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FRITZ W. SCHARPF

Combating Unemployment in Continental Europe

Policy Options under Internationalization

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There are policy areas where the legal force of negative integration and the economic pressures of transnational factor mobility and regulatory competition have significantly reduced the problem-solving capacity of national political systems, and where this loss is not compensated by corresponding gains in European problem-solving capacity. Unfortunately, these include areas that are close to the core of output-oriented democratic legitimacy as it has evolved during the postwar decades in European welfare states (Marshall 1975). At the very minimum, their citizens have come to expect that the democratic state should be able

- to prevent mass unemployment that would exclude large parts of the working-age population from active participation in the processes of social production;

- to prevent extreme poverty that would force persons to live below socially acceptable levels of income and access to life chances; and

- to assure a fair sharing of benefits and tax burdens.

The glaring failure to maintain even these minimal assurances during the Great Depression destroyed the legitimacy of democratic government in Weimar Germany, and put it at risk in other countries. At any rate, in trying to cope with threatening legitimacy crises, most democratic governments found themselves forced to resort to protectionist policies that destroyed the integrated world economy of the time (Röpke 1942). After World War II, therefore, world markets were only gradually re-integrated under American-led international regimes that have been aptly characterized as 'embedded liberalism' (Ruggie 1982). They were in fact able to strengthen democratic legitimacy because they allowed national welfare states to gain economic benefits from international integration while maintaining or increasing the protection of their citizens against the 'creative destruction' associated with vigorous capitalism (Gilpin 1987; Eichengreen 1996). In most member states of the European Union, citizens have come to consider these achievements of postwar welfare states as constitutive elements of a legitimating social contract (Jacquemin/Wright 1993). If they should now be revoked under the pressures of run-away globalization or the asymmetry of negative and positive integration in the European Community, there is indeed a danger that rising political disaffection will again undermine either the political legitimacy of democratic governments or their political commitment to economic integration (Ruggie 1994; Leibfried/ Rieger 1997). It may not be by accident, therefore, that the radical right-wing opposition in several European countries is also radically anti-European.

There is reason, therefore, to search for options that could restore the political capacity for dealing with mass unemployment, the crisis of the welfare state and rising inequality at all levels of the multi-level European polity. In this paper, I will explore options that even in an internationalized economy could still be pursued nationally. I will begin with employment, and I will try to show how the persistent employment gap in Europe is related to the structures of European welfare states, and in particular to the prevailing mode of financing the welfare state — with the implication that appropriate structural changes could ease both, the problems of underemployment and the fiscal crisis of the welfare state. At the end of the paper, I will then discuss some of the options that might allow national governments to deal with the erosion of their tax base.

1. The European Employment Gap

Present political discussion in Europe emphasizes the superior employment performance of the United States where the rate of unemployment is now lower than it is, on average, in Europe, and where the rate of job creation has been much higher over the last two decades or so. In fact, between 1971 and 1994, civilian employment increased by 55 per cent in the United States, and only by 11 per cent in the present member states of the European Union (OECD 1996a). However, if anything is to be done about this European employment gap, it is first necessary to understand its causes.

In searching for an explanation, Keynesian economists and politicians tend to emphasize contingent factors. For the present decade, it can indeed be argued on good theoretical grounds that macro-economic policy has played an important role in bringing about very high levels of unemployment: Even if one should accept the monetarist claim that *expansionary* fiscal and monetary policy, when anticipated, will produce more inflation, rather than more employment, that proposition could not be reversed. Given that wages, and hence prices, are downward-sticky, *restrictive* fiscal and monetary policy is surely able to reduce effective demand and destroy jobs. Hence the tight-money response of the *Bundesbank* to German unification in the early 1990s must be as much part of the dismal European employment performance as is presently the desperate attempt of practically all European governments to cut budget deficits in order to meet the EMU criteria. These matters are well known, and nothing of interest could be added here.

What is more worrying, however, is the structural component of the European employment gap. It is reflected in the high level of long-term unemployment. In 1995, for instance, only 9.7 per cent of the unemployed in the United States had been out of work for 12 months or longer. Among the member states of the European Union, this ratio varied between 17 per cent in Austria and more than 60 per cent in Belgium and Italy, with most countries having shares of long-term unemployment between 30 and 50 per cent (OECD 1996, Table Q). As everywhere, the main victims of long-term unemployment are unskilled workers and young job seekers with low levels of schooling.

For an explanation of the structural component of the European employment gap, most commentators see little need to search beyond the usual suspects that were blacklisted in the notorious OECD Jobs Study (1994) — institutional rigidities, union power, and the burdens of the welfare state. In an age of intensified global competition, so it is argued, government regulations and collective-bargaining agreements can no longer be considered 'beneficial constraints' but have become fetters that prevent European firms from achieving the flexibility and innovativeness that allow American firms to compete successfully. In addition, the European economies are laboring under the dead weight of bloated public sectors that are claiming more than 50 per cent of GDP in Sweden and Denmark, more than 40 per cent in France, Germany and other Continental countries, as compared to less than 30 per cent in the United States and Japan — and of overextended welfare states with overly generous rates of income replacement that have raised reservation wages and reduced the incentives to work.

1.1 The Measure of Success: Employment Ratios

In my view, these conventional explanations are not focusing on the critical structural factors. If the employment performance of different countries is to be evaluated and explained, there is, first, a need for valid indicators of success. For this, the usual reference to unemployment figures will not do. They do not include persons on disability pensions, in early retirement and other forms of paid non-work,[1] and they are notoriously subject to political manipulation — the British Conservatives are said to have changed unemployment definitions more then thirty times during their period in office, each time reducing the number of the registered unemployed. Moreover, and even more important, the rate of unemployment is defined by reference to the size of the 'active population' which is, of course, strongly affected by factors on the supply side of the labor market. Thus, the willingness of married women to enter the labor market as job seekers may be as much affected by the separate or joint taxation

[1] For a careful comparison of the Dutch and German systems of paid non-work, of which only some forms are counted as 'unemployment', see Schmid 1996.

of spouses' incomes or the availability of day care as it is by the availability of jobs.

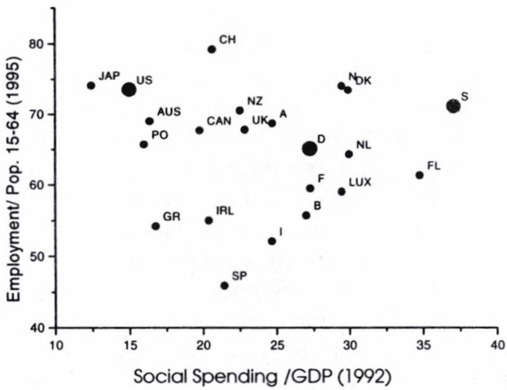
Compared to unemployment rates, employment figures and their changes over time seem to be a much better indicator of comparative performance — but they also are affected by changes on the supply side: larger populations imply more jobs. Even when employment figures are normalized by reference to the population of working age (15 to 64), comparability suffers from differences in working time and in the share of part-time employment (which happens to be unusually high in the Netherlands, for instance). With this caveat in mind, however, employment/population ratios still seem to be the most valid indicators of relative employment performance for which internationally comparative data are readily available in OECD publications (OECD 1996; 1996a). I will use them throughout.[2]

Similarly, the causal relationship hypothesized by conventional explanations is not fully captured by the usual reference to the share of taxes and social security contributions in GDP, since a large (but variable) part of public budgets is actually spent on subsidies to business and on public infrastructure and services that should increase the productivity, and hence the international competitiveness, of national economies.[3] Instead, I will use OECD data on the share of total social expenditures in GDP (OECD 1996b) which, better than any other internationally comparable indicator, should indeed reflect the 'dead weight' of the welfare state on the economy that is presumed to explain the poor European employment performance.

[2] It would be possible to use total hours worked as an indicator that neutralizes differences in part-time employment. However, if the underlying normative criterion is the involuntary exclusion of large segments of the population from participation in the process of social production, there is little reason to consider (voluntary) part-time employment as being inferior.

[3] I ignore here the proposition that the welfare state itself should be considered a productivity-increasing factor — either because it allows firms to externalize the social costs of efficiency-increasing decisions, or because it legitimates free-trade policies pursued by democratic governments (Leibfried/ Rieger 1997).

Figure 1: Total Employment and Social Spending



Taking the latest available OECD (1996) data on employment ratios for 1995, and on total social expenditures for 1992, welfare spending as such does not seem to explain the differences in employment ratios. It is true that the United States and other countries with very low shares of social spending had very high employment ratios, and it is also true that the German score, at 65.1 per cent, was significantly lower, closely followed by the Netherlands (with all those part time jobs) at 64.3 per cent. France, at 59.5 per cent was even further behind, and in Belgium only 55.7 per cent of the working-age population were actually working. Ireland and the Southern European countries, with the notable exception of Portugal, scored even below the Belgian level. At the same time however, the Scandinavian welfare states with extremely high shares of social spending were also highly successful in employment terms, reaching levels that were as high or even slightly higher than in the United States. Overall, it should be said, the statistical association between employment and social spending is practically zero. So much for conventional wisdom?

1.2 Exposed and Sheltered Sectors

But how could one account for the fact that the most expensive welfare states with the highest tax burden among OECD countries and with powerful unions should be doing exactly as well in employment terms as the United States which has practically ceased being a welfare state and has just about the lowest tax burden in the OECD, and where unions have lost all control over wage levels and structures? And why is it that Continental welfare states at similar levels of economic development, and with intermediate levels of tax burdens, should be doing so much less well?

The explanation is likely to be found in sectoral differences. Since the current debate focuses on international competitiveness, one might expect that — when compared to the non-taxed, deregulated and de-unionized U.S. economy — employment in European welfare states should be generally weak in sectors that are exposed to international competition.[4] By implication, then, European countries with high levels of employment should have achieved their success in the sheltered sectors of the economy. Unfortunately, this theoretically interesting distinction is not directly represented in the employment data available in the OECD Labour Force Statistics. Also, the boundary is shifting as hitherto sheltered jobs — for instance in telecommunications, financial services or in the construction industry — are becoming exposed to foreign competition with the completion of the European internal market and under the new WTO rules. Opting for the most comprehensive definition, I have included employment in all I.S.I.C. major divisions whose products are, actually or potentially, exported or subject to import competition. This includes not only all agricultural and industrial employment, but also service employment in I.S.I.C. Divisions 7 ('Transport, Storage, and Communication') and 8 ('Financing, Insurance, Real Estate, and Business Services').

[4] It is perhaps worth pointing out that, as used here, the definition of 'exposed sectors' does not depend on the greater or lesser *degree* of 'openness' of economies (i.e., the share of exports plus imports in GDP). Since competition works at the margin, it tends to affect the whole sector, even if only a small part of its product is internationally traded.

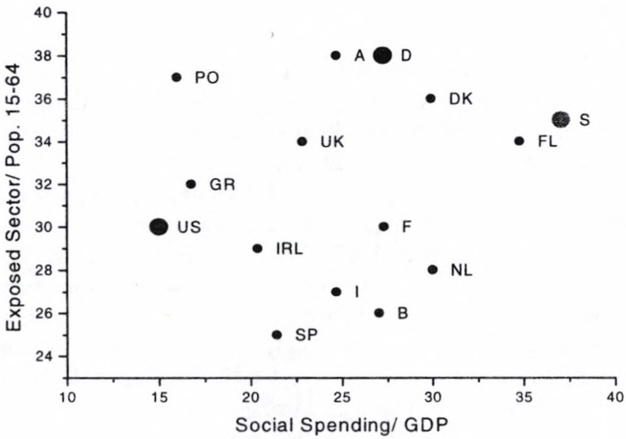


Figure 2: Employment in the Exposed Sectors (ISIC 1-5, 7, 8)

Taking these branches together, and focusing now more narrowly on the United States and the countries of the European Union, the pattern again seems to disappoint conventional expectations. The overall statistical effect of the size of the welfare state on employment in the exposed sectors (1993 data) is extremely weak (and in fact slightly positive). Even more remarkable, the United States is not doing very well here, with an employment ratio of about 30 per cent — at the same level as France, and not much better than Ireland, the Netherlands and Italy. By contrast, the Scandinavian countries with very large welfare states, achieve significantly higher employment ratios than the United States, whereas Austria and Germany with intermediate levels of welfare spending, have the best employment performance in the internationally exposed sectors of the economy.[5]

Beyond the conclusion that the size of the welfare state does not seem to affect international competitiveness one way or another, the policy implications of these data are obviously ambivalent: On the one hand, countries with a high employment ratio in the exposed sectors will find a larger share of present jobs affected by the increasing pressures of international competition and by, perhaps temporary, downturns in the international demand for their products.

[5] The employment ratios of Greece, Ireland, Spain and Portugal include relatively more agricultural jobs than is true of the other countries.

That justifies the present nervousness in countries that have so far been doing comparatively well.

On the other hand, however, one should warn of the danger that the more important other part of the message might be forgotten: The countries with the highest levels of employment in the internationally exposed sectors of the economy are characterized by stakeholder-oriented forms of corporate governance and by cooperative industrial relations that differ significantly from American (and British) forms of shareholder-oriented corporate governance and deregulated labor markets (Streeck 1992). That does not mean that there is no need for reforms in countries with high employment ratios — as the intensity of international competition increases, employment in the exposed sectors can only be maintained if the speed of adjustment and innovation, and hence the flexibility of corporate and industrial governance, does increase as well. However, in view the superior employment performance of the 'Rhine model' (Albert 1993), there seems to be no reason at all for throwing it out (even if that were politically feasible) in favor of Anglo-American models of market driven corporate controls and industrial relations.

In any case, however, the data demonstrate that the generally poor employment performance of, say, the German economy over the last decade cannot be ascribed to a general loss of international competitiveness. It must find its explanation in the sheltered sectors of the economy. Within the definition used here, these comprise the service branches in I.S.I.C. 6 ('Wholesale and Retail Trade, Restaurants and Hotels') and in I.S.I.C. 9 ('Community, Social, and Personal Services') — a heterogeneous collection which, however, shares the characteristic that local demand is being served by locally supplied services, and that foreign competition plays practically no role.[6] It is in these 'local services' that the data show a significant difference that could lead to an explanation of the poor employment performance of Continental welfare states.

Again, there is no linear relationship between employment and the size of the welfare state. Instead, the relationship which does exist (with an R^2 of 30 per cent) is U-shaped, with high employment at the upper and lower ends of the welfare-spending scale, and low employment in the Continental welfare states characterized by intermediate levels of welfare expenditures. Thus, in the

[6] That classification is questionable for employment in hotels and restaurants catering to tourists. While services are locally supplied, their consumers could opt for other locations. But tourism is not a separate category in OECD employment statistics, and the quantitative impact of the distortion seems to be limited. Countries that are strong in tourism do not seem to have exceptionally high employment ratios in local services.

United States altogether 41 per cent of the working age population have jobs in local services, and Sweden is not far behind at 39 per cent. In Austria, Germany, France and Italy by contrast, the employment ratio of local services reaches only 28 per cent — 13 percentage points less than in the United States (which would be equivalent to 6 million jobs in Germany). Finland, Portugal, the Netherlands and Britain are doing somewhat better, and in Denmark local-service employment is almost as high as in Sweden, whereas Ireland, Belgium, Spain and Greece have relatively few jobs in the local services.

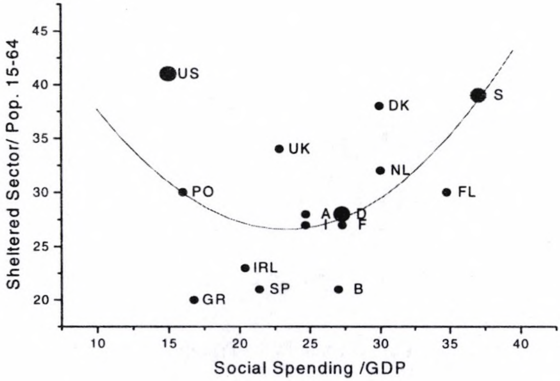


Figure 3: Employment in Sheltered Sectors (ISIC 6 and 9)

It is worthwhile therefore to further explore the factors underlying the curvilinear association between local service employment and welfare spending. Since many of these services are in fact financed from either public or private sources, and may be provided by either public agencies or by non-profit organizations, by private professionals or by commercial firms, a further disaggregation along these lines may finally provide the explanation of different employment performances.

1.3 Public and Private Services

Again, however, internationally comparable OECD data do not reflect all theoretically interesting dimensions. In particular, they do not distinguish between publicly or privately *financed* local services (which would directly correspond to welfare spending). The distinction that is possible is between employment in services *provided* by government agencies and services provided in the private sector.[7]

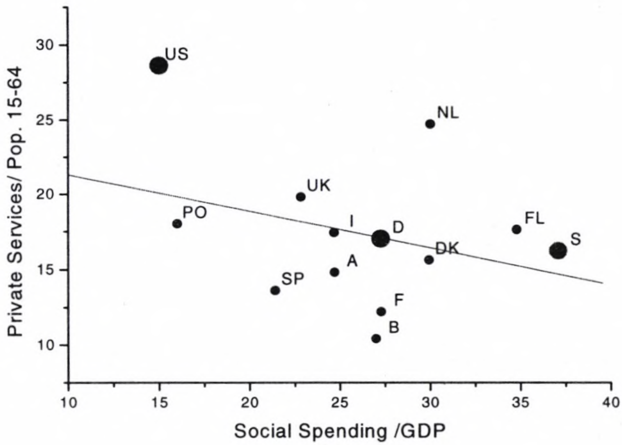


Figure 4: Sheltered Employment in the Private Sector

As it turns out, this distinction does in fact point to an explanation. There is a negative linear association between welfare spending and local services provided in the private sector. That it is weak ($R^2 = -.10$) is not surprising in view of the widely differing role of (publicly subsidized) private charities among the countries included here. But it is interesting to note that, in Figure 4, the United States and the Netherlands occupy positions far above the regression line, whereas France and Belgium have very low levels of private service employment. Surprisingly, Spain and Austria (with considerable employment in tourism) are also quite weak in private services, whereas Portugal, the United Kingdom, Italy, Germany, Denmark, Finland and Sweden are all located fairly close to the regression line.

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[7] Again, these data are not directly available, but they can be obtained by deducting OECD figures on employment in 'government services' from total employment in divisions I.S.I.C 6 plus I.S.I.C 9. 'Employment in the private sector' would thus include services performed by private physicians or by charities even if they are financed by the state or by social insurance funds.

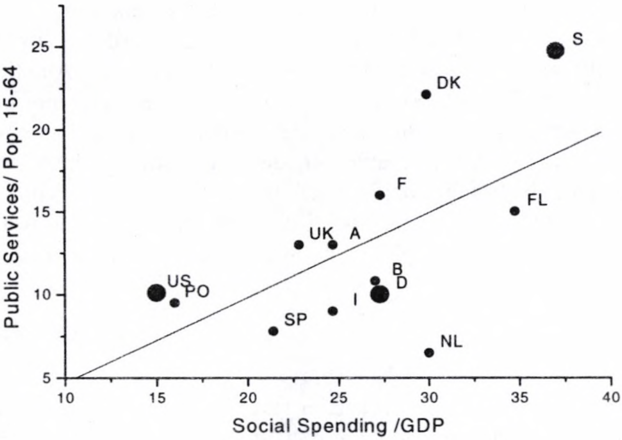

Figure 5: Employment in the Public Sector

Employment in public services, by contrast, is positively and quite strongly ($R^2 = .36$) associated with welfare spending. Employment ratios are by far the highest in Sweden and Denmark, and they are expectedly low in the United States. Public sector employment is even lower in the Netherlands — where (publicly subsidized) charities play a large role not only in the social services but also in education. In France, by contrast, public-sector services are stronger, and private-sector services weaker, than expected. Belgium and Spain have low levels of employment in both sectors. Germany, finally, manages to have almost as little employment in private sector services as is true in Sweden, and to have a public sector that is exactly as 'lean' as is true in the United States.

The curvilinear pattern of employment in the sheltered sector as a whole is thus a composite result of two separate linear effects: In the United States and other countries with a small welfare state, local service jobs are created in the private sector of the economy, whereas in Denmark and Sweden with large welfare states, the public sector is able to provide high levels of local service employment. But why should the Continental welfare states with intermediate-size social expenditures have the worst of both worlds, instead of combining intermediate levels of employment, in the public and in the private sector, to achieve equally high overall levels of service employment?

2. *Service Employment and the Welfare State*

The explanation, I suggest, lies in differences in the levels and structures of national welfare state and industrial relations systems. In order to simplify the argument, I will now concentrate on three models only, the American, the Scandinavian (represented by Sweden) and the Continental (represented by Germany), even though I know that there are significant differences among the Scandinavian welfare states and even greater ones among the Continental systems, that need to be brought out by much more careful analyses than I could present here. In the American and Swedish cases, the explanations for their exceptionally high levels of employment in the sheltered service sectors are fairly straightforward.

2.1 The American Model

In the United States, generally low levels of taxation and the additional tax cuts of the 1980s have contributed to a highly unequal distribution of incomes (OECD 1995) which facilitated the simultaneous expansion of private service employment at the upper and at the lower end of the skill scale. Since education and health care are to a much larger extent than elsewhere privately financed, the growing demand of affluent consumers for high-quality educational and medical services increases the number of well-paid jobs at the professional level. At the same time, the failure of Congress to raise the statutory minimum wage combined with weak or nonexistent unions combined, with the short duration of unemployment benefits and the virtual absence of social assistance for the long-term unemployed have favored the emergence of a large low-wage labor market. This, in turn, facilitated the creation, or maintenance, of service jobs in hotels, retail trade, restaurants, and a great variety of other household and personal services. In these jobs, labor productivity tends to be very low. But since wages are also very low, the American model allows large numbers of low-skilled workers to find employment in the private sector. As a matter of fact, in 1993-1995, the share of low-wage employment[8] was 25 per cent in the United States, as compared to only 5.2 per cent in Sweden, 7.2 per cent in Belgium and between 12 and 13 per cent in most other Continental countries (OECD 1996, Table 3.2). Thus, the up side of the American model is the dynamic expansion of service employment at all qualification levels. Its down

[8] In the OECD study, low-paid workers are defined as full-time workers who earn less than two-thirds of median earnings for all full-time workers (OECD 1996, 69).

side is the plight of the 'working poor' receiving incomes below the subsistence level even when employed full time (Freeman 1995; Weir 1995).[9]

2.2 The Scandinavian Model

In Sweden and Denmark, by contrast, very high taxes, strong unions and generous rates of income replacement in case of unemployment have reduced income inequality and wage differentials to the lowest level among OECD countries. At the same time, education and health care are publicly financed and publicly provided. As a consequence, there is neither a low-wage labor market nor much room for private services at the professional level. Instead, high levels of tax revenue are used to finance universal health services and education as well as a wide range of free social services for families with young children, for the elderly, the handicapped[10] and the sick, for drug addicts and immigrants. These services involve not only work for highly trained professionals but also provide a large number of decently paid jobs for persons with relatively low levels of formal training.

The obvious down side of the Swedish model is its dependence on very high levels of taxation which have become vulnerable to increasing international tax competition for mobile capital, and to the growing tax resistance of mobile professionals (Freeman 1995a). Thus the need for fiscal retrenchment in the 1990s forced governments to reduce not only the generosity of welfare payments, but also the level of public-sector employment — with the consequence that unemployment has risen to normal European levels, even though the level of employment continues to be very high by international standards. In Denmark, however, employment has held up remarkably well even in the 1990s.

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[9] It should be emphasized, however, that the United States already has a federal program, the 'Earned Income Tax Credit' which, if adequately funded, would be perfectly suited to deal with the inadequate incomes of the 'working poor' (Haveman 1996).

[10] In 1993, Sweden spent 6.39 per cent of GDP on 'services for elderly and disabled people' and on 'family services'. In Denmark, the percentage was 4.36, and in Finland 3.01. The level is much lower in Luxembourg (1.23%), in the Netherlands (1.16 %), in France (1.11%) and in the UK (1.05%), and lower still in West Germany (0.74%) and Ireland (0.53%). Expenditure on these services is minimal in Belgium (0.36%), Italy (0.30%), Spain (0.20) and Portugal (0.13%), and practically nonexistent in Greece (OECD 1996a).

2.3 The Continental Unemployment Trap

The more highly developed Continental welfare states, with the notable exception of the Netherlands, have not been able to achieve high levels of local services either in the public or the private sector. In contrast to the United States, however, their levels of employment in the public sector cannot simply be explained by the smaller size of the welfare state. While it is true that total social spending amounts to more than 37 per cent in Sweden, whereas Continental welfare states tend to absorb only between 25 and 30 per cent of GDP, that is still much more than the 15 per cent share of social spending in the United States (OECD 1996b). If nevertheless public-sector employment in Germany is exactly as low as it is in the United States, that appears as a path-dependent consequence of the Bismarckian model of the welfare state, that was originally meant to deal only with the social risks arising if the single (male) breadwinner was unable to support his family through full-time work (Esping-Andersen 1990). Hence, Continental welfare states provide quite generous transfer payments in cases of disability, retirement and unemployment — but they never developed a Scandinavian commitment to social services that would complement or compete with the functions performed in the family by mothers, wives and daughters (see note 10, above). As a consequence, the Continental welfare state does not create much employment in publicly financed social services.

There are of course well paid professional jobs in public education and in publicly-financed health care provided in public hospitals or in private practice. But the fact that these services are publicly financed, from tax revenues or from social insurance funds, implies that employment growth is held back or even reversed by efforts to reduce tax burdens and public-sector budget deficits, whereas employment in the United States will dynamically expand as affluent consumers are increasing their demand for high-quality services in education and health care in the private sector.[11]

In Continental welfare states, service employment in the private sector is held back at the upper end of labor market by the fact that public education and publicly financed health care are largely provided free of charge. Thus even when the quality and quantity of publicly financed services should be unsatisfactory, consumers will hesitate to switch to privately supplied services for which — in addition to their tax bill — they would have to pay high prices

[11] Moreover, since American state universities are also charging high tuition fees, even public sector employment is able to expand as a consequence of rising private demand.

covering the full cost of production. Hence high-quality private services are more or less confined to the niches of luxury markets.

At the lower end of the labor market, however, the Continental welfare state is as effective as its Scandinavian counterpart in destroying the viability of a low-wage service jobs in the private sector. Compared to the United States, at any rate, levels of taxation are high, unions are strong, income inequality and wage differentials are low,[12] and reservation wages are defined by relatively generous wage replacement in case of unemployment and indefinitely available social assistance payments. Hence the American problem of the 'working poor' with full-time jobs at wages below the subsistence level could not arise in either the Scandinavian or the Continental welfare states. But in avoiding that problem, the Continental model is actually destroying more employment opportunities in the private sector than is even true in Scandinavian welfare states.

The reason is that Continental welfare states are primarily financed through payroll taxes. In Germany, for instance, 74 per cent of total social expenditures were financed through workers' and employers' contributions to social insurance systems in 1991, and in France that was true of 82 per cent. In Germany, these contributions amount to about 42 per cent of the nominal wage paid be the employer. By contrast, Scandinavian welfare states are to a larger extent financed from general tax revenues which, in Denmark, did amount to 83 per cent of total social spending, leaving only 17 per cent to be paid as surcharge on wages (BMA 1995).

The dependence of payroll taxes makes Continental welfare states particularly vulnerable to any increase in unemployment which increases expenditures and reduces revenues at the same time. As a consequence, it becomes then necessary to either reduce benefits at a time when more persons become dependent upon them, or to raise payroll taxes at a time when firms are particularly sensitive to any increase in labor costs. Neither of these options is politically easy to implement. Moreover, there is now a widespread belief that social insurance contributions, collected in the form of payroll taxes, are themselves a major cause of high levels of unemployment. By raising the price of labor, so it is argued, they reduce international competitiveness and contribute to the substitution of labor by capital.

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[12] In 1993, the ratio of median wages (for men and women) to wages in the lowest decile (D5/D1) was 2.05 in the U.S., 1.79 in the UK, 1.75 in Italy, 1.65 in Japan, 1.64 in France, 1.54 in the Netherlands, 1.44 in Germany, 1.43 in Belgium and 1.34 in Sweden. Germany, incidentally, is practically the only OECD country where wage differentials have continuously *fallen* between 1983 and 1993 (OECD 1996, Table 3.1).

From an economic point of view, however, not all of these arguments are well founded. If the price of labor were generally raised by social insurance contributions (which in Germany amount to more than forty per cent of the total wage bill), the effect on international competitiveness would be neutralized by a fall in the exchange rate — and if devaluation were prevented by monetary policy, the lack of competitiveness would have to show in the form of a persistent trade deficit. Since neither of these effects seem to have been generally true for Continental welfare states over the last decade (OECD 1996c), it is reasonable to think that the impact of social insurance contributions on the cost of labor has been internalized, together with all other factors affecting the cost of production, in the normal processes of wage setting (Härtel 1997).[13] As a consequence, the take-home pay of workers in countries that rely largely on payroll taxes will be lower than it would otherwise have been — which also will reduce the effect on the rate of substitution between capital and labor.

All that, however, is true only at the middle and upper ranges of the labor market, whereas things are very different at the lower end of the pay scale. Here, the availability of social assistance defines a lower threshold below which net wages cannot be reduced. Thus, certain types of 'bad jobs', which are economically viable in the United States, simply could not exist in Europe — which is, of course, a fully intended effect of European welfare states. But what is probably not intended, is the impact of payroll taxes on jobs well above the subsistence level.

If the net wage of the worker cannot fall below a guaranteed minimum, the consequence is that any social insurance contributions, payroll taxes and wage taxes that are levied on jobs at the lower end of the pay scale will not be absorbed by the employee but must be added to the total labor cost borne by the employer. In Germany, that would amount to a surcharge (social insurance contributions plus wage tax) of at least 50 per cent. Assuming that additional overhead costs will be proportional to total labor cost, the implication is that the minimum productivity that a job must reach in order to be viable in the market is raised by more than 50 per cent above the level that would be required if labor costs were equal to the net reservation wage of the worker. As a consequence, a considerable range of perfectly decent jobs which, in the absence of payroll taxes, would be commercially viable are eliminated from the private labor market of Continental welfare states.

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[13] This is not meant to deny that *increases* in the rate of social insurance contributions will have negative effects on employment, since the adjustment of wages will take time, especially if the rate of inflation is very low.

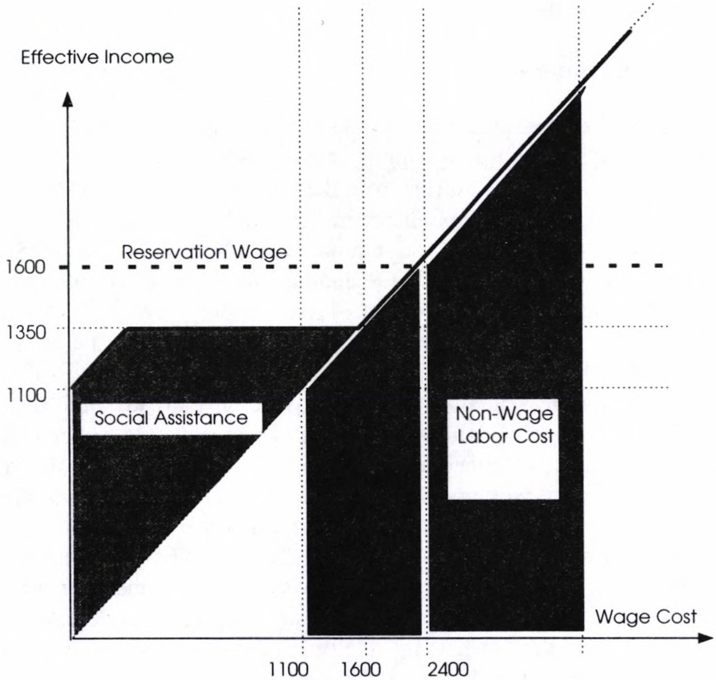

Figure 6: Social Assistance in Germany

In Germany, to give a numerical example, social assistance for a single person amounts to about DM 1100 per month, in addition to which that person may earn up to DM 250 by part-time work. Any additional income from work, however, is fully set off against social assistance — i.e., it is taxed at a marginal rate of 100 percent. Assuming that an additional financial incentive is needed to make full-time work attractive, the minimum net reservation wage in Germany may presently amount to about DM 1600 per month (i.e. about DM 10, or a bit less than US $ 6, per hour). In order to provide the worker with that net wage, however, the employer will have to pay a total wage bill of at least DM 2400 per month which — if due allowance is made for other taxes and overhead — will allow only jobs with fairly high productivity to survive in the private sector. In this sense, therefore, it is indeed fair to say that Continental welfare states are causing high levels of long-term unemployment for persons with low levels of marketable skills.[14]

2.4 Continental Options

If the downside of the American model is the plight of the working poor, and if the Scandinavian model has become highly vulnerable to the erosion of its tax base, Continental welfare states suffer from their inability to expand domestic-service employment either in the public or in the private sector. In the abstract, one might think that the Continental employment gap might be closed by moving either in the American or in the Scandinavian direction. If both options were equally feasible, political preferences would widely diverge. Practically speaking, however, the Scandinavian option appears to be out of the question. The reasons are financial and political. Continental welfare states, even though less expensive than their Scandinavian counterparts, are already hard-pressed financially. Thus, a Scandinavian-type service expansion would either require substantial tax increases or further reductions of welfare transfers; at the same time, there is no large and well organized political demand for additional public services, whereas the political opposition against either tax increases or further cutbacks in social transfers is already highly mobilized. Thus a Scandinavian solution is not even discussed on the Left, whereas the 'American way' is strongly advocated by business associations and neoliberal parties demanding to cut social assistance to the bone. It is equally strongly resisted by unions and political parties defending the 'Rhine model'. As a consequence, any change is blocked and mass unemployment continues to rise.

Nevertheless, it is possible to specify, at least in the abstract, strategies through which Continental welfare states could help to create, rather than to destroy, private employment in local services. To be effective, such strategies cannot primarily aim at attractive jobs in the middle and upper ranges of the labor market (even though changes in the financing of high-quality services, to be discussed below, could make a difference there as well). At any rate, any attempt to close the European employment gap must address the specific problems of low-skill groups — and if the solution is to be found in the private sector, that implies that European countries must actively promote the creation of a low-wage labor market that does not presently exist. In order to be normatively acceptable and politically feasible, however, European solutions cannot allow the emergence of a large underclass of the 'working poor'. Hence

[14] In Germany, there are practically no negotiated wage scales with hourly rates below DM 10; and jobs at or slightly above that wage level often cannot be filled.

low-wage jobs, European style, would still need to provide net incomes well above the subsistence level defined by social-assistance rules.

If the problem is defined in this fashion, the solution seems to require a reorientation of the welfare state from providing full income support for persons who are full-time unemployed to providing partial income support for persons working at wages below the present minimum level. The most comprehensive solution could be achieved by a fundamental reorganization of the welfare state along the lines of a negative-income tax — which is presently discussed in Germany under the name of '*Bürgergeld*' (Mitschke 1985; 1995).

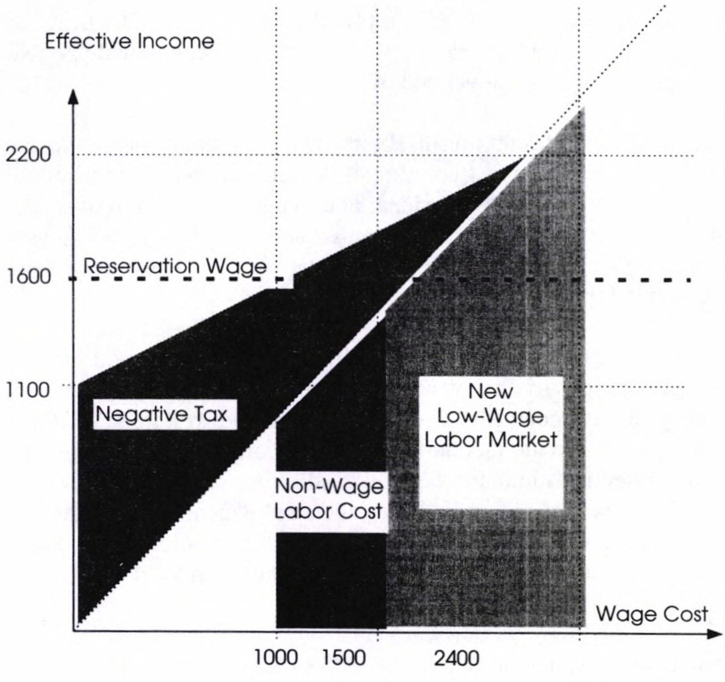

Figure 7: Negative Income Tax

The negative income tax would replace all present forms of means-tested social transfer payments by a single payment that decreases at a rate of, say, 50 per cent as income from work (or other sources) increases. The diagram represents the situation of a single person who only receives income from work.[15] It is also assumed that in the absence of any other income, the negative tax would guarantee a subsistence income of DM 1100 per month. At a degression rate of 50 per cent, transfers would cease when income from work exceeds DM 2200 per month. It is further assumed that the net reservation wage of workers at the low end of the labor market still remains at DM 1600. But at that level, the net wage received from the employer would now be only DM 1000, while DM 600 would be received from the negative tax. Even if the employer would still have to pay a social-insurance surcharge of 50 per cent, the total wage bill would then be reduced by more than one third, from DM 2400 to 1500. The negative income tax would thus open up a wide range of additional, economically viable employment opportunities at the lower end of the labor market.

That, however, is no reason for optimism. By its own logic, the negative income tax would require a far-reaching restructuring of the present systems of taxation, social assistance, social insurance, pensions, and wage setting. Moreover, the available estimates of its overall financial consequences are still enormously diverging.[16] Thus, chances are slim that Continental welfare states could soon be reorganized in this fundamental fashion.

Many of these difficulties could be avoided, however, by more modest, less costly, and simpler proposals that would focus exclusively on job creation, rather than attempting a fundamental reorganization of the welfare state. Such solutions would simply provide income subsidies to workers in low-wage jobs below the present effective minimum, and leave all other present rules as they are (Scharpf 1993). In both versions, however, the employment effect of income subsidies would depend on the cooperation of unions that would have to agree to the creation of new wage scales below the present minimum level. That is not

[15] The negative income tax, like the Earned Income Tax Credit in the United States and similar schemes in the UK and in Ireland, would be oriented toward family or household incomes — which is not the optimal criterion from a purely employment-oriented perspective. This aspect is not reflected in the diagram.

[16] A major cost factor results from the fact that the lower threshold of income taxation will shift from the present subsistence level to twice that amount. Beyond that, the estimates are highly sensitive to assumptions about how the higher threshold should be treated throughout the tax scale, and about which present transfers are to be replaced by the negative income tax. As a consequence, estimates of net costs (in the absence of any employment effects) vary between zero and close to 200 billion DM (Hüther 1990; DIW 1996).

an attractive function for unions that see their mission in raising, rather than lowering, minimum wages. Moreover, unions fear that wage reductions at the lower end could induce a general erosion of the present wage structure (Hanesch 1995). Even though that objection may not be plausible in economic theory, it has so far prevented political parties in Germany from responding to proposals of this nature.

Nevertheless, there is now a slight hope that a functionally equivalent solution — which would not depend on the active cooperation of the unions — might find more political support. Its feasibility rests on precisely those features of the Continental welfare states that are so damaging to service employment, i.e., their dependence on social insurance contributions from employers and workers as a major source of welfare finance. In Germany, for example, they presently amount to about 42 per cent of the employer's wage bill, and they are shared equally between employers' and worker's contributions. Hence, if these contributions were (almost) completely waived at and below the present minimum wage of about 10 DM per hour, the wage bill of the employer would be reduced by 22 per cent — which would increase the profitability of service employment by the same percentage.[17] At the same time, the take-home pay of the worker would also increase by the same percentage — which would increase the attractiveness of low-end jobs and, perhaps, would also make jobs below the present minimum wage more attractive.

Of course, these jobs would still need to be fully covered by the social insurance system. Hence, the contributions waived would have to be made up by payments financed from general tax revenues. Like the negative income tax, the size of the subsidy would have to decrease at higher wage levels. Thus, one might eliminate contributions almost totally at and below the level of the present minimum wage, and the subsidy could again be reduced to zero at twice that level. But these are matters for political judgment and compromise, which would have to vary from one country to another. In principle, however, this solution should be open to all countries that are financing very large shares of their social expenditure through non-wage labor costs.

In conclusion, I suggest, the Continental employment gap does not primarily result from a loss of international competitiveness. It affects the sheltered sector only; it is caused not by the size of the welfare state, but by its characteristic structure and mode of financing; and these causes could be remedied by

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[17] A more far-reaching proposal following the same logic has been presented by Jean-Paul Fitoussi (1994): It would relieve employers of the social-insurance contributions required at the level of the minimum wage, for *all workers* presently employed.

institutional reforms that would increase, rather than destroy, the level of social-policy support for disadvantaged groups in Continental societies. In other words, the rigidities that seem to matter here are the rigidities of political systems that are incapable of effective reforms, rather than the alleged rigidities of the labor market.

3. *The Erosion of the Tax Base*

To the extent that unemployment could be transformed into subsidized employment in the private sector, the fiscal pressures on the welfare state would be reduced.[18] In that case, the present Continental practice of relying largely on social insurance contributions for its finance might in fact have certain advantages over some alternative types of tax finance.[19] It is a form of raising revenue which, because of its perceived insurance character, may be less likely to provoke tax resistance than, say income taxes. Moreover, since the ultimate incidence even of employers' contributions is likely to be on the take-home pay of the worker, it should also be less vulnerable to the pressures of regulatory and tax competition for mobile factors of production.[20] Thus, if changes are considered at all, they probably should emphasize the insurance character even more by eliminating employers' contributions altogether and moving from systems that insure only workers to systems of universal and compulsory individual insurance (which would also have the effect of reducing the contributions paid by individual workers, who are presently required to pay for the insurance of the non-working population as well).

If a negative income tax system were in place that assures basic incomes for everybody, including pensioners, the insurance contributions would only have

[18] Quantitative estimates of the employment effect of the negative income tax and similar schemes are not available, and for good reasons: In order to be effective, these programs must change the present structures of labor markets — hence simulation models validated by time-series data reflecting past and existing structures cannot be used to predict their effects. At the most, it might be possible to estimate how many, and which, presently existing jobs would be lost in the United States if the U.S. labor market were truncated at the de-facto minimum wage that is presently effective in Germany.

[19] In this regard, I must now qualify a more negative judgment of non-wage labor costs in an earlier article (Scharpf 1997, 31).

[20] That conclusion may seem overly optimistic in light of the persistent political campaign of employers and business associations against the high level of non-wage labor costs in Germany and other Continental countries. Conceivably, business decisions may be as much affected by a 'tax illusion' as Keynes thought that wage setting was affected by a 'money illusion'.

to cover income risks above that level, and would only have to be paid by persons with incomes (from any source) above the minimum level. In the absence of a negative income tax, contributions from persons with low incomes would need to be substituted or subsidized from general tax revenues. These changes would in effect immunize those parts of the welfare state that assure income support in cases of unemployment, sickness, disability and old age, against the competitive pressures of an internationalized economy. Insurance contributions, even if required by law, would assume the character of private investment or consumption expenditures, rather than of public burdens on the economy.

However, if the insurance elements of social security are emphasized more, that would leave a larger part of redistributive transfers to be financed from general tax revenues. That would add to the difficulties European countries already face in raising the taxes to finance existing levels of public services. As discussed before, these problems result from the economic competition over mobile tax bases, which primarily affects the taxation of capital incomes, business taxes, and taxes on the personal incomes of internationally mobile professionals. As it is, countries are responding by reducing the rates of taxation, sometimes to zero, and by increasing the tax burden on less mobile factors. This, in turn, increases the political tax resistance of those groups that cannot escape national taxes by moving their assets, or themselves, out of the country. So what options do remain?

The most general escape route considered seems to involve a shift from taxes on profits and incomes to taxes on consumption — including taxes on energy input, on pollution and other 'green' taxes. They have the dual advantages of being difficult to avoid even for the owners of highly mobile assets and, if applied in the form of a value-added tax, of affecting imports as much as local production, and of not burdening exports.[21] But consumption taxes are also associated with two disadvantages. First, at uniform rates their distributive impact tends to be regressive since poor people must spend larger shares of income than rich people. Hence countries that already depend heavily on consumption taxes tend to have split tax rates — high for 'luxury goods' and low for 'basic needs'.[22] Second, and perhaps more important, generally high consumption taxes would eliminate low-productive service employment just as

[21] Within the European Community, that is of course only true as long as the 'country-of-destination principle' is still in force.

[22] Discussion on the more radical option of replacing the progressive income tax by a progressive tax on consumption expenditures is not sufficiently advanced in Europe to allow an estimate of its desirability and political feasibility.

effectively from the 'official' labor market as was shown to be true for high payroll taxes. Hence it would also be necessary to reduce or eliminate the value-added tax on services produced by low-wage labor. Unfortunately, both of these forms of 'positive discrimination' are difficult to define and also difficult to implement efficiently.

The second option, that so far is not actively explored in Europe, concerns services that are presently provided free of charge, or with heavy subsidies by the public sector.[23] Many of these — e.g., secondary and higher education or museums and opera houses — are predominantly used by the medium and higher income groups whose tax burden must be reduced as a consequence of international tax competition and political tax resistance. At the same time, however, high quality universities, cultural facilities or medical services have become even more important for maintaining, or increasing, the economic attractiveness of regions exposed to international competition. Hence, cutting back on these services under the pressures of international competition, as is presently happening in most European welfare states, is likely to be self-defeating in economic terms. The same is true of much of the public infrastructure in transportation or communication, and of essential public services from waste removal to public security.

In some of these areas, like telecommunications and air transport, privatization may be the perfect answer; in others like waste removal and the maintenance of residential roads, cost-covering user charges have long been used and are considered unproblematic. Still other services, as for instance public security and crime prevention, may have the character of 'club goods' at the level of local communities which, if transparently financed by local taxes, will encounter little taxpayer resistance. Others, like national defense, are in the nature of 'pure public goods' that must be financed from general tax revenues if they are to be provided at all.

But that still leaves a wide range of facilities and services that provide 'private goods' of great value to those who use them, but which also are important to the social, cultural and economic viability of advanced industrial societies (i.e., they have positive externalities). However, they are not used by everybody, or not by everybody all the time, and they tend to be used more frequently and more intensively by high-income groups. At the same time, the full cost of their provision is so high that low-income groups would be unable to afford these services even if a negative income tax or similar redistributive schemes were in

[23] Perhaps the decision of the new Labour government in Britain to charge substantial student fees may initiate the search for such solutions in other service fields as well.

place. In European welfare states, the traditional response to this distributive constellation has been to provide high quality services to everybody free of charge, or at heavily subsidized user charges, and to rely on progressive taxation in order to make high-income groups pay a disproportionate share of their cost.

As this form of financing is eroding under the pressure of international tax competition, and is losing its normative plausibility as national tax systems are becoming more regressive, one of two scenarios seem possible. In the first, the quality of universal public services is progressively reduced to the point where they become a 'poor man's' option while the rich will emigrate to expensive private schools, private universities and private medical practice. Alternatively, public services will be reduced, and publicly financed or subsidized facilities will be closed down, to such an extent that the ideal of universal access to quality libraries, museums, theater, opera and concert performances, swimming pools and sports facilities, or public transport, will be abandoned altogether. What will survive, then, are private facilities serving luxury markets or catering either to the highly concentrated demand in a few metropolises (as is true on Broadway) or to the common tastes of mass audiences.[24]

Much of this is happening already, and not all of it is unacceptable. But where it is considered unacceptable, a second scenario needs to be explored that aims at maintaining the ideal of universally available high quality services by shifting a larger part of their financial support from general tax revenues to means-tested user charges. The logic is simple: If high-income groups are no longer willing to pay the high taxes that could support free services, they could at least be made to pay the full cost of those services that they are in fact using. Social justice could then be maintained by providing means-tested vouchers for low and medium income families that could not afford to pay full-cost user charges[25] — which would have the attractive side effect of introducing a strong element of consumer power into the governance of education and other public service sectors, and of allowing competition on equal terms between public and private service providers.

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[24] It is true that the electronic media are now able to provide highly specialized information and entertainment services to dispersed audiences that could not previously have supported commercial programs catering to their tastes or needs. But that covers only a relatively small range of the classical functions of public services and infrastructure facilities.

[25] If it is thought to be a problem that university students should be made dependent on their families, vouchers could be made available to all (qualified) students, but recipients might be required to pay a lifelong surcharge on their income tax which, on average, would correspond to the cost of the voucher.

To summarize: There is reason to expect that increasing constraints on the national capacity to tax will affect the viability of European welfare states. Nevertheless, the values served by the welfare state may be defended by a shift from highly vulnerable sources of revenue to modes of finance that are more robust against the pressures of economic competition. Depending on the existing mix of transfers and services, and existing patterns of finance, optimal solutions would surely differ from one country to another. Nevertheless, it should be worthwhile in most countries to emphasize differentiated consumption taxes for the collection of general revenue, to emphasize individual insurance for the financing of income-maintaining transfers, and to emphasize means-tested user charges for the financing of public services. These suggestions are not meant as patent solutions, and they certainly would not be easy to adopt and implement, but they are meant to show that the democratic welfare state is not condemned to abdicate, or to organize its own dismantling, even if the hope for its reconstruction through positive integration at the European level should not be fulfilled.

This conclusion contrasts, somewhat, with the deep pessimism of authors who have long studied and thought deeply about changing conditions in the area of industrial relations (Visser/Ebbinghaus 1992; Streeck 1997). What I could add is the observation, based on the employment data presented above, that apparently the most highly institutionalized ('corporatist') industrial relations systems have not been doing badly at all in terms of maintaining high levels of employment in the internationally exposed sectors of the economy (Neubäumer 1997). If this were more generally realized, perhaps political campaigns against the institutional 'rigidities' of corporatist industrial relations would appear less justified by the pressures of international economic competition.

That is not meant to suggest that the corporatist model of highly institutionalized 'cooperative' industrial relations should be generally superior, under present conditions, to the Anglo-American model of deregulated labor markets, shareholder-oriented corporate governance and highly decentralized wage negotiations (Streeck 1995; 1997). It seems more likely that both of these models are able to succeed reasonably well in a highly competitive international environment (OECD 1997). But what of countries in which industrial-relations institutions have not been weakened to the extent that is true in the United States and in Britain, but are also not 'cooperative' to the extent that is possible in Sweden, Denmark, Austria, Germany or the Netherlands? For them, one might expect serious difficulties — especially if they should become members of the European Monetary Union. Given a uniform rate of inflation throughout the EMU, countries where the rise of unit labor costs exceeds the current rate of inflation are bound to suffer competitive disadvantages that will increase unemployment in the exposed sectors. Countries with corporatist institutions are, in principle, capable of influencing wage setting to avoid such consequences (Scharpf 1991); and presumably market-driven systems can do so as well. The critical question for other countries then seems to be whether they will be able to change their existing industrial-relations institutions in one or the other of these directions.

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