The Labour Cost Enigma: An Inquiry Into the Cause of the Structural Unemployment in Western Europe

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High labour costs are the main reason for many firms to transfer their activities to countries with low labour costs. So, in western countries unemployment is partly a result of high labour costs. The first question is: Why the cost of labour is so high? In Western Europe, high labour costs are partly due to the way in which the social insurance system is functioning. But this way of funding the social security is working counter to its purpose. The conclusion is that there is only a historical reason for it based on the principal that social security is the responsibility of the workers. The next question is: How can a growing proportion of the qualified labour force be left out? The root cause for this problem can be found in the composition of the cost of labour. The basis for levying contributions on the sum-total of wages paid is wrong. If a society considers social security as an essential right of every member of the community, it is no longer logical to put the burden of funding this obligation to every citizen on those working in paid employment. The unavoidable conclusion is that looking at the situation from a national point of view the labour force is used not only in a highly inefficient manner, it is also certainly under-utilised. This article argued to choose the gross domestic product as the basis for levying contributions for social security with a rebate on this tax which is determined by the number of employees. These findings form a rough sketch of a human oriented market economy with its main feature to make it economically attractive for employers as well as for employees to act in a manner, which is socially desirable.

Keywords: structural unemployment, labour costs, social security, value added tax, social market economy, socially desirable behaviour will be economically attractive

Introduction

The financial crisis is nowadays the centre of attention of economic science. It hardly gives any attention to the possibilities to increase economic growth as the only way out of the enormous burden of debts of western countries (Reich, 2007; Stiglitz, 2010). An increase of economic growth in western countries depends on their competitiveness. The competitiveness is mainly determined by costs of raw materials, costs of capital, and labour costs. The costs of raw materials and capital are set on world trade prices. So the level of the labour costs is of great importance for the competitiveness of the industry (Stiglitz, 2002).

The free market economy as practised in most Western European countries is presently treating available labour highly inefficiently. In the European Union, the workforce unemployed rate is nowadays 10% (Eurostat, 2011). This is a social disaster of a magnitude unheard of, carrying along a high burden of social cost. The
disaster also has an important economic dimension in its under-utilisation of labour while social benefits; welfare and other allowances to the destitute have to be paid for. The economic costs of this under-utilisation are enormous but hardly possible to calculate.

In the most Western European countries, the economic cost of this under-utilisation of labour weighs heavily on the wages of those in work, pushing up the total cost of labour. This in turn increases the pressure to lower the total cost of labour leading inevitably to a deterioration of the conditions of labour and social benefits (European Parliament Directorate-General for Research & Innovation, 1998). At the moment, this feeling is painful in Greece, Spain, and Italy, especially for the youth. The unemployment rates for the youth are nowadays 43% in Greece, 45% in Spain, and 28% in Italy (Eurostat, 2011). Their governments can do nothing for them. They have to reduce strongly their public expenditure.

Because the wage costs are higher than the neighbouring countries and worldwide, unemployment is soaring. Western Europe is now compelled to take harsh measures in social benefits to lower the cost of labour. In case they do succeed in reducing the cost of labour substantially, unemployment will rise in the neighbouring countries, starting a spiralling effect. As a result of the free movement of goods and services in Western Europe, less wealth will be enjoyed by those at the bottom of the labour market; worst of all will be those dependent on welfare payments. Paid employment at reasonable wages and under acceptable conditions has become a luxury enjoyed by few and envied by many.

**Why the Cost of Labour Is So High?**

In the past decades, the contributions towards social benefits have risen considerably. They now amount to roughly one third of the cost of labour and in some countries more. What is the reason social benefits place such a burden on wages? From the end of the last century, different schemes were developed in Europe to ensure the payment of benefits to workers in need. They were all intended to secure a minimal subsistence to anybody no longer capable for one reason or another of earning an income on his own. Initially those schemes were aimed at distinct and limited groups of society, but gradually and certainly after World War II they became applicable to the total population practically. Nobody showing the willingness to participate in the labour process should be impoverished (Glebbeek, 1996). But, with the extension of the sphere of influence to the total population the logic of placing the burden of cost solely on those in work has disappeared.

Although there are differences in the schemes to offer social security, they all have in common that funds are generated on the basis of wages paid to workers either as a tax or as an obligatory contribution. Whichever method selected will always work out as an increasing burden on the cost of labour. Because, with an increasing need to help the less well-off the charges on wages paid will have to grow, increasing the total cost of labour. This will induce efforts on the part of employers to reduce the influence of the cost of labour on the manufacturing costs of their products and services. The first and foremost remedy is to invest in labour saving equipment. A second option is to increase pressure on the labour force formally or informally to produce more goods per hour paid. One way or another the number of unemployed will rise, requiring additional social security payments, starting a vicious circle putting people out of work first and companies out of business in the end (Weitzman, 1984). The free market of labour seems to turn against itself: a decrease in demand for labour leads to an increase in the cost of labour per hour and per unit of production.1

It is therefore not surprising at all that nobody can solve the problem of unemployment.

The funding of social security appears to be working counter to its purpose. Extra benefit payments are called for just when premium income is decreasing and in the case of an economic upturn larger amounts of premiums are collected for a decreasing number of people eligible for such benefits. This is an absurd way of funding a system intended originally to provide protection to individuals and the community they work in. It poses a huge political problem that is totally unconnected to economic situations described as boom or slump.

Politicians generally present the point of view that the bad times will tide over, especially once their policies are adopted. With statements such as “an economic upturn will come certainly to wipe out the temporary setbacks for some members of the labour force, we have to accept that having a job is an item of luxury”. The remedies put forward as temporary measures to create jobs for underprivileged groups as school-leavers, re-entering females, the over 1940s, members of the groups of foreigners attracted in time of labour shortage do not amount to anything else than a forced circulation of unemployment. Everybody will have to take his or her turn. It maintains the pressure on labour unions not to be too demanding in wage claims and it keeps those in employment on their toes and careful not to be kicked out again. At least that is the way the burden of the payments for social security works out in the Netherlands.

The opposite applies in the United States. The social security system is very limited and minimum wage levels are not common. In several states the government has set up a system of earned income tax credit, which helps the employee with a surplus from the government when they receive from the employer less than the minimum wage (Eissa & Hoynes, 2005; Hotz & Scholz, 2006). Paul Krugman stipulated as follows:

In the United States, which has managed to maintain relatively full employment but has experienced rising inequality, the incomes of low-wage workers need support; but that must be done, so far as possible, without raising the cost to employers of hiring those workers. The obvious answer is something like a much bigger version of the earned income tax credit—an income supplement for workers with low earnings that falls off as a worker’s earnings rise, but not so rapidly as to negate pay increases and discourage work. (...) Europe has nearly the opposite problem. The poor receive relatively generous support, but not enough people are employed. What Europe needs to do is reduce the cost of employing the less skilled, so that the private sector will offer them more jobs. But it must do so without, so far as possible, reducing their incomes. In this case reducing or removing the tax burden associated with hiring low-wage labor, and possibly providing some employment subsidies, are the obvious answers. (Krugman, 1996)

But the labour market responds predictably in economic terms, the free market works! When a few years ago the demand for labour decreased sharply, the cost of labour adapted it to the market conditions. Without a statutory minimum wage level the cost of labour went down considerably, especially at the lowest levels and comprising relatively large groups in the labour force. The United States now enjoys a higher level of wealth for small groups at the top and a growing population of lowly paid dissatisfied people at the lower end of the labour ladder. A growing crime rate cannot be seen as unrelated to the economic conditions created.

How Can a Growing Proportion of the Qualified Labour Force Be Left out?

In the Netherlands the general economic condition looks quite favourable. Yet the growth in employment lags considerably behind the growth in gross domestic product (GDP). On top of that, politicians and economists were startled recently by the discovery of a huge shortage in the level of funds collected for social security. This shortfall in income points to a lack of meaningful (contribution paying) jobs and a large number of part-time employment contracts contributing only marginally to the social security funds. It seems the situation is not as favourable after all. The relative advantage compared to the neighbouring countries was
achieved by two closely linked phenomena:

- A very limited growth in real wages was reached through wage restraint on the part of the labour unions;
- The development of the contribution to social security funds, directly influencing the cost of labour and of production, was strictly controlled by the government.

But nowadays the situation has changed. In 1998, the labour costs in the Netherlands were about 17% lower than in Germany. Therefore the Netherlands was in a favourable competitive position against his neighbour Germany. Ten years later, in 2008, the labour costs in Germany were 3% lower than in the Netherlands (Eurostat, 2011).

This means that only a government convincing its people (and voters) successfully to accept ever-decreasing standards of living will survive in the end. It is highly questionable if a policy aimed at structurally decreasing standards of living is socially acceptable. Should people really be aiming for such a development?

The root cause for the problem of a growing proportion of unemployment can be found in the composition of the cost of labour. As demonstrated above, a decrease in demand leads inadvertently to an increase in cost, an enigma in dogmatic economic theory of the free market. The problem is growing worse by the fact that in modern western democracies, it has become unacceptable to reduce substantially the standard of living of those unfortunate to lose their employment. The right to an income minimally at subsistence level is already stated in the constitution of some countries.

If a society considers that social security is an essential right of every member of the community, it is no longer logical to put the burden of funding this obligation to every citizen on those working in paid employment. The basis for levying contributions should rather be the GDP, not the sum-total of wages paid.

Considering this difference, enormous by itself, another very important aspect crops up. Looking at wages paid at a company level, the difference between labour cost with or without one employee is the sum of his wages and the contributions towards social benefits borne by his employer. At the national level, on the contrary, this amount is reduced to the difference between wages and contributions paid by the employer and the benefits paid out to the unemployed person. This looks like a substantial reduction in actual cost to the economy as a whole. Seen from a national level, getting that person back into work is less costly than it is to his former or new employer. A company employing the person is not rewarded in any way at the moment, yet it does contribute to the national economy by doing so. Employing a previously unemployed person costs the company his wages increased by social security contributions. In the Netherlands this amounts roughly to wages and an addition at the level of the social benefits for one person, not now any longer paid out by social security and thus a saving for the national economy. This enormous difference between the cost at the national level and at the level of the employer makes that an employable person will be engaged only if an employer is certain that the new employee will have a larger added value to his operation than wages which plus social security contributions. The unavoidable conclusion is that looking at the situation from a national point of view, the labour force is used not only in a highly inefficient manner, but also certainly under-utilised.

**Human Oriented Market Economy**

Most western democracies are governed in a way that pre-supposes the self-sufficiency and independence of individuals balanced by a mutual responsibility of all citizens for the well being of the population (Rawls, 1996).

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THE CAUSE OF THE STRUCTURAL UNEMPLOYMENT IN WESTERN EUROPE

1999). This has found the following wording in the Netherlands:

The society organised in the state is liable to provide social security and the freedom from want for all its citizens, provided each and every member of society contributes to the best of his efforts to safeguard his social security and freedom from want.

In practice, the mutual responsibility for the social security of the population as a whole now rests solely on the shoulders of those members of society in employment. They have to produce the income for the system of social security. This is the present-day result of the gradual development of social security schemes over a period of decades. But as the benefits of social security have been extended gradually to cover all members of the society requiring support, it is not unreasonable to shift the basis of funding from the workers only to the wealth of that society as a whole, expressed in economic terminology as the gross domestic product (GDP).

The GDP is the sum-total of the value added by all companies and all other organisations in a country. At the level of the individual company or organisation, the value added (i.e., everything an organisation creates in additional value from the raw materials and unfinished products it buys in) should be used as the basis for levying social security contributions instead of using the wages paid for that purpose. Accepting that basis to charge for social security contributions the proper rate of the charges on the value added needs to be established in such a manner that the requirements for the payment of social benefits to members in need of the total population can be met on a national scale.

A very important consideration at this stage is the realisation that companies and organisations paying wages to their employees provide means well above the guaranteed income deemed necessary socially. For this service to society, companies and organisations ought to be rewarded. This can be achieved by a rebate on the contributions towards social security they will be required to pay on the grounds of value added. The rebate will be determined by the number of people employed (as a multiplier) and the level of the initial claim on social benefits by members and past members of the workforce at day one of the introduction of the new scheme.

This will lead in a short period of time (less than a year) to a manner of financing for social security that is always in balance and completely in step with the general state of the economy.

The method of charging for social security has to be refined to take account of the different types of organisations. Using one flat rate would certainly put capital-intensive branches of industry at a disadvantage, whereas labour-intensive ones would benefit disproportionally. This is not the aim of the changeover. It could mean driving out labour-intensive operations. The new method of funding for social security will have to allow a smooth changeover. In fact no company or organisation should suffer setbacks or enjoy advantages in the period of implementation. This means for the scheme that for every organisation the new charge on value added reduced by the rebate for the number of people employed should balance with the existing contribution towards social security. This implies that in the transition period the percentages paid on value added will be determined by the calculation new charges on value added minus rebates for number of employees equals old charges on wages paid. The calculation can lead to different percentages to be applied on value added for different branches of industry. The recent history of employment by the organisation can be expressed in the level of rebate per employee, benefitting those companies within a branch with a relatively large labour force per unit of output.

To save a lot of administrative work, it is advisable first to start out from the same amount of rebate for every person employed full-time. Secondly, the rate to be charged on value added should be the same for all companies within a branch of industry, for it appears that within a branch the value added per worker does not
vary widely.

This approach implies low percentages for capital-intensive branches and higher ones in labour-intensive industries. This is in short the outline of the human oriented market economy.

**How Will This Human Oriented Market Economy Work out in Practice?**

1. Calculations and forecasts of the central economic planning agency (CPB) of the Netherlands have shown that employment will increase considerably, without negative effects on other important socio-economic indicators. This can be explained quite easily, for when the cost of labour is reduced drastically from wages plus social security contributions to wages minus fixed rebates a lot of work becomes economically viable again. This is realised without costly job creation schemes but rests solely on the considerations of entrepreneurs realising that they can create a larger value added by increasing their output with a relatively smaller increase of labour cost.

2. The shorter life cycle of products requires an increasing contribution to research and product development from the sales value of products. Research and development are labour-intensive. In the new, social market economy such activities become cheaper, because employing an extra person gives an immediate rebate while the charge for the added value is postponed till the time a new product contributes to the turnover of the company. The expenditure on research and development will grow in many companies. To give one example: the cost of writing software or the development of a new chip consists mainly of labour cost. The mass production cost per unit is relatively low. With a reduction of the cost of labour by 30% than to the new, social market economy, more effort can be spent profitably on research and development.

3. Providing services of all kinds will increase due to the fact that it is labour intensive and is therefore limited to the bare minimum. Now it enhances the product offering, without contributing immediately to the value added, the tables are turned.

4. The incentive to replace labour by mechanical or electronic means of production will slacken. Calculations show this trend is not persistent over a longer period. Lower cost of research and development make cheaper and better ways of production available earlier and at acceptable prices.

5. Companies will experience an improvement in their competitive strength. A decrease in prices forced on them by the market does not influence their profits proportionally, because part of the shortfall in value added is compensated by the lower contribution to be paid for social security. This is, however a temporary advantage; once the new, social market economy is in force generally this advantage no longer applies. Still, fluctuations in the selling prices obtainable in the market will always be dampened in this manner.

6. On top of this positive effect for companies, there is also a national advantage: The temptation to pay “below board” no longer exists for employers. In the new social market economy an employer forfeits the rebate for the person he employs if the payment of wages is not “above board”, making wages paid illegally more expensive than properly declared ones. Realising that today estimates of wages paid illegally amount to 10% of GDP, the whole structure of collecting and distributing of social security will benefit because recipients can also no longer conceal income.

7. The advantages of the new, social market economy are by no means limited to the manufacturing industry. The cost of labour will be reduced by half for the not-for-profit sector of the economy, for utilities, for education and for the transport industry. It means re-introduction of the conductor on tram or bus is a paying proposition. As soon as the extra income from tickets sold exceeds just the difference between his wages and

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the rebate paid to the transportation company, the job is paying its own way. This phenomenon also makes it more attractive to increase the frequency of service with smaller units. In fact it becomes economically feasible to operate a fine-mesh high-frequency system of public transport, capable at last of competing effectively with travel by private car.4

The above forms a rough sketch of the new, social market economy with its main feature to make it economically attractive for employers as well as for employees to act in a manner, which is socially desirable.

Experiments

From 1996 till 1999 a practical experiment took place in Rotterdam with 12 commercial companies. The human oriented market economy was applied without the necessity to change the normal (Dutch) taxation regime.5

Also, the calculation of the new social security tax (NSST) can be done on base of the existing company-administration. The NSST was calculated and the difference with normal taxation was paid to or collected from the company.

From 1999 till 2001 another practical experiment took place in de Provence of Groningen with 23 commercial companies (Centre for Labor and Policy, 2001).

The outcomes of these experiments are:

1. The human oriented market economy lowers the wage-costs by introducing a tax-deduction per worker. The method therefore generates new jobs. On one side by splitting up simple tasks that can be done by a low-educated person who’s lowered wage-costs can be earned by the employer more easily. On the other side small employers can afford high-educated employees because of the reduced wage-costs.

2. The present wage taxation and high wage-costs force the employer to fire employees in case of declining commerce, whereas the NSST decreases with declining commerce. Therefore it is much easier for the employer to keep his employees (and know-how) during a temporarily decline. This effect has shown up in the experiment.

3. In situation of growing commerce an employer has to invest in new employees whereby the present wage taxation increases the necessary investment and also the employer’s risk. Whereas the NSST only has to be paid when the value added is realized. The experiment has shown up that this gives a strong stimulation to investments and innovations. For employers do not look only to investments in capital goods but also to their investments in wages.

4. The human oriented market economy benefits training on the job, because improductive time is not taxed (no added-value).

5. The human oriented market economy lowers the productivity pressure on labour without lowering company profit.

6. The governmental costs of the tax-deduction per worker are less than the governmental earnings; these earnings are extra tax-income by economic growth and savings by unemployment benefits. The increase in employment at the participating companies was 17%. This number may not be generalized because of the voluntary participation in this experiment.

In February 2001, The Center for Research in Experimental Economics and Political Decision-Making of

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the University of Amsterdam has investigated the human oriented market economy commissioned by the Dutch Government on that moment under the name “The van Elswijk Plan”. The following summary can be found in the final report from CREED, titled: An experimental study of the van Elswijk plan by van Winden, Riedl, Wit, and van Dijk (2001).

Summary

The most important experimental results concern the testing of the hypotheses regarding capital flight, employment, net wages, the relative size of the labour intensive (sheltered) sector, and welfare. The results of these tests are favourable for the Van Elswijk system. In comparison to the wage tax system, under the Van Elswijk system, there is no capital flight and employment does not decrease. Ultimately, a substantial capital import and increase in employment are observed. The greater production leading from this does not appear to be more labouring intensive.

In this regard, the internationally operating (exposed) sector is not displaced. When tax rates are adjusted to the budget deficit, there are also positive effects on net wages and on the various welfare indicators. Few negative effects (decreases), in the net wages and in one of the four welfare indicators, only occur if tax rates are not adjusted to the budget deficit, that is, if they are kept constant. However, this is coupled with a substantial budget deficit for the wage tax system and a substantial budget surplus for the Van Elswijk system.

Furthermore, it appears that with the wage tax system, the (domestic) wage tax rate always has a negative effect on the variables that are central to the hypotheses and this effect is usually significant. With the Van Elswijk system the effect of the product tax rate is in the same direction, but it is always less negative and usually not significant.

These economic effects of the Van Elswijk system can be explained by two factors. In the first place, the assumed presence of some immobile capital leads to a shift in the tax burden from labour to capital under this tax system, in which not only labour but also capital is taxed (implicitly). This makes an increase in efficiency (a well-known result of the theory of optimal taxation) possible. In the second place, it appears that the shift in the moment of taxation plays an important role. With the wage tax system, the producer is already confronted with taxation at the moment of acquiring production factors (labour). At this moment, it is still uncertain to what extent the production costs that are incurred will lead to profits. On the contrary, with the Van Elswijk system, the costs of the production factor labour are no longer taxed but are in fact subsidized. Moreover, taxation takes place at a later stage and is in proportion to the price development on the product markets. In contrast to the wage tax system, with this system the government therefore shares the sales risk of the producer. The relatively better performance of the Van Elswijk system can be explained by also taking into account these uncertainty effects.

The additional theoretical analysis, in which these uncertainty effects are ignored, shows that the Van Elswijk system can lead to better economic performances than the wage tax system due to the mere possibility of shifting the tax burden to capital. people say, “can lead” because besides a “favourable” equilibrium for this taxation system in comparison to the wage tax system, an “unfavourable” equilibrium is also found. In the “favourable” equilibrium, there is a considerable increase in employment with some capital flight. However, in the “unfavourable” equilibrium, there is a considerable decrease in employment and substantial capital flight. The “favourable” equilibrium, which receives the most empirical support in the experiment, does not disappear when a sensitivity analysis is conducted, involving changes in the unemployment benefit level or a decrease in the labour subsidy. The theoretically favourable effects of this taxation system also appear to have less to do
with the labour subsidy than with the increase in efficiency, which occurs through the implicit taxation of the fixed factor (immobile capital). This is because of the higher tax rates accompanying a subsidy. However, even if this fixed factor is considerably reduced, the levels of employment and welfare in the “favourable” equilibrium are still clearly higher than with the wage tax system. The same holds for when the ratio of the unemployment benefit rate and wage rate is held constant instead of there being a fixed benefit.

**Conclusion**

The financial crisis force western countries to cut strongly on public expenses with the result that the purchasing power reduces and the economy shrinks. The only way out is to increase competitiveness by reducing the burden on labour (not the wages). Germany gives the direction to a solution, yet without realizing it. On the basis of the proposals of the Harz committee, Germany has reduced the burden on labour and raised the VAT.

Some people find the ideas of the human oriented market economy so outrageous that they compare them to the perpetuum mobile or the squaring of the circle, improbable solutions to inherently insoluble problems. If one realises however that in 2011 in the Netherlands 23.5 billion Euro (€ 23,553,000,000) (Eurostat, 2011) in benefits is paid to people between the ages of 15 and 65 who do not work but are also under obligation not to work, the wasting of public money and productive capacity becomes painfully clear.

The human oriented market economy does nothing more than reducing the improductivity of money and labour.

**References**


