Both these papers are concerned, in very different ways, with the effects of government intervention in the labour market on employment. The first applies the model proposed by Patrick Minford (1983) to Germany. The second examines some perverse effects of the tax wedge.

I

Patrick Minford is often represented as saying that unemployment benefits encourage voluntary withdrawal from the labour force, therefore the level of benefit should be reduced to increase employment. When pressed, what he says is that for those of low earning-capacity the fixed-rate component of benefits is higher than their productivity and their expected real wage. Hence, rationally, those people cease to search for work. And those on earnings-related benefits can afford longer search. Reducing the disincentive effect of benefits would encourage the unemployed into jobs; society would have the benefit of their output, and their incomes could be ‘topped up’ later.

Allowing for the fact that for psychological and social reasons some people will accept a wage below benefit level, this seems to me not entirely an unfair point, though it says something devastating about either the ability of some people to earn a minimum standard of living or the ability or willingness of firms to pay it. As a microeconomic proposition the model of Figures 12.3 and 12.4 deserves to be tested on a disaggregated basis. Mr Davis avers that data are not available.

In any event, Davis and Minford are looking for macroeconomic results: the thesis of the paper before us is that the cause of unemployment is to be found in ‘the prevention - by way of unemployment benefits and social aid’ – of real wage adjustment. Such a thesis supposes that all unemployment is voluntary (in the technical sense used by Keynes, which includes, inter alia, the effects of trade-union pushfulness). Not only does the model assume that we know the ‘labour force’ which serves as a benchmark, thus ignoring those who are ineligible for benefit because not registered (for example – and
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these must be numerous now – discouraged workers). But more important, demand-deficient unemployment is ruled out, despite what they say in their last paragraph.

I shall have to make that charge stick, but since the treatment of demand is a problem in both papers I shall deal with some other matters, theoretical and empirical, first.

On the theoretical side I point out two puzzles which occur throughout Minford's work on unemployment. One is why, if unionised labour always sells at a premium, firms buy it at all. Another is that unions seem to be the only agents in the economy which make price or inflation expectations, although this seems not to matter empirically in the German case. This specification problem is related to the demand issue.

When we come to the empirical work (section 12.3) we face the usual problem of the correspondence between the theory and the empirical investigation. A theory of the effects of benefits is transformed into a four-equation model of the German economy, from which a 'natural rate of unemployment' can be extracted. Little can be said about the effects of benefits as such, apart from noting the size and significance of the actual coefficients on $T_L$ and $T_F$.

It is concluded that the 'natural rate of unemployment' rose significantly after 1974 (we are to infer this fact from Figure 12.5) at 'about the same time as the possible regime change' (italics added) toward a greater reliance on fixed-rate benefit. A somewhat less equivocal statement of what actually did happen to German benefit policy, and when, is required to make Davis's and Minford's case convincing even if one has no doubts about their econometric evidence. There is no formal test for a change of regime.

The evidence is also subject to Nickell's (1984) criticisms of Minford's earlier work, not, in my view, adequately answered by Minford (1984). The point I have in mind concerns the importance of the lagged values of the dependent variable in the 'short-run' equations. These generate spuriously large long-run effects for the other regressors.

The authors conclude that unemployment benefits, unionisation, and employers' taxes have resulted in real-wage rigidity, thus confirming and reinforcing their prediction that benefits cause demand shocks to result in unemployment rather than wage adjustment. As a Keynesian I should expect negative demand shocks to result in unemployment anyway, and not to be much alleviated even if wages were to fall.