output growth in excess of 3% with employment growth above 1% leaving a margin of at most 2% for real wages. We suggest that such a margin may call for negotiated settlements at or near constant real wages. Combined with our proposal of reduced indirect labour costs for the unskilled, who make up most of the pool from which workers can be drawn at little or no inflationary pressure, constant real wages would undoubtedly provide an adequate supply side pillar for sustained growth. Provided the demand pillar can be similarly strengthened, the prospects for a sustained recovery would improve.

Is a medium-term pattern of constant negotiated real wages acceptable and realistic? One controversial aspect concerns the significance for wage developments of the relative tax burdens on capital and labour. The gradual decline in the labour share throughout the eighties has resulted from wage settlements affected by unfavourable business conditions (demand and profitability) and persistent unemployment. At the same time, high interest rates and indebtedness led to an increase in the share of interest income. This redistributive shift was further exacerbated by tax considerations.

Due to the international mobility of capital, several European countries have faced problems of tax evasion, and they have settled for a low withholding tax on interests earned by their residents (sometimes with no further obligation to report these under the personal income tax). The tax evasion issue is compounded by the fact that tax competition has led most European countries to exempt non residents from any levy on interest incomes. The relative tax burden on capital and labour has become very unbalanced.

Short of systematic reporting, a uniform withholding tax on interest income at the European level is the only avenue to correct that imbalance. Whether or not such a tax is desirable in its own rights is a debated issue. That debate should be enlarged to recognise that distributional fairness in the tax treatment of capital and labour could make a significant contribution to wage moderation – even though it may be premature to regard the empirical evidence as conclusive.

9. Elements of synthesis

Our analysis has led us to advocate both a set of policy measures and a serious effort for rethinking, then reforming, some basic structures of our

economies. We do not claim originality in devising new proposals.[5] The distinctive feature of our message at this time of high and rising unemployment is to express two firm beliefs:

(i) measures have to be implemented on a bolder scale, faster and with more determination than is usually considered;
(ii) problems are fundamental enough to call for an active participation of

Table 1
Budgetary and institutional implications of proposed measures

Section	Measure	Budgetary implications	Level of responsibility
3	Lower short-term interest rates	Lower cost of servicing public debt, with country specific quantitative impact	Central banks
4.3	ESIC exemption on minimum wages	Uniform exemption would cost about 3% of GDP, degressive exemption about 1.2%, with substantial country differences	National governments, typically in concertation with labour unions and employers' organisations
4.4	CO_2 tax	As currently considered, would bring 1% of GDP or more	Under consideration at EC level
5.5	Targeted investment programs	Migh deserve wage subsidies up to 1% of GDP	Programs to be defined by national governments (housing, urban renewal or transportation) or possibly by EC instances; wage subsidies to be decided by national governments; funding involves specialised intermediaries
7	Welfare programs	In some but not all countries aim should be to reduce expenditures by 1 or 2% of GDP	National governments, typically in concertation with labour unions and employers' organisation
8	Withholding tax on interest income	Could bring in 1% of GDP or more	EC decision subject to unanimity rule
8	Wage moderation	Neutral for public budgets except through inflation and interest rates	Wage bargaining institutions, country specific

[5] Decrease in short-term interest rates is managed by some central banks. Reduction in unskilled labour costs belongs to government policies in the UK, France and Belgium. Stimulation of specific investment projects is the core of the Edinburgh Growth Initiative. Lowering monetary uncertainties is at the heart of the EMU effort and at the forefront of much policy debate. Promoting a more efficient Social Security system in an explicit recommendation of the OECD Working Party interim report and a common preoccupation of all EC countries. Taxation of interest income is an announced priority of the Belgian Presidency.

academic economists, who should not leave entirely the task to policy makers.

It may be helpful to recapitulate the budgetary and institutional implications of the measures we have considered (see Table 1).

It would be appealing to consider policy packages with consistent overall budget implications and to compare them in terms of likely impact on employment. Unfortunately, Europe lacks the institutional basis needed for such an integrated approach. How the efforts of European governments should be organised and coordinated is a difficult political issue, that we have not addressed. Instead, we have stressed the absolute need for ambitious, speedy, decisive efforts, and we have hopefully demonstrated the possibility of defining a significant initiative to promote growth and employment in Europe.