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Comment on Jacques H. Drèze and Henri Sneessens: Technical Development, Competition from Low-Wage Economies and Low-Skilled Unemployment

Harry Flam*

I will make four main points: (1) the proposals of Drèze and Sneessens deal with a minor cause of the present high unemployment in Europe and should be evaluated in this light; (2) transfers from high- to low-paid labor create disincentives for investment in human capital and are therefore counterproductive; (3) integration between Eastern and Western Europe will probably not cause large-scale disruption of industries and employment in Western Europe; and (4) one should be cautious about introducing a short-run remedy for a long-run problem.

1. Technological change, deindustrialization and other causes of the present unemployment

Western Europe has had high unemployment – around 10 per cent – since the early eighties. The main reasons for the surge in unemployment at that time were restrictive fiscal and monetary polices in the face of balance of payments problems and high inflation, and following supply shocks. The restrictive policies were in some cases introduced during the downturn of a business cycle and made its consequences more severe. A lack of wage flexibility, high unemployment benefits in some countries and slow growth have combined to keep the unemployment rate high.

Drèze and Sneessens argue that technological bias against low-skilled labor, a secular decline in manufacturing's share of GDP, and competition from cheap foreign labor have aggravated the unemployment problem,

* *The discussant is Research Fellow at the Institute for International Economic Studies, Stockholm University.*

especially for low-skilled labor, and they present various statistical evidence to that effect. I find the evidence suggestive but not conclusive, considering the mixed results in some areas and the relatively few studies made. In any case, it is important to keep in mind that these factors cannot constitute the main causes of the present high levels of unemployment. They existed before 1980. Some countries – Finland, Norway and Sweden – maintained low levels of unemployment until the early nineties.

I would believe that the effect of relative wages *on* technological change has been more important than any inherent bias in technological change against some particular type of labor. Specifically, relatively high wages to low-skilled labor – to some extent due to minimum wages – should have induced (low-skilled) labor-saving technological change.

The share of manufacturing output and employment has been falling over time in industrialized countries. A great number of relatively high-paying jobs for relatively low-skilled labor have been eliminated in this way. But the mirror image of the falling share of the manufacturing sector is the rise of the service sector. The service sector is on average intensive in low-skilled labor compared to the manufacturing sector. The net effect of these secular trends on the demand for low-skilled labor may well be positive, not negative as assumed by Drèze and Sneessens.

It is important to know more about the reasons for the low-skilled bias among the unemployed in order to pursue the right policies. If the bias is due to factors that can be expected to remain in force in the long run, then their prescription, a one-time reduction in the relative cost of low-skilled labor, is only a short-term remedy.

2. Disincentives to investment in human capital

Every developed economy redistributes income from those with high incomes and high skills to those with low incomes and low skills. All of the different ways to lower the cost of low-skilled labor discussed by Drèze and Sneessens lead to stronger redistribution. A subsidy to employers of low-skilled labor, or the proposed reduction of employers' social insurance contributions for low-skilled labor, not only lowers the cost of such labor to employers but raises wages at the same time (if demand and supply curves have negative and positive slopes, respectively). The incentive for younger individuals to acquire non-mandatory formal education and for employees to acquire more skills and training is thereby further weakened.

I do not think that such effects are negligible. According to recent research by Fredriksson (1994), changes in economic incentives – including variations in the rate of unemployment – provide a good explanation of the fluctuations in enrollment in higher education in Sweden over the period 1967 to 1991. The substantial wage equalization in Sweden in the early seventies was a major cause of the drop in demand for higher education during the subsequent 15 years.

Disincentives for investment in education and training are a cost to society that will manifest itself in the long run. Empirical research on economic growth is turning up increasing evidence that the benefits to society of investment in human capital are substantially greater than what is measured by the higher wages to high-skilled labor alone.

3. Competition from cheap labor in Eastern Europe

My next point concerns the consequences of freer trade with the countries of Eastern Europe and the former Soviet Union. At present, labor is paid at least ten times more in Western Europe than in these countries. For example, Volkswagen estimates that labor costs at its plants in Western Germany are twenty times higher than at Skoda, its newly aquired subsidiary in the Czech Republic. It is very safe to assume that such wage differences – after adjustment for differences in skill levels, infrastructure, etc. – must result in job losses in Western Europe and a downward pressure on wages in some industries and for some types of labor.

Such an assumption is supported by the findings of Ben-David (1993), demonstrating clearly that previous trade liberalization in Western Europe had a definite and substantial equalizing effect on per capita incomes across countries. There was no trend towards equalization before the creation of the EEC in 1957 between the original EEC members or other Western European countries. The countries that remained outside the EEC did not experience income equalization to the same extent as EEC members after 1957, despite taking part in free trade agreements among themselves (EFTA) and with the EEC. Thus, stronger forms of economic integration seem to have induced stronger equalization of per capita incomes across countries.

The best way to avoid that some groups will lose during the adjustment to a new pattern of international specialization and trade is not to increase protection – a possibility that Drèze and Sneessens seem to be a tiny bit ambivalent about – but to subsidize resource reallocation. This means that workers must be properly compensated for relocation, paid for retraining, and protected in other ways from losses during the transition from old to new jobs. In this respect the rest of Western Europe probably has much to learn from Swedish policies in the sixties.

Another lesson from the economic integration of Western Europe is that it took place without large-scale reallocation of resources between different sectors and industries, and without great changes in income distribution between different kinds of labor and between labor in different industries. The reason was that integration mainly caused *intra*-industry specialization and trade. To take an example from the automobile industry: the number of producers and plants was reduced, but output could be increased in almost every country due to specialization and large-scale production. France was shipping more Peugeots and Renaults to Italy at the same time as Italy was sending more Fiats to France. Similar intra-industry specialization may take place between Eastern and Western Europe. We are already seeing that the largest firms in the West are establishing subsidiaries in the East and locating the labor-intensive stages of the production process there.

The EU has signed free-trade agreements with several Eastern European countries but has in practice been very sensitive to increases in exports in the areas where these countries have the greatest comparative advantage, namely agriculture, textiles and steel. Such protectionism might well help a development towards intra-industry specialization, as the Eastern European countries are left to exploit comparative advantage in low-skilled activities and stages of production within many different manufacturing industries.

4. A short-run remedy for a long-run problem?

Let me end by making the point that technological bias against low-skilled labor, deindustrialization and competition from low-skilled foreign labor are long-run phenomena. Even if we manage to eliminate the negative consequences for low-skilled labor by the right amount of subsidies or tax reductions today, we are likely to find tomorrow that the problem has reappeared and calls for more of the same. At that point the distortionary costs are higher and vested interests have been created. When can and should we stop?

References

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