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MAASTRICHT 2042 AND THE FATE OF EUROPE

Toward Convergence and Full Employment

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The European Paradox

Why does—why should—any country wish to join the European Union? The answer is plain: to become European. And what does that mean? If it means anything, surely the European dream is to be stable, democratic, and prosperous, with a touch of the "social model" that is supposed to distinguish Europe from the United States. This is obvious, and not only that: it is spelled out explicitly in the founding documents of the union.

For the presently less-prosperous regions of the European Union (EU), especially to the east, becoming European requires that they catch up, toward the living standards prevailing in the west. It does not require equality. But the EU, as a project, does require that the gap between countries narrow over time. This we may call the imperative of income convergence.

This brief explores that imperative over a relatively long time, stretching out to the 50th anniversary of the Maastricht Treaty in 2042. Will that landmark be truly a golden jubilee, or will it prove nothing more than a sour footnote in the record of a failed endeavor? The answer will depend, in part, on whether the convergence imperative is recognized and realized between now and then.

Mathematically, the convergence imperative imposes a simple condition: growth of wages and incomes must be inversely proportional to present wage rates. Incomes and wages of the rich

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must grow more slowly than those of the less rich, and those of the poor should grow the most rapidly of all.

The force of foreign direct investment has been bringing the start of convergence to some of the accession countries of the EU–25. Thanks to appreciating currencies, wages in these countries have been rising quite rapidly—when measured in euros. But this process is unlikely to complete the job, for two reasons: investment booms tend to peter out, and once a country joins the eurozone, exchange rate–based convergence will stop. Over the long run, therefore, convergence will not just happen. It must be made to happen. And that means it must be part of an economic policy agenda for Europe.

But here we encounter a problem. The economic policy prescription being advanced across Europe is the project of labor market reform. A truism of labor markets is that they are supposed to operate under the guidance of supply and demand. If unemployment exists, the cause must lie in a failure of the real wage to adjust to its equilibrium value. This is the rigidities doctrine. To restore full employment, wages paid to workers with limited skills must fall. Labor market reformers believe that the EU should eventually become flexible enough to reach levels of inequality characteristic of a "dynamic" capitalist economy—the United States. For them, the American model stands as the template for the degree of inequality that must be achieved in order to enjoy full employment.

A second truism of current economic discussion is globalization—the idea that workers must now compete across international lines. This truism carries a clear implication: if wages must fall for low-skilled workers in the rich countries, then they must also fall for low-skilled workers in the poorer countries, where unemployment is high and educational attainment is comparatively low. Unfortunately, the consequence of this logic of globalization, combined with the logic of labor market reform, is divergence, and potentially even declining relative pay rates, in the poor regions of Europe.

This is the European paradox. European ideals require convergence. But the logic of present European economic doctrine dictates divergence. And divergence, if it occurs, will be fatal to Europe. Unless income gaps between rich and poor countries continue to decline over the long run, the European project will fail, and sooner or later the EU itself will disappear.

For these reasons, I take the position that the European project must be saved, most of all, from itself. And this means that the paradox of Europe must be overcome. The question is how to do it. An answer requires a reexamination of underlying economics. But, fortunately, there *is* an answer. Contrary to theory, supply-and-demand economics do not rule the labor market. And in fact, the United States does not represent the ultimate example of high inequality in its pay structure, even compared to Europe. Therefore, a policy of convergence is *not* incompatible with progress toward full employment.

The Economics of Inequality and Unemployment

In this section, I document the following propositions:

1. The theory of unemployment underlying the policy doctrine of labor market reform is fallacious, and its implication that jobs are purchased with inequality is incorrect.
2. Across Europe, the opposite relationship holds: countries and regions that are *more* egalitarian systematically enjoy *less* unemployment. This is not an anomaly, but entirely in accord with correct principles of economics.
3. The claim that the United States has a more unequal pay structure than that of Europe is false.

As widely believed, moving Europe toward American levels of employment means moving Europe toward American levels of inequality. But to achieve this goal, inequalities within Europe must be *reduced*, not increased.

This is the resolution of the European paradox. No contradiction exists between the ideal of European equality and an efficient economic policy that results in full employment. The contradiction is only between the policies that are required and what, so far, the political, academic, media, and business elites of Europe have believed.

A. Why the Conventional Theory of Unemployment Is Wrong

In the textbook theory of labor markets, unemployment is voluntary. It is a matter of personal or social choice. Unemployment by social choice occurs when workers find that some larger power—the government or a union—has set the prevailing wage too high to justify their employment. Excess labor supply exists, but the normal market response—namely, the bidding down of wages to an equilibrium level—is blocked by some barrier in the labor market. Minimum-wage laws, trade union contracts, and job protections are standard examples of rigidities thought capable of producing this effect. This is the prevailing form of voluntary unemployment in the imagination

of modern Europe and its media, economists, and policymakers, and it justifies the campaign for "labor market reform."

But the claim that workers could cure unemployment by accepting a reduction in their wage rates underpinned the classical response to the Great Depression, just as it does the neoclassical response to unemployment today. Keynes destroyed this argument, showing that workers not only *did not*, but also *could not*, make a wage bargain in real terms. Instead, workers merely accept the aggregate volume of employment offered by employers at a given, conventionally fixed structure of money wages. Under these conditions, the total volume of employment could be increased very simply: by inducing employers to offer more jobs at the same money wages, which could be done by creating the conditions for greater profit, associated with higher employment. And if that were so, Keynes argued, the previous unemployment would have to be considered *involuntary*.

Ever since Keynes, policymakers in the United States have responded to unemployment as if they believed in this possibility. They routinely cut interest rates or income taxation in order to induce consumers to spend and businesses to invest. Or government may spend more. This response is the common practice, but it is widely overlooked, especially in Europe, where unemployment is almost always linked to the flexibility of labor markets, not to demand. Indeed, policies to "reform" labor markets are routinely announced, and they always fail.

This brief argues that a full appreciation of the unemployment problem in Europe requires a new integration of Keynes's demand theory with an understanding of how pay structures influence the rate of unemployment.

A More General Theory of Unemployment and Inequality

In 1955, Simon Kuznets argued that inequality would rise in the early stages of economic development and transition to industrial growth. John Harris and Michael Todaro (1970) offered a model of unemployment in this transition. In the model, workers migrate from low marginal-product rural sectors to cities, where minimum wages are imposed, and accept a high probability of sustained unemployment, in exchange for a low probability of getting jobs and enjoying the resulting rise in income. A positive relationship between inequality and unemployment emerges: more inequality means more unemployment. No matter how rapidly cities grow, mass unemployment is inevitable for a time. It will end only when the rural population is absorbed or emigrates.

While Harris and Todaro focused on East Africa, their argument is quite general and may be used for modern societies, which have elites in technology and finance, a core of manufacturing workers, and a large reservoir of low-paid workers in services. Access to elite jobs is restricted by cartels and credentialing. The same is not true for manufacturing workers, who nevertheless enjoy wage premiums, or for service workers, whose pay is largely set by the social minimums of the welfare state.

From the standpoint of the individual worker, the decision to risk unemployment depends on two parameters: the difference between current income and the hoped-for improvement, and the probability of attaining that improvement. The former can be measured by the inequality of wages. The latter depends in part on the rate at which new higher-wage employments are offered. Thus, structural factors (inequality) and demand both play important roles in determining the rate of unemployment.

In particular, *pay inequality causes unemployment*. This is partly a matter of individual choice, as search theorists have argued. Yet, since unemployment can be reduced by policy without changing the underlying preferences of the workforce, then, by Keynes's definition, *it is involuntary*, in spite of having been individually chosen.

Meidner and Rehn (1951) pointed out another consequence of inegalitarianism in the structure of pay: high inequalities permit technologically backward firms to maintain competitiveness, despite higher unit costs, by paying their workers less than more progressive firms. Egalitarian societies, on the other hand, enjoy efficient use of all their labor resources, high absolute living standards, and competitive advantages over societies that allow markets to adjust wages more "freely."

Inequality is a feature of society. A question of crucial importance to Europe, one entirely overlooked in the literature, is: What are the boundaries of the society? Are they purely local? Are they national? Or are they continental in scope?

As economic barriers fall between regions and countries, and as communications improve and discrimination decreases, individual prospects must necessarily expand. This process has been going on in Europe for 50 years. Given the theoretical proposition just stated (relating the *perception* of inequality to unemployment), it is immediately obvious that European integration poses a huge conundrum for European employment.

For the further one looks in any direction across Europe, the greater the inequality one observes. *It follows that the more Europe integrates, the greater the problem of unemployment will be*, unless

drastic measures are taken to reduce interregional inequalities. This is the economic logic of a strategy of income convergence.

B. Inequality and Unemployment in Europe

What is the effect of expanding the sphere of European economic integration on the inequalities experienced and perceived by Europeans? The importance of this question stems from the fact that Europe experiences different levels of inequality at different levels of geographic aggregation. In many parts of the continent, local or national inequality is low. However, wage differentials between European countries are high.

Conceição, Ferreira, and Galbraith (CFG) (1999) showed that there was an uncanny negative correlation, on the order of -0.8, between European GDP per capita and rates of unemployment from the late 1970s to the early 1990s (when the collapse of Eastern markets upset it). This shows that the European economies are interdependent: if national labor markets cleared independently, then per capita GDP and unemployment would have been uncorrelated.

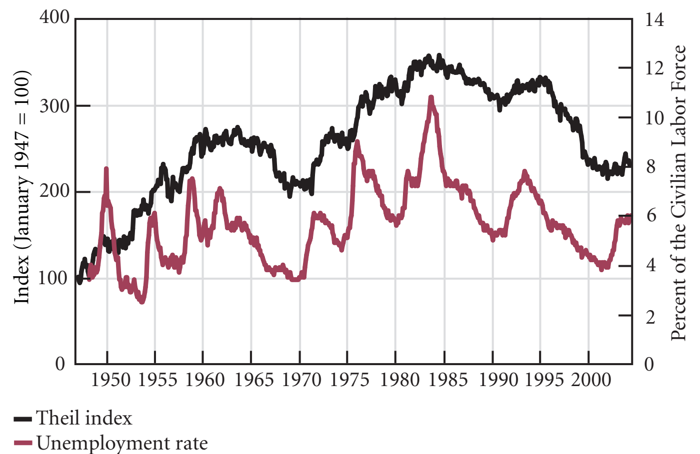
CFG also found that, in general, European countries with less inequality enjoy less unemployment, which is consistent with the theories outlined above. Galbraith and Garcilazo (GG) (2004) confirmed CFG's findings using detailed regional data. These findings are all inconsistent with the national labor market–rigidities framework, and support an augmented version of the Kuznets/Harris-Todaro/Meidner-Rehn view. In sum, the wealthy countries of Europe avoid unemployment most effectively, not by liberalizing their labor markets, but by maintaining their welfare states, fostering competitiveness in traded goods with egalitarian wages, and subsidizing service workers in the public and private sectors.

C. The Case of the United States

What is the relationship of inequality to unemployment in the United States? Ample evidence suggests that it too is the opposite of the rigidities-framework prediction. In periods of high unemployment, American inequality in pay structures *increased*. In periods of full employment, pay inequality *declined*. Figure 1 illustrates this finding. The variable observed is average weekly earnings measured across industrial categories. The association with the monthly unemployment rate is far too close to be coincidental.

What about the commonsense argument that "everyone knows" that overall American society is grotesquely unequal, while Europeans retain values of solidarity, which impart rigidities to their wages? How can this argument possibly reconcile low unemployment in the United States with high unemployment in Europe?

Figure 1 **Inequality in U.S. Manufacturing Wages 1947–2004**



Source: U.S. Bureau of Labor Statistics

Part of the answer is that the relevant inequalities are of wages. They do not include inequalities of other forms of income, including income from property and capital, which are very large in the United States. Taking wages alone and comparing the United States to Europe, the United States comes off as comparatively egalitarian. When one takes account of the large differentials that exist between European countries, intersectoral industrial pay inequalities are actually larger in Europe than in the United States.[1]

In this brief, I present a direct and updated comparison of between-regions pay inequalities, using measures of total payroll and total employment for 215 European regions and all 50 U.S. states, plus the District of Columbia. The measures are made comparable by presenting them in the form of Gini coefficients.

This comparison is not a full comparison of inequalities within the United States or across Europe. However, for a theory of unemployment, interregional inequalities are particularly important. They measure, quite directly, the incentive for long-distance economic migration and, therefore, the incentive to expose oneself to the risk of unemployment in order to gain the possibility of a high-income job.

The results are quite striking. A European cross-regional Gini coefficient is about 0.235, or more than twice the value across the American states (0.101). Across continental distances, average European incomes are dramatically more unequal than

are those in the United States.[2] For the purposes of a theory of unemployment, moreover, these differences in nominal earnings, not differences in real living standards, may be mitigated by regional differences in the cost of living. Convergence policy must, therefore, deal with nominal differentials, as expressed in the common currency unit. It is, above all, a matter of money, and particularly of the money wage.

The Mechanics of Convergence

In this section, I present the results of a calculation of relative growth rates of wage incomes that are required to achieve a degree of convergence across the European regions. My chosen objective is to reduce the degree of interregional inequality across Europe to American levels by 2042, the 50th anniversary of the Maastricht Treaty. The point of the exercise is to illustrate, under certain assumptions, what the relative annual growth rates of wages in each European region would have to be in order to meet the stated objective.

First, I assume that the present hierarchy of relative incomes between sectors of each European region will remain strictly unchanged. Second, I assume that present gaps between region-sector cells will remain exactly proportionate. Third, I assume that the richest region-sector cells experience zero real-wage growth between now and 2042. Fourth, I assume no structural change in the balance of employment in any region between now and 2042.

The results are shown in Figure 2. For Europe, I calculate that the average rate of wage gain between now and 2042 implied by my convergence parameters is about 3.5 percent. This is only slightly above historically achieved rates of productivity growth at high employment, and perfectly achievable when the increases are concentrated in low-income regions with productivity catch-up potential.

Convergence would raise effective demand emanating from the low-wage regions. It would raise the demand for traded goods produced elsewhere in Europe, and therefore help to absorb unemployed labor in the traded-goods producing centers. And it would raise the demand for (white-market) service employment in the converging countries, absorbing labor in situ at increasingly tolerable and ultimately attractive wages. Convergence would reduce incentives to economic migration and reduce pressures on labor supply in the richer countries, even as unemployment fell in the poorer regions.

At the end of the day, Europe would approach full employment in harmony and solidarity, without serious inflation. With confidence that this policy can, in fact, succeed at that objective, opposition to broadening the scope of European integration and governance should eventually melt away. A convergence policy, I suggest, is the only way to achieve this goal and to preserve the European ideal in the face of debilitating challenges of unemployment, immigration, and social dislocation that are attendant on the manifest failure of European economic policy so far.

The Policies of Convergence

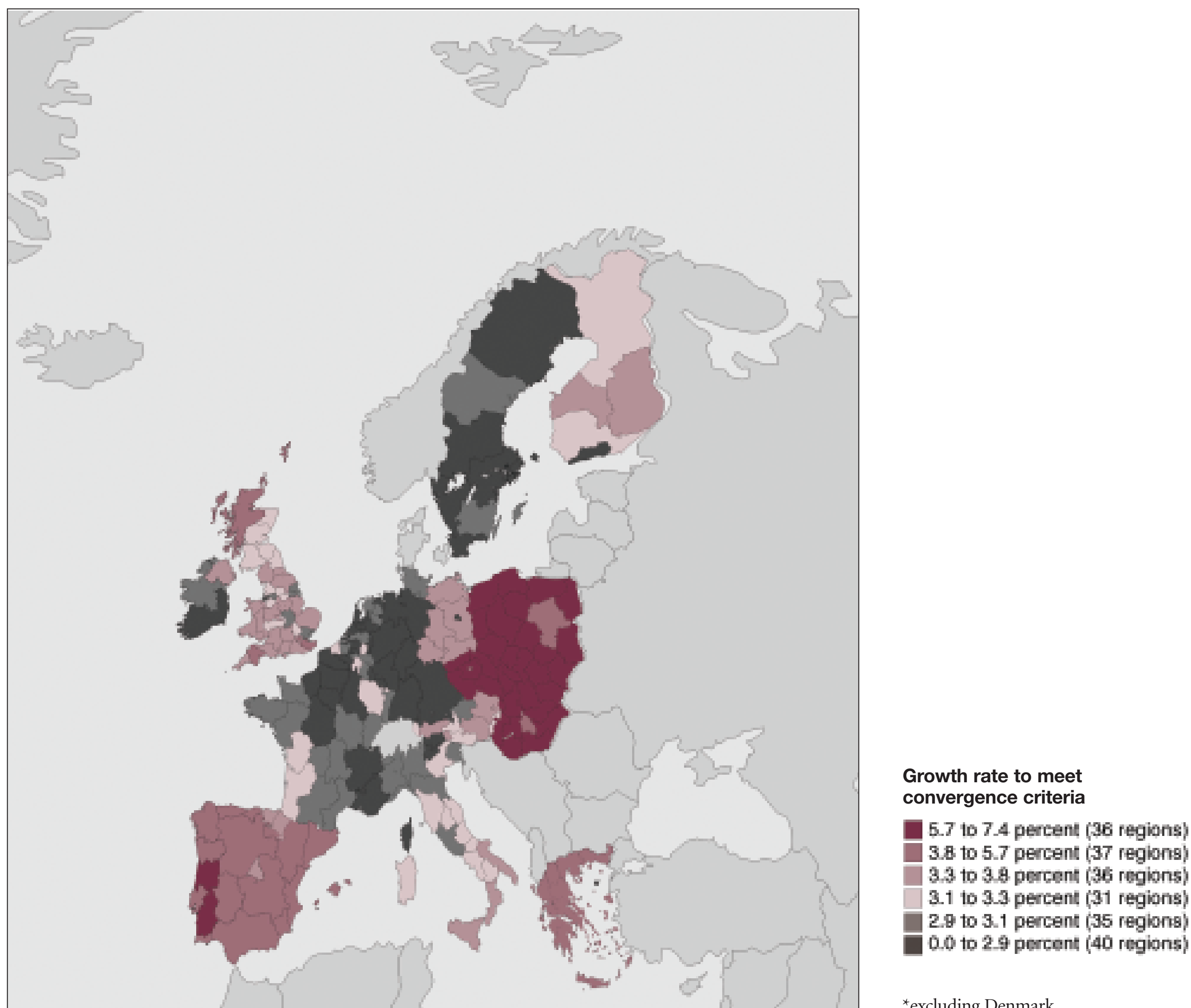
Hurricane Katrina and the destruction of New Orleans in 2005 exposed the folly of the American model, commonly understood to be the neglect of public infrastructure in favor of private markets, to many Europeans. Nevertheless, Europeans previously enamored of American dynamism would be mistaken to swing to the view that America's experience has nothing to offer in the way of useful ideas against mass unemployment. It was only six years ago that the United States achieved full employment, including a high labor force participation rate, measured unemployment rates below 4 percent for three years in a row, and recorded low unemployment and poverty among ethnic minorities. America achieved this with negligible price inflation.

The question is: how? As we have seen, the answer cannot be found in the hypothesis of labor market flexibility. Rather, the United States grew by a powerful expansion of effective demand, powered by capital inflow, the run-up in equity prices in the technology sector, and household debt, especially in the housing sector. As this happened, pay inequalities declined.

In a similar vein, an *egalitarian growth policy*—with directed measures to raise relative growth rates in the poorer regions of Europe—would be a powerful medium-term measure for the reduction of European unemployment. Some instruments for this policy already exist. Regional funds should be expanded. But they are limited by the capacity of direct state action and by their effect on employment. New instruments are required.

Interregional personal income convergence is one key to less inequality and fuller employment in Europe. This is an old story in the United States: Social Security, a continental minimum wage, a national industrial development policy and transportation network, Medicare, and Medicaid all emerged in the New Deal, the postwar boom years, or Lyndon Johnson's Great Society. The

Figure 2 **Distribution of Growth Rates of Real Average Annual Pay Required to Meet Convergence Criteria between 2007 and 2042, by Region***



*excluding Denmark

continental integration of social welfare policy in the United States today is much further along than in Europe. Continental integration, not flexible labor markets, accounts for America's relative success against entrenched structural unemployment.

In sum, more social democracy and a more unified social democracy—following American precedent in certain important respects—is the answer to European unemployment. The EU should identify specific measures and prove the model with bold experiments, such as the creation of a European Pension Union, minimum pensions on a standard governed by the average productivity of Europe as a whole, and a reduction of unskilled pay differentials across Europe. These measures would slow economic dislocation and reduce the incentive to migrate, by directly raising pay and purchasing power in the nontraded-goods sectors of peripheral Europe.

Other examples of effective redistributive policy include investments in higher education, which would mobilize resources in the lower-income areas while sharply reducing the incidence of youth joblessness, by converting the unemployed into students. Let Europe fund and build European universities on a scale and of a quality to rival higher education in the United States. No one would wish the American health system on any

other country, but an expansion of medical services and personal care, especially for the elderly, could also absorb unemployed labor in Europe on a large scale.

The active role of monetary policy in a convergence strategy is somewhat limited. And yet, the monetary front is not entirely barren. The euro has worked (so far) for much of the periphery of Europe, and the decline in unemployment in countries such as Spain clearly owes much to the disappearance of exchange-rate risk and interest-rate convergence. In principle, these monetary policies reduce distortion in favor of manufacturing activity in peripheral countries and absorb the unemployed into better-paid service jobs. However, more direct policies will be needed to keep the convergence process underway.

Effective fiscal policy might be achieved by revising the Stability and Growth Pact to permit *any* country of the EU to run deficits greater than 3 percent, so long as unemployment *on average* in Europe is higher than a threshold value. A threshold figure need not be set at full employment; any figure well below the present European averages (for instance, 6 percent) would do. For, once unemployment in Europe started decisively on a downward path, the private sector's demand for credit (and its perceived creditworthiness by financial institutions) would rise, allowing the private sector to take over some of the expansionary burden from the state.

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Notes

1. Hourly pay inequalities within industries in the United States may be larger than indicated by the data, thus blunting the intersectoral comparison. However, my experience with these comparisons is that the same order of difference usually prevails within and between industries. CEO compensation, a notorious American scandal, comes heavily from stock options and is better treated as a raid on capital than as a part of "pay" in the economic sense.
2. For the EU–15 alone, the interregional Gini coefficient comes to 0.142, which is still 40 percent higher than in the United States.

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