

The Political Economy of a Consensus Society: Experience from Behind the Dykes*

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Abstract: The Dutch economy shows that capitalism with a friendly face can work. Job growth has been spurred by an investment and export boom and a move towards more labour intensive methods of production. The combination of anchoring the guilder to the D-mark and a policy of sustained wage moderation has been the motor for the job growth. It has led to a boost in profits and competitiveness and held back labour productivity. Wage moderation, a strong currency and social cohesion do not come like manna from heaven. They require consensus, trust and corporatism as well as tax cuts, training and child care programmes to support it. The challenge for the Dutch is to boost labour market participation, particularly of older workers and partially handicapped. This requires specific tax incentives as well as further reform of social security.

I CONSENSUS AS A COLLECTIVE SOCIAL HABIT¹

The Netherlands is an odd country. The pillars of the Catholic and the Protestant culture pervade all aspects of society, from trade unions, employers' federations and broadcasting corporations to political parties. At the same time the Dutch have a liberal attitude towards soft drugs, dark rooms, prostitution, abortion and euthanasia. Although the law formally dictates a tough attitude, in practice the legal system closes an eye to many of these practices. The Dutch have a healthy dislike of anything to do with

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1. This section makes use of Weinberger (1997).

status or hierarchy. If you are wealthy, you are supposed to do your utmost to hide it. A top business man used to be driven around by a chauffeur in a Fiat Cinquecento. Foreign prime ministers and presidents may be surprised to be treated to cheese sandwiches, a bowl of soup and glass of milk instead of a state banquet. The worst thing a child who works hard at school can be called is a "streber", somebody who tries to be better than the rest. A popular Dutch saying is that somebody who pokes his head above the corn field will invariably get it chopped off.

People who visit The Netherlands from abroad always have difficulty with the fact that status is measured in others ways than in wealth, authority, appearance and/or dress. W.T.M. Frijhoff argues that status in The Netherlands has much more to do with your place in the consultative hierarchy than with wealth, position or the clothes you wear: be normal, that is silly enough. The Dutch derive their value from the way in which they are able to establish agreement with the other party/person and not from the way in which they differentiate themselves from others. The latter is much more common in centrally administered states, such as France, but The Netherlands has never been such a state.

The Dutch love to have meetings about everything and nothing. Sitting around the table is a collective social habit and is the quintessential feature of the Dutch consensus society. The point is that everybody can participate, have their say and feel part of the decision making procedure. To reach consensus requires talking and talking until unanimity or broad support is reached on the issue concerned. Consensus thus seems to be an essential part of the Dutch mentality.

Frijhoff believes that the roots of the Dutch consensus culture go back to the Middle Ages, when the powers of the feudal lords were tempered by the towns and cities. The Dutch, traditionally a nation of merchants, like to organise their own affairs and thoroughly dislike rules imposed from above. The decentralised structure of administration not only applied to government, but also to big trading companies such as the Dutch East India Trading Company; the centralised state never got much of a chance in The Netherlands. In recent years furthermore, the Dutch have displayed a remarkable gift for consensus at the level of the national government.

The Netherlands has an almost proportional voting system. The result is a wide variety of political parties in parliament. Apart from the traditional social-democratic, right-wing liberal and Christian Democratic parties, the parliament includes the Socialist Party, the Green Left Party, a left-wing liberal party, three smaller christian parties, four old-age citizens' parties and a fascist party. After decades of Christian Democratic hegemony, there is a consensus government without the Christian Democrats since 1994. This

“purple” coalition consists of the “red” Social Democrats, delivering the former trade union leader Wim Kok as prime minister, and the “blue” right-wing liberals, with the left-wing liberals as the cement in the middle. Although there are huge differences between the Social Democrats and the right-wing liberals, the government manages generally to agree on policy. In fact, the ability to reach consensus in this “purple” coalition has led to a decisive government.

II CORPORATISM BEHIND THE DYKES²

Consensus and consultation is also engrained in industrial relations in The Netherlands. Both the social partners (trade unions and employers' organisations) and the government aim to reach agreement on such matters as wage moderation; employment; working hours; schooling; child care facilities and social security. There are three big trade union associations: the Federation of Netherlands Trade Unions; the Christian National Trade Union; and the Federations of Trade Unions of Intermediate and Senior Personnel. Employers are organised in the Federation of Netherlands Industry; The Netherlands Federation of Christian Employers; Small and Medium-Sized Enterprises Netherlands; and the Agricultural and Horticultural Organisation. Consultation between the social partners takes place at the national level, the industrial level and the firm level. The government sets the legal framework for terms of employment, allocates tax funds and fulfils a steering role in consultations with the social partners.

The Wassenaar Agreement in 1982 committed government and social partners to a very successful policy of voluntary wage moderation in exchange for the social partners getting more freedom to determine wage increases. The government operates at arm's length by means of legislation and regulation, e.g., the legal minimum wage and the possibility of extending coverage of collective labour agreements for a whole branch of industry. The government is advised by the Socio-Economic Council, a body consisting of social partners and independent members appointed by the government, and consults regularly with the Joint Industrial Labour Council on wage moderation, shorter working hours, employment and training.

Although only a quarter of Dutch employees are trade union members, more than 70 per cent work under the terms of a collective wage agreement which settles issues like working hours; working conditions; annual leave; training; pensions; and deployment of the long-term unemployed and handicapped. The social partners can ask the Minister of Social Affairs and

2. See the Ministry of Social Affairs and Employment (1997).

Employment to extend the agreement to everyone working in that particular branch of industry. Individual companies can in consultation tailor these agreements. All companies with more than 35 workers have a works council, consisting of employee representatives. The works council consults with the employer on all major decisions affecting the company (mergers, share issues, working hours, etc.).

III NEO-LIBERAL CRITIQUE OF CONSENSUS AND CORPORATISM

Many economists in The Netherlands and in international organisations have criticised the Dutch model of corporatism. Eduard Bomhoff, Sweder van Wijnbergen and others have argued that extending collective wage agreements represents a conspiracy between the government and the unions to give labour a monopoly at the expense of outsiders. The monopoly makes it possible for trade unions to push for higher wages and harm employment.

The Dutch miracle of wage moderation spurring job growth shows that this critique is probably off the mark. However, it is true that extending collective wage agreements keeps in force a fairly rigid structure of relative wages which contributes to the country's low labour market participation rate. Wages in collective agreements are primarily determined by educational qualifications and work experience. As a result, very many elderly workers have been dumped into early retirement as their wages go up and their productivity falls with age. Also, since people with a university degree earn the same wherever they work, there are a relatively large number of unemployed academics in attractive university cities such as Groningen and Amsterdam. The neo-liberal critique also argues that minimum wages and the level of social security should be cut in order to make the labour market more flexible and absorb more low skilled workers.

Recently, many of these economists, including those of the OECD, have changed their tune in the light of the remarkable performance of the Dutch economy.

IV CONSENSUS AND CORPORATISM SUCCEEDS³

Since the Wassenaar Agreement in 1982 wage rises have been very moderate while industrial conflicts and strikes have been rare and do not last long. Unit labour costs in Dutch manufacturing remained roughly constant over the last 15 years, while rising in other European countries by about 3 per cent per year. Given the policy of anchoring the guilder to the D-mark,

3. See Bovenberg (1997).

competitiveness improved substantially and engendered a boom in net exports. Wage moderation also boosted the share of profits in value added from 15 per cent in 1991 to about 17 per cent now. The resulting boost to private investment spurred job growth further. Wage moderation has induced firms to switch to more labour-intensive methods of production, thereby contributing to the growth in employment albeit at the expense of a drop in labour productivity.

These three factors help to explain why employment has grown at the spectacular rate of 1.4 per cent per year during the period 1983-95, compared with only 0.4 per cent for the European Union. Labour supply has grown rapidly due to rapid population growth and catching up of female labour market participation. Nevertheless, unemployment has fallen from 12 per cent, more than 2 percentage points above the European average, to a bit more than 6 per cent, about half the European average. During the four years of the current purple coalition half a million jobs will have been created and the number of unemployed will have fallen by a quarter. In recent years the share of long-term unemployed in total unemployment has started to fall as well. In 1996 the number of people on social security dropped for the first time in many years. Due to the spectacular drop in the ratio of the number of inactive to active people, benefits, after being frozen for many years, have been indexed again to the growth in nominal wages.

Of course, the Dutch economy has its problems. In contrast to the United States, the same people are again and again unemployed. These long-term unemployed are, typically, males with little or no schooling. Most of the new jobs have gone to school leavers, women re-entering the labour force and job switchers rather than to the long-term unemployed.

Despite the catch up in the female participation rate, the Dutch economy is troubled by a very low participation rate, particularly among the unskilled population. Too many people in The Netherlands are unemployed, sick, disabled or have taken early retirement. As a result, the tax base is narrow causing high tax and social insurance rates, which pushes up wage costs and damages employment. If society is not prepared to carry the burden of higher tax and social insurance rates, the financial sustainability of the welfare state is threatened. This is why the purple coalition places so much emphasis on cutting back the number of people on benefits, not by cutting the benefit levels or duration but by toughening up eligibility requirements. Of course, the government would have been unable to do this without the co-operation of the social partners.

V SHORTER WORKING HOURS

Is it right that a small number of people work long hours while many others have to remain idle? If 5 million people work a five-day week, an extra 1.25 million people could be given a job if everybody were to work a four-day week instead. Why not share work and impose shorter working hours? The fallacy is that the total number of hours is not a given constant; Layard, Nickell and Jackman (1991). Shorter working hours seldom go hand in hand with pro-rata reduction of monthly pay packets. People earning low wages especially will not be keen on proposals to shorten working hours. Companies face extra costs, because personnel have to work overtime. There are also extra costs for companies arising from having to pay for unproductive hours. After all, it is difficult to juggle the new time tables for all workers and there is time involved in handing over dossiers. In addition, the rate of return on schooling/training falls with a shorter working week, as there is less time to put the acquired skills into practice. All these factors push up labour costs per hour worked, so employment measured in man years drops.

Even without all these cost-push factors, employment will fall. Shorter working hours reduce labour supply and thus exert upward pressure on wages. In the long run labour demand and employment will fall as well and the whole economy will move into lower gear. The tax base will shrink and less funds will be available for essential public services. Shorter working hours will lead either to public squalor or to a fall in the purchasing power of the public. Employment will fall.

The Netherlands is the champion of shorter working hours. Dutch employees work only 1,447 hours per year, compared with 1,747 hours in the US; 1,683 hours in the UK; 1,590 hours in Germany and 1,544 hours in Sweden. Due to the low participation rate in The Netherlands, the number of hours worked per head of population is even lower than elsewhere. However, The Netherlands has tried to cut working hours in a productive way by trading a shorter working week for wage moderation and flexible working hours (so firms can process peak orders and make better use of expensive machinery and shops can open in the evening and on Sunday). In addition, the reduction in working hours has been used in a productive way by making room for schooling and child care. Of course, as a country grows wealthier, its citizens will automatically choose to have more leisure. The main point is that shorter working hours should not be forced from above by the government, but arise naturally on the work floor as employees trade shorter working hours for more flexibility, lower wages, training and child care facilities and as employees choose to consume more leisure as they become richer.

VI REFORMING SOCIAL SECURITY

In the early 1960s for every person on benefit there were three people working, paying taxes and making social insurance contributions. Nowadays, there is roughly only one person working for every person on benefit. Clearly, something had to be done to keep the social security system affordable.

In 1985 statutory unemployment and disability benefits were cut from 80 to 70 per cent of pay. By freezing the minimum wage and, consequently, the minimum level of social benefits in nominal terms, the replacement rate was reduced substantially. In 1993 partially disabled people had to apply for a wider range of jobs. This resulted in many disabled people receiving partial rather than full benefits. From 1994 existing claimants of disability benefits were gradually reassessed to examine whether they were still eligible for benefits. Many are declared fit for (part-time) work. From 1995 onwards unemployment was no longer sufficient grounds for disability. Further improvements have been achieved by making the social security system more efficient and toughening up eligibility requirements.

The responsibility for insurance against the first year of illness has been handed over to firms. They have an obligation to provide insurance for employees; the government provides a safety net for people who otherwise would not be covered (e.g., the unemployed). It is important to reduce the large number of people on illness benefits, because experience suggests that many of these slide into long-term disability benefits.

The purple coalition intended to cut the number of people on disability by giving firms a chance to opt out of the social security system. The idea was that more competition between private and social insurance companies lowers costs and thus lowers insurance contributions and labour costs. The resulting boost in employment should give disabled people a better chance of finding a job. In the end the purple coalition decided to keep private insurers at bay in order to avoid adverse selection and segmentation of labour markets. Otherwise, firms with a young and healthy labour force would opt out of the social security system by going to private insurance companies. Competition in the area of disability insurance was rejected, because it would destroy the solidarity between the young and the old as well as between the healthy and the ill.

The Netherlands has recently differentiated disability premiums by sector. Sectors with a lot of disability casualties pay higher premiums in an attempt to encourage them to pay more attention to working conditions. A consequence is that the solidarity between blue and white collar workers will diminish. For example, the building sector will probably have to pay higher premiums than the banking industry. Because the differentiation of disability

premiums does not occur at the level of the firm, but at the level of the industry, free rider problems are bound to stay. It is still possible to shift the burden of dumping workers into disability schemes onto the other firms in the sector.

The government also considered differentiating unemployment insurance contributions by firms. However, experience rating is like a penalty on sacking labour. It is irritating for politicians to see big firms making huge profits while at the same time shedding labour and reorganising at the cost of the community. In fact, experience rating hurts people who need a job most. It reduces the chances of being fired, but also reduces the chance of being given a job. The problem of the Dutch labour market is not so much a high level of inflow into unemployment, but a low level of outflow from the pool of unemployed. Experience rating does not attack the root of the problem of Dutch unemployment. It particularly hurts sectors that vary with the cycle and damages the prospects of people with little or no schooling. It does not seem fair to punish firms that have to fire workers due to a drop in demand or a bad winter.

A more effective strategy is to try to boost the outflow from the pool of unemployed by supplementing the current system of unemployment benefits and insurance contributions with a system of individualised unemployment accounts; see Orszag and Snower (1997). With an individualised system of social miles the government only guarantees a minimum level of social security (welfare assistance). Although a system of social miles may lower unemployment by boosting efforts of the employed and increasing search activities of the unemployed, there is a danger that it will destroy the solidarity built into the system.

As a result of reforming social security, The Netherlands has enjoyed a reduction in the ratio of inactive to active people. The public sector deficit has dropped from 10 per cent of national income in the early 1980s to 1.75 per cent next year, while at the same time job growth has been formidable. The Dutch experience shows that deficit reduction and job growth can be compatible. However, if taxes are raised and public investment projects are delayed in order to reduce the public sector deficit, labour costs are pushed up and employment prospects damaged.

After many years social security benefits have finally been indexed again to market wages. There do not seem to be any financial reasons for further reform of Dutch social security, but there are at least five good social reasons:

(1) There is still poverty, particularly among single mothers without work. They should be given the opportunity to work by providing, for example, better child care facilities. Empowerment is the key word here. (2) Dutch

labour market participation is embarrassingly low due to the high incidence of part-time work, early retirement and disability. Also, the participation rate of women is (despite a catch up) too low. (3) The social security system is based on the increasingly outdated notion of a breadwinner with one job for a lifetime. Dutch society nowadays features many households with two earners and many single-person households. A modern social security system aims for individualising entitlements and abolishing breadwinner advantages. (4) An increasing army of flexi-workers is bearing the brunt of globalisation, technical change and economic adjustment. The current system of social security penalises flexi-workers: they do not build up entitlements to social security and pensions as easily as regular workers. A system of social miles (individualised welfare accounts) allows flexi-workers to build up the same rights as regular workers. (5) The saving of social miles can be used for the finance of retraining or study or child care leave. To help matters, a bill is prepared to give people the right to career breaks for care or study.

None of the big political parties in The Netherlands argues for basic incomes, unless it is partial and tied to the obligation to look for a job. Basic incomes are either social but unaffordable, or affordable but socially unacceptable; see van der Ploeg and Bovenberg (1996). Although unconditional basic incomes avoid all kinds of Kafka-esque bureaucracy and invasions of privacy, they are a very unfocused and thus expensive way to provide social security for people who really need it. In addition, basic incomes are frequently considered an excuse for policies such as getting rid of the legal minimum wage and deregulating labour markets.

VII PENSIONS: SOLID AS A ROCK

The Dutch pension system is the envy of many countries. The system consists of three tiers and is therefore often referred to as a cappuccino model. The first tier (the coffee) is the old age pension to which every citizen over 65 is entitled. This state pension is independent of income or wealth. Traditionally, the first tier of the Dutch pension system has been financed on a pay as you go basis. However, the population of The Netherlands is rapidly greying, the bulk of retired people appearing round 2020-30. Consensus has emerged to put aside part of the extra money pouring in from rapid growth into a special fund to help finance future state pension obligations. Of course, lowering the public sector deficit and the government debt would make room as well by lowering future interest obligations. However, by putting money aside in a special fund, people can be sure the money goes towards safeguarding the state pension rather than to taxcuts or other government expenditures. In fact, the fund for state pensions has proved a reliable method to

commit the left-wing part of the coalition to lowering government debt (net of the fund) as well as safe-guarding the state pension.

The second tier of Dutch pensions consists of obligatory additional pensions up to 70 per cent of the wage earned during the final years before retirement (the cream). Even though the pension that can be built up is substantial, the second tier is, in contrast to many other countries, funded. The purple coalition is currently attempting to convince the social partners to move away from a final wage towards a middle wage system. The idea is to stimulate flexible instead of early retirement, which is important given that the average age a person stops working is 58. By relating the pension to the salary in midlife, persons can gradually (rather than abruptly) withdraw from the labour market. A middle wage pension system is typically cheaper. Hence, labour costs fall and labour market participation is boosted. Until these measures have taken effect, there is no point in talking about raising the statutory retirement age. In order to avoid cherry picking and safeguard the solidarity between young and old, rich and poor, healthy and sick, it has been decided not to move ahead with privatising the second tier of pensions. The experiences in Britain with abolishing the second tier do not appeal to the Dutch: privatisation has not lowered costs and solidarity is easier to demolish than to build up.

The third tier of Dutch pensions consists of personal equity plans and other voluntary private pensions (the cacao). The government adopts a hands-off approach with respect to the third tier. Many of the schemes are tax deductible. Due to problems with narrowing of the tax base, there are moves to restrict the tax deductibility of private pension schemes. This would allow a cut in the top marginal income tax rates.

VIII EXTENDING COVERAGE OF COLLECTIVE AGREEMENTS

The textbook story of monopoly unions is that they are harmful. They push up wages and destroy jobs. Calmfors and Driffill (1988) have provided a more sophisticated analysis. They argue that there is an inverse U-shaped relationship between the degree of centralisation of labour markets and the unemployment rate. Decentralised labour markets, such as in Britain and in the United States, benefit from competition among workers, forcing down wages and lowering unemployment. Centralised labour markets, such as in Austria, manage to internalise all kinds of externalities and avoid free-rider behaviour. Unions know that going for a wage boost is pointless; it either destroys jobs or merely leads to higher prices and no gain in purchasing power. Also, a wage boost destroys social cohesion as the government finds it more difficult to index social security benefits and civil servant salaries to

market wages. In addition, centralised trade unions and extending coverage of collective agreements are more likely to moderate wages and give more flexible working hours in exchange for schooling, training and child care facilities. Furthermore, this way unions can play a crucial role in providing social security and pensions and overcoming problems of adverse selection where the government is retreating.

Calmfors and Driffill argue that countries with a degree of centralisation somewhere in the middle, such as The Netherlands, fare worse. According to their theory, these countries should have high wages and do not internalise externalities. The Dutch experience suggests that the theory developed by Calmfors and Driffill does not capture all features of corporatism. In fact, the Dutch experience of local trade unions favouring shorter working hours over wage increases does not fit the theory. One could argue that countries such as The Netherlands, with neither fully centralised nor decentralised labour markets, manage to capture the best of both types of markets.

Teulings (1997) and Teulings and Hartog (1997) argue that a characteristic feature of Dutch labour markets is that employers and employees engage in long-term relationships by investing in each other. In conventional labour markets firms hesitate to invest in firm-specific training of employees, because employees then become more powerful as they become more attractive to other firms. Employees can "steal" part of the return on a specific investment in future wage negotiations. Employers react by delaying investment in firm-specific training. This is known as the hold-up problem; see MacLeod and Malcolmson (1993). Also, a worker is less likely to buy a house near the company as this weakens his position in future wage negotiations with his employer. Both parties have an incentive to find a solution to the hold-up problem. This can be done by setting the future wage in the current contract, so that there is no need for future wage negotiations.

From time to time the contract needs to be renegotiated (due to unpredictable events). Still, the hold-up problem is much reduced as there is less need for future negotiations. Figure 1 below illustrates what might happen. The negotiated wage must be at least as high as the wage workers can obtain elsewhere, otherwise employees would leave the firm. Conversely, the negotiated wage must be less than the cost of replacing a current employee by an outsider, otherwise the firm has an incentive to sack employees. At time 2 the contract needs to be renegotiated upwards (as may be the case for computer staff), because otherwise there is a danger that workers leave the firm. At time 3 the wage needs to be renegotiated downwards (as may happen when the firm is in dire straits) to avoid the firm having to fire workers and employ new ones.

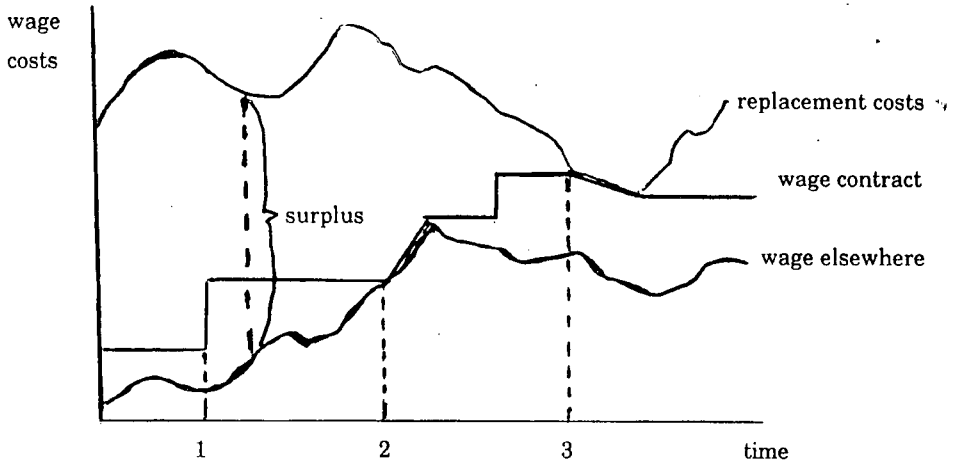


Figure 1: *The Hold-up Problem*

Corporatist organisations are essential to minimise the hold-up problem: they negotiate at a higher level (at the industry or national level) than the individual firm and worker. They decouple (re)negotiations from daily work situations, so that there is no need to postpone investment by the employer or employee. They also limit the power of insiders to profit from higher demand for the output of the firm, by demanding higher wages. Wages of individual employees are not set by the unions, but by the level at which employees are scaled in at the moment of joining the firm. At the micro level decisions about moving more rapidly up the scales are made, while at the macro level the yearly percentage wage adjustment is decided. Wage increases are thus made up of three parts: (i) initial wage increases as dictated by collective wage agreements; (ii) periodic wage increases as employees move up the scales; and (iii) incidental wage increases in special situations.

The added value of corporatism for The Netherlands can, according to Teulings and Hartog, be summarised as follows:

- parties have an interest in decoupling wage negotiations from daily working conditions;
- collective negotiations settle the yearly initial wage increases, including schooling, training and child care facilities;
- collective agreements leave employers free to scale in employees as they wish;
- firms can depart from the collective agreements on an individual basis, if a worker wishes to leave the firm;
- conversely, the collective agreements allow if necessary, for example in the case of potential bankruptcy, wage freezes or wage cuts.

A telling remark of the metal employers in this context is "our speciality is fitting pipes, not bargaining about wages". The Dutch corporatist model is one of flexibility in a framework of industry-wide, "rigid" wage contracts. When it really matters for the success of the company, market forces beat rigid contracts by renegotiation at the individual level. The Netherlands has no incentive to move towards Anglo-Saxon labour markets. In fact, the *Economist* argued that "the Dutch have tried to combine the flexibility of America with the security of Germany". This is also apparent from the stress the Dutch put on *internal* flexibility rather than *external* flexibility, all against a background of consensus in favour of wage restraint. The high degree of internal flexibility shows up in the gradual rise of work through temporary employment agencies to about 3.5 per cent of working hours and the high incidence of part-time labour, at 35 per cent about twice as high as the European average. The Dutch model is one in which firms and workers invest in each other within a stable macro-economic climate. The Anglo-Saxon model of quick hire and fire practices is not considered very attractive by the Dutch.

An essential part of Dutch corporatism is extending coverage of collective wage agreements. However, the government has threatened to stop extending coverage unless the unions and firms create employment in the salary scales just above the legal minimum wage. This is considered important, because many of the unemployed in The Netherlands have little or no skills and can only get low-paid jobs.

The Dutch model of wage moderation has worked. Since 1980 real earnings in manufacturing have risen by a mere 3 per cent, whereas in France and Germany the corresponding figures are 28 and 40 per cent, respectively. Can or should the Dutch model be exported to other countries? The Dutch solution only works because of a long history of consensus and labour market institutions. In any case, there is a danger that, if all the countries of Europe follow the Dutch example, aggregate demand gets choked off and Europe is thrown into a Keynesian recession.

The strength of the guilder is as much due to the wage moderation pursued by the trade unions, and supported by the social policies of government and firms, as by the discipline of the Dutch central bank. Monetary expansion, and the depreciation of the currency that goes with it, is considered an underhand way to fool the unions. Politicians from the left to the right argue that this induces a wage-price spiral without a sustained increase in jobs. The strength of the guilder and low inflation require the government to strike a bargain with unions to moderate wages.

IX MINIMUM WAGE LEGISLATION

The standard neo-classical textbook story is that cutting the legal minimum wage gives people with little earning potential a better chance to find a job. A high legal minimum wage prices people out of a job. These arguments are not very popular in The Netherlands.

The work of Card and Krueger (1995) carries, in contrast, more weight in the Dutch policy debates. By paying a higher wage an employer can boost hours worked, morale and productivity of its workforce. Consequently, the assumption of a given wage in the neo-classical analysis of the legal minimum wage is invalid. Employers can influence both the quantity and quality of labour supply, which gives firms some monopoly power on the local labour market. At the same time, firms cannot hire enough qualified personnel. Each worker is paid less than his contribution to the added value of the company, since firms pay more to recruit, motivate and retain workers. The difference is the degree of exploitation. This can explain why a higher legal minimum wage allows a higher wage as well as more jobs, while allowing firms to still make a profit. Also, with a higher legal minimum wage there is less inflow and outflow of workers, so the costs of recruiting, training, etc. are less for the employer. Hence, a higher legal minimum wage can lead to lower labour costs and boost jobs. Although the empirical evidence obtained by comparing experiences of different states of the US is mixed, the Dutch instinctively give Card and Krueger the benefit of the doubt.

An important reason is that cutting the legal minimum wage necessitates cutting the level of social security, which is considered unacceptable. Instead, it is considered more acceptable to cut labour costs at and just above the legal minimum wage by cutting taxes. Even the right-wing conservative party has abandoned its aim to cut the legal minimum wage.

Instead, the discussion focuses on whether employees or employers should be topped up from social security funds to the level of the legal minimum wage. The left argues, in contrast to the right, that people who work should not have to degrade themselves by having to go to the offices of the social services in order to obtain a top-up. As long as each worker receives at least the legal minimum wage, they consider it acceptable for firms to be subsidised from social security funds. Such active labour market policies should be temporary and focus on the long-term unemployed in order to avoid, on the one hand, crowding out of regular labour and, on the other hand, deadweight subsidies to workers who would have found a job anyway. Currently, there is an experiment with 20,000 jobs in the private sector of at least 32 hours a week and paying not more than 120 per cent of the legal minimum wage. The subsidy to employers is 18.000 guilders per year and can last for a maximum of two years.

In The Netherlands the slogan "low pay is a low way to run an economy" strikes a chord. Rather than competing by bidding down labour for the weakest members of the labour force, it is considered more fruitful to provide schooling in order to boost the earning potential of these people. An interesting discussion arose in this context around a bill to allow temporary dispensation of the legal minimum wage. This was considered acceptable provided four conditions are satisfied: (i) the dispensation is temporary (no more than two years); (ii) there is a reasonable prospect of a permanent job (contract at least four years); (iii) the pay must be no less than the social minimum (70 per cent of the legal minimum wage for single people, 100 per cent for breadwinners); (iv) firms must provide schooling. The labour market can be likened to a house with all the good jobs starting on the ground floor and becoming more attractive as one moves up to the higher floors. People are not allowed to work permanently in the cellar, but if there is a staircase from the cellar to the other floors it is allowed. Unfortunately, this bill never got passed because there was political disagreement on whether the differential treatment of single people and breadwinners was fair.

X WAGE SUBSIDIES FOR THE LOWER END OF THE LABOUR MARKET

The Dutch have also managed to reduce labour costs for low skilled people by giving directed tax credits to firms. Employers who hire long-term unemployed, hire people on wages less than 115 per cent of the legal minimum wage and/or provide training schemes can get a cut in their tax bill of up to 6.000 guilders per year. Again, these tax subsidies satisfy three important criteria in order to avoid substitution and deadweight losses: they are temporary, aimed at the long-term unemployed and more substantial if training is provided. After many years the number of long-term unemployed is falling. These directed tax credits seem to be working. It is perhaps useful to analyse why tax cuts directed towards the bottom end of the labour market are a better way to combat unemployment than general undirected tax cuts.

In a competitive labour market hours worked and production are high if tax rates and tax progressivity are small. In labour markets with structural unemployment arising from hiring costs and search frictions the results do not hold; Pissarides (1990), and Phelps (1994), Bovenberg and van der Ploeg (1994). In the Appendix a model of such a labour market is set up. In particular, the Beveridge curve, the hiring schedule and the wage schedule are derived.

The hiring schedule and the wage schedule jointly determine the effects of taxation and benefits on labour market tightness and wages. The Beveridge

curve gives the effects on employment and the unemployment rate. For example, a higher energy tax induces a lower productivity of labour, a lower wage, a looser labour market and a higher unemployment rate. In contrast to what happens in a competitive labour market, a less progressive tax system pushes up wages and boosts the unemployment rate. Conversely, a Robin Hood strategy among the employed is good for getting the unemployed into a job. Figure 2 below illustrates that a more progressive tax system induces wage moderation, a tighter labour market and a lower unemployment rate.

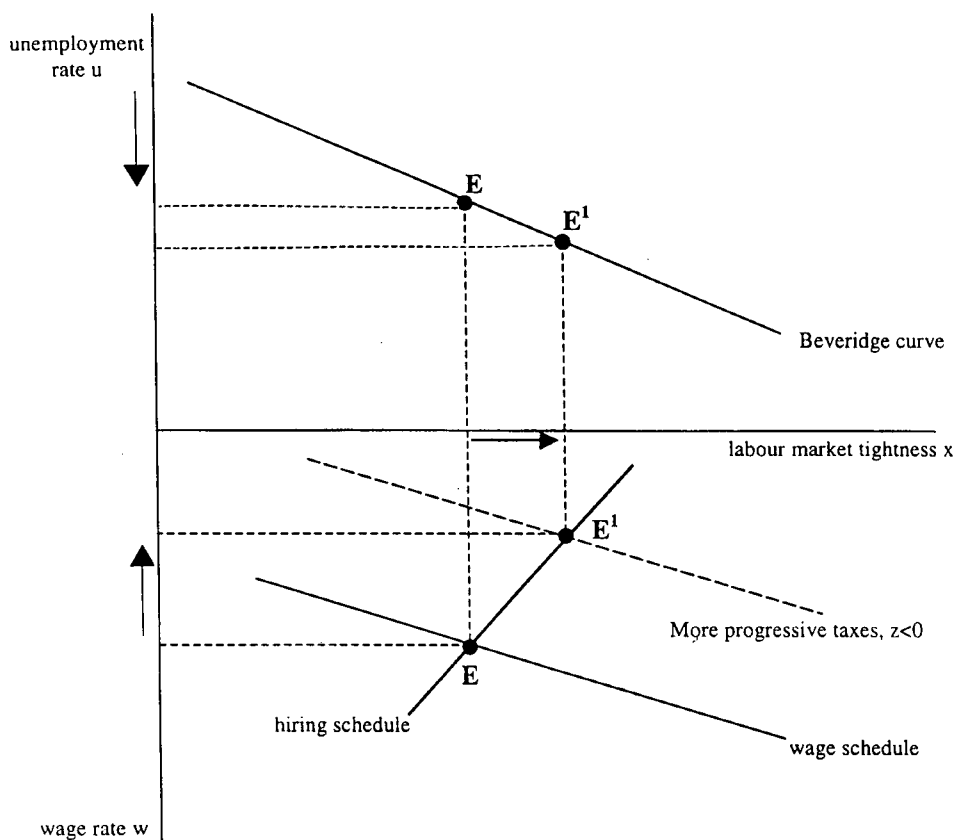


Figure 2: *Labour Market with Structural Unemployment*

The precise effects of taxation depend on how benefits are set. If unemployment benefits are indexed to after-tax consumer wages, the replacement rate is a constant. A rise in the average labour tax rate is entirely borne by both employed and unemployed consumers, so that the producer wage and the unemployment rate are unaffected. Conversely, lowering the average labour

income tax rate does not affect the unemployment rate either. A fall in labour productivity (e.g., caused by a rise in the energy tax) induces a one-for-one cut in the consumer wage and no change in the unemployment rate. The substantial productivity improvements over the centuries have indeed not affected the unemployment rate. Hence, changes in the average labour tax rate should not affect the unemployment rate in the long run either.

Indexing to prices rather than after-tax wages implies that less progressive taxes induce a smaller rise in wages and thus a smaller increase in unemployment. As wages rise, the unemployment benefit does not rise which weakens the bargaining position of workers and moderates wage pressure. Similarly, a higher labour tax rate or adverse shocks to productivity (such as a higher energy tax rate) induce a smaller drop in wages and thus a rise in unemployment. Since the unemployed escape the tax burden, unemployment becomes less unattractive for the employed. The resulting wage pressure boosts after-tax wages at the expense of more unemployment. Tax policy thus has real effects. Payroll and consumer taxes are not fully shifted to consumers. Labour income taxes are to some extent shifted to firms, thereby harming employment.

This analysis illustrates two lessons on how to fight unemployment in structural slumps. First, in contrast to what the competitive labour market story tells us, a progressive tax system induces wage moderation and boosts employment. In a second-best world the distortions arising from non-competitive labour markets are partially offset by the distortions arising from progressive taxes. A more progressive tax system also reduces hours worked per person, which yields a further boost to the number of people at work. Progressive taxes induce work sharing and thus boost employment. More flexible arrangements for daily, weekly, annual and life-time working hours are good for a more dynamic economy (e.g., more intensive use of machinery or a better match of demand and production) and for emancipation of the work force.

Although higher tax progression boosts employment through wage moderation and shorter working hours, a few critical remarks can be made. Tax progression makes it less attractive to accumulate wealth and become an entrepreneur. This harms the future creation of new firms. Tax progression also reduces the incentives and possibilities for investing in human capital, which harms long-term growth and employment.

Second, cutting (average) tax rates on labour or on energy use only cuts unemployment if benefits are not fully indexed to after-tax consumer wages. This highlights the cruel trade-off politicians on the left have to face: cutting taxes *either* leads to higher disposable incomes for the employed and the unemployed and no boost to employment *or* to more employment if one is

willing to accept more inequality between the employed and the unemployed. These two lessons also hold in labour markets with trade unions or efficiency wages; Bovenberg and van der Ploeg (1994).

XI EARNED INCOME TAX CREDIT, VOUCHERS AND TRAINING⁴

One possible way out of the dilemma between more jobs or less poverty is to introduce a special tax credit for low-paid workers — the Earned Income Tax Credit (EITC). The best way to stimulate job growth is, on the one hand, to make the tax system for those in work more progressive (viz. Robin Hood), and, on the other hand, to widen the gap between employment income and unemployment income. Instead of pursuing the unpopular policy of cutting unemployment benefits, it is easier to gain political support for a policy of giving a tax credit for those working at or just above the minimum wage. One should be careful, of course, to avoid high marginal tax rates for the low paid and the associated poverty traps by *gradually* reducing the EITC as people earn more. Means-tested subsidies (e.g., for housing and legal assistance) also contribute to poverty traps. In practice, the poverty traps are a major obstacle but only few people are affected by them. A potential problem with an EITC without a sliding scale is that incentives for training, education and moving up the earnings scales are destroyed. The EITC carries the danger of creating segmented labour markets. Nevertheless, it is better for people with few skills to get work experience rather than stay on the dole. Of course, even though the EITC clearly reduces unemployment, the EITC should not be so large as to harm schooling, capital accumulation and innovation too much. Hence, there is an optimum level of the EITC.

In non-competitive labour markets more progressive taxes punish wage increases and boost employment. In fact, more progressive taxes also stimulate shorter working hours. Both boost employment. A disadvantage of progressive taxes, however, is that by diminishing the incentive to acquire skills they harm productivity and economic growth. They also reduce the intensity of job search. The same is true for an EITC. Targeting tax and premium exemptions on the lowest paid makes it difficult for these people to move up. However, in many European countries there is a significant gap between the minimum wage and the first wage scales. Targeting the EITC at that segment gives people out of work a chance of a new type of low-skill job, especially in labour-intensive services, without jeopardising the job of those in work too much. It seems sensible to integrate the EITC with existing wage subsidies for the long-term unemployed.

The challenge is to avoid displacement and deadweight losses by opening

4. Also, see van der Ploeg (1997).

up new markets and new jobs for the long-term unemployed. Deregulation of markets for goods and services and innovative ways of pursuing active labour market policies are essential for giving unemployed people with few skills a chance. Wage and labour costs in Europe should be made more flexible and more in line with local conditions and individual skill levels, particularly for young employees. There is a potential for new simple jobs in personal services (gardening; shopping; child care; painting; cleaning; etc.). Since trade unions may not be too enthusiastic about exploring the potential for creating new jobs in personal services, a market-oriented rather than just a corporatist approach should be followed.

Schemes for job vouchers that operate in Belgium (PWA), the UK (Workstart) and Australia (Jobstart) seem very promising. One should avoid displacement (subsidised workers crowding out existing employees) and deadweight (vouchers spent on those who would have found a job anyway), especially as even the best programmes waste about half the subsidies on these undesirable side-effects. Hence, wage subsidies (i.e., vouchers) should be temporary and targeted at the long-term unemployed; Snower (1994). By giving the long-term unemployed a better chance to compete with insiders for jobs, wages are bid downwards and the demand for labour rises. The value of vouchers should be higher if there is an on-the-job training component. Training and education subsidies compensate for the adverse effects of progressive taxes and the EITC on investment in human capital. Vouchers may help to bring work from the informal to the formal economy. Being targeted at the long-term unemployed, vouchers do not add inflationary pressure. OECD countries typically spend two or three per cent, in Europe more, on passive (unemployment benefits) and active labour market policies, but less than one per cent on active programmes. Europe may benefit from more active labour market programmes.

New cohorts entering the labour market can no longer expect to serve one employer through their entire working life. People must be able to adjust to multiple careers. Hence, education and (re)schooling is of immense importance. Legislation and fiscal incentives to make schooling and training sabbaticals more attractive are thus desirable. Trade unions and employers face the challenge of integrating reductions in hours worked with new patterns of life-long learning. Such a high-skill, high-wage strategy is essential for Europe. Evidence from France, The Netherlands and the US suggest that children from disadvantaged backgrounds benefit from pre-primary schooling; once they leave school it is important that youngsters return to school regularly until they find a job. The German, Austrian or Swiss apprenticeship schemes work and are an example for other European countries suffering from excessive youth unemployment rates.

For those people in the labour market who have so few skills that they cannot find a job in the private sector, a large variety of public sector jobs has been created. For example, 40,000 low-paid jobs for long-term unemployed have been created in the public sector. These entail jobs such as watchmen, carers for the elderly, municipal cleaners and hospital staff. These public sector jobs are not meant to be the cure for unemployment. They are meant to help people who are not reached by other means while at the same time improving the quality of public services.

XII DEREGULATION AND NEW ENTERPRISES

The Netherlands has made a lot of progress in freeing up goods markets. Shops are allowed to stay open until ten o'clock in the evening, rather than six thirty, and are allowed to open more often on Sundays. There are both social and economic arguments for longer shopping hours. Two-earner families find it easier to care for the home. Effectively, this policy may encourage female labour market participation. In addition, it is estimated that the extra competition forces prices downwards and boosts demand. This is good for job growth and gives splendid opportunities for new entrepreneurs especially from ethnic communities. The Netherlands has also made it easier for people to start a new firm by requiring general-purpose rather than special-purpose diplomas. This, together with the establishment of free enterprise or empowerment zones, should stimulate new businesses. Finally, a new competition bill will be in force from 1998 where all forms of price cartels and dividing up the market are forbidden, unless an exception is granted. This is a big improvement over the current situation where cartels are allowed, though the government can forbid particular cartels that harm the public interest.

Since Europe has, in contrast to the US, created on balance few private sector jobs during the last decade, Europe should benefit from promoting entrepreneurship. This can be done by giving starters a better chance. This requires less bureaucratic headaches by removing unnecessary red tape or stream-lining necessary regulations and controls. Also, creating free-enterprise zones near areas with a high concentration of unemployed and cheap housing and enforcing tough anti-cartel regulation stimulates entrepreneurship. Reliable infrastructure and easy access to centres of technological know-how also help. Since small and medium-sized enterprises can be viewed as the engine for durable job growth, Europe should set aside additional funds for stimulating starters rather than using perhaps too much public funds to create public sector jobs for which there may be no real need. Given the scarcity of seed capital, venture and equity capital for starters and

the inherent risk that starters take, tax incentives for citizens who put up equity for starters are a good idea. Capital market imperfections can be remedied by making the return on equity and, if the starter goes bankrupt, the equity stake itself exempt from income taxes. To avoid fraud, there should be a limit on the equity stake that is covered by this scheme. Other possibilities are exemption from VAT for the first few years of operation, wage subsidies (especially for personnel that is involved in research and development), facilities for export credit and accelerated schemes for writing investment off for tax purposes. The recent agreement at the top in Amsterdam to use the reserves of the European Investment Bank to give credit for small and medium-sized high-tech enterprises in order to boost jobs in Europe is along the lines of existing programmes in The Netherlands.

XIII CONCLUSION

The Dutch economy has performed remarkably well in recent years. In 1983 the unemployment rate stood 2 percentage points above other European countries. Now it has been halved, and 5 percentage points below that of the rest of Europe. The unemployment rate at around 6 per cent is close to that of the United States and Britain. The purple coalition of Social Democratic and market-oriented parties has reduced the numbers unemployed by a quarter and created half a million jobs in four years. They have done this while maintaining the social fabric of the country and an equitable income distribution. The growing gulf between the poor and the rich and the steady decline of public services, familiar from for example Britain, has not been a feature of the Dutch recovery. However, the Dutch share with the British a trade- and market-oriented outlook.

During this period the Dutch have also trimmed down the public sector deficit from more than 10 to less than 2 per cent of national income and arrested the growth in the debt to GDP ratio. At the same time, they lowered taxes for business and citizens and undertook massive public investment programmes. The Dutch have profited for decades from a sound monetary policy that guarantees a strong currency, low inflation and low interest rates.

How has this Dutch miracle been achieved? The double sword of sustained wage moderation and anchoring the value of the guilder to the Deutsche-mark has dramatically improved the competitiveness of Dutch firms. Unit labour costs remained roughly constant during the last 15 years; elsewhere in Europe they rose steadily by 3 per cent each year! The share of profits in value added more than tripled. These two factors fuelled the engine for a boom in net exports, private investment and employment. Wage moderation induced enterprises to use less capital and more labour, so labour produc-

tivity growth has been less strong. Consequently, employment has grown rapidly despite modest growth of the gross domestic product.

Wage moderation does not come like manna from heaven. The Dutch trade unions have restrained wages in exchange for social policies from government and enterprises. The government has actively supported wage moderation through cutting taxes on labour. By giving tax cuts to firms who hire long-term unemployed, employ low-paid workers or provide apprenticeship schemes and child care facilities, the government encourages firms to act in the public interest. Workers have agreed to work on the weekend; in the evening and at night in exchange for shorter working hours. The boom in part-time work has contributed to the flexibility of the Dutch economy and boosted female participation.

The late Lord Kaldor may have been right in arguing that monetary policy is only of secondary importance in controlling inflation. The real credit for the strength of the guilder and the low inflation rate must go to the conscientious trade unions of The Netherlands. Conversely, critics of European Monetary Union who argue that Europe's unemployed are in dire need of a dose of monetary expansion live in cloud-cuckoo land. Once wages catch up with inflation, monetary expansion only leads to more inflation and a weaker currency, not to more jobs. In fact, the Dutch argue that monetary expansion is a mischievous attempt to moderate wages and fool the unions. Trust is built up by negotiating with the unions face to face and by offering tax cuts, training, child care and shorter working hours in exchange for wage moderation and more flexible working hours.

Another factor behind the job growth is that the government has cut back social security. Not so much by cutting the generous level or duration of benefits, but by toughening up eligibility requirements, improving the efficiency of the social security system and introducing market-oriented reforms in disability and sickness insurance. As a result, social insurance premiums and labour costs have fallen, further spurring job growth. Raising taxes and postponing public investment projects cuts the public sector deficit, but pushes up labour costs and destroys jobs.

What other lessons are there to be learned from the Dutch experience? First: the government should engage in a fruitful dialogue with trade unions and enterprises. The social partners should be encouraged to take a long-term view and invest in each other. Rather than the practice of quick hire and fire, firms and unions should agree to retrain workers who face the sack. It is essential that negotiations do not take place at the level of the individual firm or worker, but at a higher level. Perhaps, agreements between social partners on wage moderation, shorter working hours, hiring the long-term unemployed, training, child care and topping up social security should be extended

by the government to cover the whole industry in order to avoid free rider behaviour.

Second: flexible and part-time work benefits both employers and employees, especially in a society where more women want to work, young people need to link up with the labour market, people have different individual needs, and firms face increasing competition from abroad. Flexible and part-time work should not be forced from above, but tailor-made to fit the needs of employers and employees. Also, unemployment should be forced down by stimulating employment rather than by cutting effective labour supply. The Netherlands still has a long way to go in getting more people from the age of 45 onwards, as well as the partially disabled and women to participate in the labour market. This is the royal route to protect people against income loss. It also boosts the tax base and provides a firmer foundation for the welfare state.

Third: cutting taxes should also feature at the top of a left-wing agenda. The idea is to use the tax system to provide incentives for wage moderation, shorter working hours, unemployment reduction, training and child care. Rather than cutting the level or duration of social security benefits, one should rely on the earned income tax credit to make it attractive for unemployed people to accept a job. Reform of the social security system should ensure that the army of flexi-workers gets similar entitlements to social security as workers with tenure. In a dynamic economy the flexi-workers take all the risks. They should not be penalised for doing so.

The British economy storms past Continental Europe in the world competitiveness stakes thanks to decades of market-oriented reforms. Still, the OECD points to Holland as the example of how capitalism can work with a friendly face as well. Ireland also demonstrates that consensus, trust, pragmatism, corporatist labour markets and a good education system can yield rapid growth without sacrificing social justice. These countries show that it is worthwhile to strike a balance between vitalising the economy and new ways of organising solidarity between the young and the old, the healthy and the sick and the rich and the poor. The Dutch and the Irish have shown that one can have a flexible economy with a fair distribution of income and access to health care and schooling regardless of income or social status. Consensus, security and social justice can go hand in hand with flexibility and rapid job growth. That is the challenge.

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APPENDIX

Structural Unemployment and Taxation

Matching Jobs and Vacancies

Consider trade between employers with vacant jobs and unemployed workers and ignore on-the-job search. Tightness of the labour market is proxied by the ratio of the vacancy rate V to the unemployment rate U , that is $X \equiv V/U$. The Poisson matching probability $Q(X)$ of a vacant job is small if the labour market is tight (i.e., $Q'(X) < 0$). The flow into the pool of unemployed

(i.e., $S(1-U)$ where S stands for the exogenous separation rate) must equal the outflow (i.e., QUX where QU is the probability of an unemployed person finding a job). Hence, the equilibrium unemployment rate rises as the separation rate rises, labour market tightness falls and matching technology worsens: $U = S [S+XQ(X)]^{-1}$. In percentage changes we obtain the *Beveridge curve*:

$$l = U(1-\mu)x \text{ or } u = -L(1-\mu)x, \text{ where } 0 < \mu \equiv -d \log Q / d \log X < 1$$

where L stands for the level of employment and small letters indicate percentage changes from the reference values.

Hiring

Each operating firm employs one unit of labour and produces output $Y=F(K,E)$, where capital is rented at the world rate of interest R and energy E is imported at the world price P_E and faces an *ad-valorem* tax rate T_E . Matching workers and jobs is a time-consuming, costly and uncoordinated activity; so hiring costs are a fraction γ of the economy-wide producer wage. In equilibrium each firm sets the discounted net productivity of labour (i.e., after separation is taken into account) equal to the expected capitalised wage costs plus hiring costs. This optimum condition can be rewritten as:

$$A(R, P_E, T_E) \equiv F(K, E) - RK - P_E(1 + T_E)E = (1 + T_L)W[1 + \gamma(R + S) / Q(X)].$$

where W is the wage rate. Rewriting this (suppressing the effects of R and P_E) in percentage terms, we get the *hiring schedule*:

$$x = -\varepsilon_D(w + t_L + \omega t_E) \text{ with } \varepsilon_D \equiv [(R + S)\gamma + Q] / (R + S)\gamma\mu > 1 \\ \text{and } \omega \equiv P_E(1 + T_E)E / A.$$

A tight labour market means that vacancies take long to fill and the capitalised value of expected hiring costs are high, hence firms are less willing to pay a high wage. A lower productivity of labour (e.g., due to a higher world interest rate or cost of energy) depresses hiring.

Sharing the Surplus

A job match involves a rent, which is the sum of expected search costs for the firm and the worker (including forgone profits and wages). Splitting up means that both the firm and the worker have to engage in costly search activities. A more progressive tax system (lower Z) induces wage moderation as the worker and the firm realise that the government gets a larger slice of wage increases. Consequently, the firm gets a larger share of the rent and the wage mark-up M falls. A bigger separation rate S or interest rate R and a

tighter labour market (higher X) raise the capitalised value of hiring costs and thus boost the wage mark-up. In addition, a tighter labour market improves the chances of an unemployed person finding a job and boosts the bargaining power of the worker thereby further pushing up the wage mark-up. This discussion of the factors determining the wage mark-up can be formalised by deriving a Nash bargain for sharing the rent that arises from frictions in the labour market. This leads to the following expression for the wage mark-up:

$$M \equiv (C_E - C_U - \delta) / C_E = \gamma \beta Z[X + (R + S) / Q(X)]$$

where C_U denotes consumption when unemployed, $C_E \equiv (1 - T_A)W / (1 + T_C)$ is the consumer wage, δ stands for the disutility of work and β is the bargaining power of the worker relative to that of the firm. If hiring costs are zero ($\gamma=0$), workers are indifferent between being employed and unemployed (i.e., $M=0$). Hiring costs drive a wedge between the utility of employment and that of unemployment (i.e., $M>0$).

Percentage changes in the consumer wage can, for constant ϵ_D , be written as:

$$c_E = w - t_A - t_C = c_U + M(z + \kappa X)$$

where $0 < \kappa \equiv 1 - (R + S)(R + S + XQ)^{-1}(1 - \mu) < 1$. This *wage schedule* clearly shows a bigger gap between income under employment and unemployment if the tax system becomes less progressive or the labour market tighter.