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Industrial Policies and Social Security: Investigating the Links

by

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Industrial and Social Policies in Countries in Transition

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This paper opens a series of discussion papers which report about the findings of a research project within the Phare-ACE Programme of the European Union. We, a group of Bulgarian, German, Greek, Polish and Scottish economists and agricultural economists, undertake this research to provide *An Integrated Analysis of Industrial Policies and Social Security Systems in Countries in Transition*.[1] This paper outlines the basic motivation for such study.

1 Introduction

Imagine a simple picture of an economic system which consists of individuals, firms, and the state (see figure 1). In this picture definitions of social and industrial policy are straightforward. Social policies are relations between the state and individuals. The state takes responsibility for the risks of unemployment and sickness and provides basic social services such as childcare and education. Social policies are conducted by regulation of people's activities or by direct public provision of social services. Similarly, industrial policies are relations between the state and firms. Firms are regulated, taxed and subsidised for various purposes. Social and industrial policies fall in

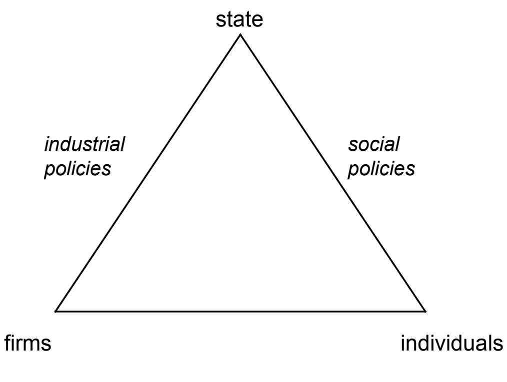

Figure 1

[1] Grant No.: P96-6227-R. I have received helpful comments from the participants of a workshop in Kostrzyn, Poland, where I presented a first draft of this paper. In particular I am grateful to Alfons Balman, Felix FitzRoy, Hans-Georg Petersen and Christoph Sowada for their contribution to the development of the research agenda in section 5 of this paper.

two distinct branches of politics whose mutual impact is often neglected. The policy definitions derived from the simple picture of figure one seems to guide much of day-to-day politics, at least in Europe. But not only politics, but also economic research is divided into branches. Social policy research is often carried out without taking note of industrial policies and vice versa. There is a (sub)disciplinary division of labour among economists. Such division of labour is suitable if and only if social security and industrial organisation are separated subsystems of an economy. However, this is not the case. Social security schemes have important impacts on the cost structure of firms; taxes and transfers are connected to labour market relations and industrial policies seem to be motivated by social goals rather than by improvements of firms' competitiveness and the efficiency of the industrial sector.

In the following, the industrial policy – social security relation is investigated from three different angles. Firstly, I examine the industrial economics view of subsidies and regulation. Secondly, I give a brief outline of the impact of social policies on firms. Finally, I discuss the third side of the triangle of figure 1, that is, firms' relationship with individuals. The particular focus is on firms' provision of voluntary social services. This leads to a research agenda for *An Integrated Analysis of Industrial Policies and Social Security Systems in Countries in Transition*.

2 Industrial economics and social goals

The new industrial economics is in the state of (Kuhnian) normal science. The *structure-conduct-performance* paradigm developed by Edward Mason in the 30ies[2] has been further developed in game-theoretic terms in more recent times. Modern industrial economics provides a theory of industrial organisation.[3] Its focus is on microeconomic analysis, in particular the functioning of markets, the internal organisation and cost structure of firms, and the relationship between cost structure and market structure.[4] The reference point of analysis is a competitive market which enforces a cost minimising behaviour of firms. In the real world the conditions of a perfectly competitive market are not met. Industrial economics investigates the impact of market imperfections on the behaviour of firms and the performance of the economic system. Accordingly modern industrial economics has developed elaborated models of monopoly, oligopoly, price discrimination, product differentiation, barriers to entry, collusion etc.[5]

[2] Mason (1939).

[3] Cf. Tirole (1988).

[4] Cf. Sutton (1991).

[5] This is roughly the table of contents of a modern industrial economics textbook, such as Waterson (1984), Tirole (1988), or Martin (1993), to name a small selection.

The structure-conduct-performance paradigm of industrial economics is connected to a particular view on the role of industrial policies. The general aim to enhance welfare and efficiency can be achieved in a competitive market system. Thus industrial policies' role is to respond to market imperfections by regulating monopolies, taking measures against collusion and defining standards for competition. This view has forcefully been argued for by Walter Eucken (1952) and the ordo-liberal Freiburg school.[6] The role of the state is confined to three types of activities: (1) to create and enforce property rights as a prerequisite for market exchange, (2) to enhance competition by effective anti-trust policies and trade rules and (3) to regulate natural monopolies. The role of the state is to guarantee the conditions for the functioning of the market without any interferance with the market process. Industrial policies are directed towards allocational goals. The distribution which results from the market process is not the concern of industrial policy.

This line of reasoning results from an interpretation of the fundamental theorems of welfare economics. If a competitive equilibrium is efficient (first theorem) and if every efficient situation can be implemented as a competitive equilibrium (second theorem), efficiency and distributional goals can be separated from each other. Using Musgrave's (1959) terminology, we can adopt a complete division of labour between the allocation branch and the distribution branch of the state. The allocation branch designs industrial policies whereas the distribution branch designs social policies to redistribute resources towards those who are left with an unfair or insufficient share in the market process.

Missing markets, public goods, market power, and informational constraints[7] limit the impact of the two welfare theorems. In the light of market imperfections a complete division of labour between the allocation and the distribution branch of the state is less compelling from a theoretical point of view. As a matter of fact there are many prominent examples of industrial policies which run counter to the efficiency goal, but rather seem to be directed towards distributional goals. The coal and steel industry, shipyards, and the farm sector are such cases, where massive subsidisation hampers structural change and directs investment into inefficient technologies. The subsidisation of declining industries is an anomaly from the point of view of the established industrial economics. These subsidies do not fit into the picture and, indeed, they are often overlooked. It is, I think, an interesting observation that all industrial economics textbooks include chapters on monopoly and regulation but hardly any one devotes more than a small paragraph to these subsidies to declining sectors which account for the largest part of the public industrial policies budget.[8] While this observation seems surprising at first sight, it is not so in the light of the above reflections concerning the scope of industrial economics. The subsidies to declining sectors are not regarded as proper objects of

[6] Hayek and the Austrians are close relatives to this view.
[7] Cf. Akerlof (1970).
[8] See e.g. Hay/Morris (1979), Scherer/Ross (1980), Waterson (1984), Tirole (1988), Martin (1993).

industrial economics research. It seems all too obvious that these policies are motivated by social goals and thus fall into the realm of social rather than industrial policy.

These reflections on the state of current research in industrial economics can be summarised into the following claim.

> Industrial economics' scope of analysis is too narrowly focused towards efficiency. Its scope must be widened to include the analysis of industrial policies designed to pursue other social goals.

There is one obvious response to this claim. Industrial economics takes a normative view. It explores second best solutions where the first best is unattainable due to market imperfections. However, the subsidies to declining sectors are not paid to correct a market failure. Their rationale lies in a different area of economics. It has been argued in the Public Choice literature that subsidies ought to be understood as a result of a policy failure rather than of a market failure. Subsidies result from of a rent seeking process. Take the example of agriculture. Subsidies are leading to land use and investments which are inefficient and environmentally damaging. The policy counteracts the efficiency goal. But subsidies also fail to reach the proclaimed social goal to stabilise poor farmers' income. The scheme of subsidisation that has been followed for more than three decades by the Common Agricultural Policy of the European Union has given advantage to large farms. Poor farmers received only a small fraction of the subsidies. Consumers – rich or poor – had to bear the burden. The agricultural lobby has successfully created and captured rents from a protectionist agricultural trade policy and has received subsidies for investments and social security contributions.

What is the conclusion from such response to the above claim? Should we conclude that subsidies to declining sectors are not a topic for industrial economics but rather for Public Choice? The theory of rent-seeking behaviour offers an explanation for the existence of protectionism and subsidisation.[9] The separate problem of justification remains to be dealt with. If industrial economics takes up this challenge it must indeed take social goals into account. Industrial policies have distributional consequences which cannot be neglected when such policies are to be assessed.

Justification of a policy spells out its consequences and compares them to some normative standard. Let me briefly examine two possible justifications for subsidies to the declining agricultural sector: (i) Subsidies are a means to maintain a sufficient income for farmers. (ii) Subsidies optimise the adjustment path during a phase of structural change.

(i) The decline of the agricultural sector puts farmers' income under pressure, probably in such a way that some of them fall below the poverty line. This is the result of a decline of relative prices for agricultural products. In agriculture we observe substantial increases in the

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[9] Cf. Mueller (1989).

productivity of labour but only a small increase in demand for agricultural products. Income declines and people will leave the sector and look for employment elsewhere. Because of a lack of training the wage a farmer can get outside agriculture will be low. To stabilise farmers' income subsidies to the farm sector have been considered and implemented in many countries. The following question must be addressed. Can agricultural policies (or indeed any sectoral industrial policies) be an adequate means to reach distributional goals at all? Since distributional goals are always a matter of debate, I propose the following assumption which any redistribution must meet:

> For all members of society j, if a policy adds x to the the income of individual j no individual who is richer than j should receive more than x from that policy.

Even such mild requirement, which rules out regressive policies, cannot be satisfied by any sectoral industrial policy. The simple reason is that industrial policies treat income from different sectors differently. From low profits in agriculture we cannot conclude that farmers are poor, if they have additional sources of income.[10]

(ii) New technologies, new products, growth of population and a changing environment produce changes in the scarcity of resources. This is reflected in a change of relative prices to which the economy's structure must adjust. The change of relative prices puts a pressure on some sectors. Investments which seemed profitable last year may not pay off under the new conditions. However, investments can only partly be put to another use. Sunk costs cannot be recovered. Structural change is therefore associated with a large depreciation of capital including human capital. For the efficiency of the economic system it is important that assets are revaluated when relevant economic parameters change.

Now consider a social planner's first best response to some exogenous change[11] in the economy. If the price system works properly, no industrial policy is required. Of course, the change is associated with distributional consequences. But, as pointed out above, industrial policies are not suitable to achieve distributional goals. However, in the case of market imperfections we may reach a different conclusion. If, for instance, the labour market adjusts too slowly, the number of jobs offered will be too small. Structural change causes unemployment; a clearly inefficient and inequitable situation. A subsidy to the declining sector can mitigate the inefficiency. A wage subsidy, for example, reduces labour costs of firms and creates employment. There are two positive effects and a danger. Firstly, workers will continue to contribute to the social product rather than being entirely unproductive. The subsidy corrects for wrong price signals due to wage rigidities. Secondly, human capital of workers can be maintained, or at least it will not suffer an additional depreciation caused by

[10] In particular Schmitt (1994) has pointed out that the income differential between agriculture and the industrial sector is a myth, if the total household income is considered.

[11] Another interesting problem which cannot be investigated here is to determine an optimal rate of structural change when the government can control the speed of changes in the legislative process.

unemployment. However, as labour markets adjust to the new situation, the subsidies ought to be reduced. It should be noted that interest groups (rent-seekers) will try to maintain the level of subsidisation. Rent-seeking can cause substantial costs; the necessary structural change will be delayed and the distorted prices lead to an inefficient allocation of resources.

The conclusion of this section is as follows. Industrial economics does not provide a systematic account of social goals of industrial policies. Its scope must be broadened to include distributional issues.

3 Social policy, social security and competitiveness

Let me now turn to the right side of the triangle of figure 1: social policies. The corner stones of social security systems in Europe are unemployment insurance, health insurance and the pension funds. In most countries these are connected to employment contracts. The social security contribution is a certain percentage of a person's gross income. Usually there is an additional scheme for basic social security which is independent of the status of employment and earlier contributions. This twofold system of insurance and basic social security has some particular features which are worth while considering. Here I want to mention two points of particular importance for the relation between industrial and social policies.

(i) Firstly, insurance and basic social security are partly substitutes. From the point of view of the individual an insurance contribution which justifies a claim also covered by basic social security is not worth while paying for. Consider, for instance, the German pension scheme. Those with low income and small contributions have no incentive to contribute to the pension funds, because their expected pension is lower than the guaranteed minimum income. Not surprisingly evasion of such contributions, even if compulsory, is widespread. Employment contracts are designed to avoid contibutions and the exchange of services is shifted to the shadow economy. To install sufficient incentives pensions based on contributions should be paid in addition to the basic social security payment. A basic level of health care and a basic income at least for pensioners should be publicly provided. When the state insures basic risks, compulsory insurance schemes become unnecessary. However, there is a remaining difficulty. Public provision of basic social security is incompatible with the principle of subsidiarity. In the context of social security the principle of subsidiarity requires that each individual is responsible for his or her own well-being. Only if the individual is incapable to earn the necessary income, the family or the local community takes responsibility. A public provision of social security comes only as a last fall back position. Thus, the introduction of a general basic income scheme would undermine the individual's own responsibility. Publicly provided social security affects the social structure of society as well as industrial relations.

(ii) A second point is of major importance. For historic rather than systematic reasons social insurance is linked to the employment contract. In the course of industrialisation workers have dropped out of the social security system of the traditional agricultural society when they moved to the cities. They were the target group of social policies. Industrial workers' main or even only source of income is their wage. Linking social insurance contributions to the employment contract can be adequat under these conditions. In a modern society characterised by a large middle class these conditons no longer apply. Firstly, traditional social security systems have lost importance. Therefore, social insurance has been supplemented by special schemes for various groups in society. Secondly, middleclass employees have other sources of income which affect risks and the ability to contribute insurance. Compare two workers. Worker *i* earns a subsistence wage and has no other income. For her social insurance will guarantee survival when she is sick or old. Worker *j* earns the same wage but lives in his own house and has some savings in a bank account. For him the insurance scheme means a protection of property rather than life. Furthermore, compulsory insurance for employees distorts relative prices within the labour market. Compare worker *i* who contributes to the insurance to the entrepreneur *k* who does not. If both lose their ability to work, *i* will receive an insurance payment and *k* will receive a transfer from the public basic security system. Risk is internalised for *i* but not for *k*. Workers therefore face a relative disadvantage compared to the self-employed person who can externalise the risk. In addition the link between social insurance and employment contracts distorts relative prices between labour and other inputs of production. Because labour is a renewable resource, this well-known complaint has recently been discussed in connection with environmental taxation.[12] The conclusion from this debate also points into the direction of a tax financed public provision of basic social security and a dissolution of compulsory social insurance schemes.

Conclusion: Sector oriented social insurance schemes can cause severe inefficiencies. Tying together employment contracts and compulsory social insurance increases labour costs and creates a disadvantage for those who rely on employment as their main source of income. A reform of the welfare state should aim at disentangling social policies and the labour market in order remove the inefficiencies and adverse distributional effects.[13]

4 Firms' provision of social services

The third side of the state-firms-individuals triangle represents the relationship between individuals and firms. Many firms voluntarily offer various social services to workers: meals

[12] Cf. Schneider (1997).

[13] See e.g. Petersen (1996).

at reduced prices, child care, sick pay, sports clubs, payments to pension funds, contributions to private saving, housing, etc. Thus, workers remuneration consists of the wage plus the value of these services. In particular in countries in transition the value of social services may be large compared to the wage.

What are the reasons and the impact of firms' voluntary provision of social services? Will firms who supply social services to their employees be driven out of the market in the course of competition? What is the rationale for firms to supply and for workers to demand social services as part of the employment relationship? I shall try to provide some preliminary answers and point out the need of further research to provide more detailed answers and empirical evidence.

A first observation is that not only state owned enterprises in transition economies but also privately owned firms which operate in market systems do provide social services to workers. Japanese companies are a telling example. Many of them offer almost perfect job security to their staff. A long-term relationship between worker and firm allows for the accumulation of firm-specific human capital of two types: (i) specific knowledge and training and (ii) mutual trust which allows firms to cut down costs of monitoring and control.

Workplace relationships of mutual trust are part of the organisational capital of a firm. Organisational capital lowers the costs of conflicts and of conflict resolution. Investment in organisational capital of this type can have high returns and can contribute to the success of a firm. When workers have other goals besides earning income, firms can offer workers a better remuneration package than one which just contains income. Such remuneration schemes can attract able workers and stabilise the relationship between workers and firms.

The supply of social services by firms will be particularly important when alternatives are missing. Markets and the state do not cater sufficiently for all needs. With regard to some social services which are directly connected to the workplace employers have a transaction cost advantage in providing the service (e.g. child care in a company's nursery or large firms' provision of housing near the firm's site).

For other types of services state and market supply are close substitutes for the service provided by employers. The following question can be raised. Which part of the social security scheme and which type of social service should be provided by the state, by firms or be left to private arrangements? This question must be answered by considering the cost of provision and the quality of the service. Pension schemes, for example, should be run (or at least regulated) by the state. The risk of bankruptcy and insufficient protection of the funds makes firm-run pension schemes unfavourable. On the other hand the provision of job security through the introduction of specific regulations (part-time work, flexibility of labour supply, early retirement on a voluntary bases with compensation) will be better service than an unemployment benefit payment provided by the state. This explains that firms provide job security, the level of which is part of the employment contract. This service is, however, only available to insiders.

5 The impact for countries in transition: A research agenda

Most studies in transformation economics are concerned with macroeconomic policies and the reorganisation and privatisation of the firm sector. Only few studies have attempted to analyse the social security institutions in transformation economies. Such an analysis must take into account the existing connections between social security and the tax and transfer system as a whole.[14] However, the connection between direct social security payments to households and subsidies to firms which indirectly provide social security by enhancing job security has not been explored in earlier studies. Also very little is known about firms' choice of level of employment (labour hoarding) in countries in transition. Although, some studies indicate that there is a connection between the governance structure of a firm and its level of employment.[15]

Estrin et al. (1995) find evidence from a survey of 200 Polish firms that state-owned as well as privatised firms provide substantial social services to their employees, namely holiday and housing subsidies as well as health care provision, and thus contribute to the social security system. Svejnar (1996) reports about results of recent employment studies in countries in transition.

The industrial policies directed towards social security deserve more attention. Here, some lessons from the steel and the farm sector in EU countries are to be learned. Economic policies which slow down structural change may save jobs and lower the rate of depreciation of real and human capital, but tend to be very costly in the long run. In the short run, subsidies to firms which improve employment may be more effective than unemployment benefits. In the long run, however, necessary structural adjustments are delayed and there is an ever increasing pressure to keep or even increase the level of subsidisation. Hence, indirect social security may become far more expensive than direct payments of social benefits.

All societies have created systems of insurance against the basic risks. The danger of being unable to provide what is necessary for one's own living is mitigated by institutions on different levels: household, local community and the state. In modern societies the provision of basic insurance has shifted more and more to the level of the nation state. An individual's ability to provide for her or his own needs and probably the needs of other family members is, of course, closely linked to employment. Hence, social security policies and employment

[14] Cf. Belka/Petersen (eds., 1995).

[15] Cf. for example Weitzman (1984), Craig and Pencavel (1992), Acs and FitzRoy (1994), Balmann et al. (1996).

policies are inextricably intertwined. This obvious fact is largely neglected in economic analysis. The division of the subdisciplines of industrial (and agricultural) economics on the one hand and the economic analysis of the social security system on the other hand is rather strict. However, the majority of industrial and agricultural policy measures are directed to create or maintain employment in the economy. There is too little awareness on either side of the disciplinary division that industrial and agricultural policies have social consequences that may differ from reasonable social goals. *An integrated analysis of industrial policies and the social security system* is necessary to overcome this deficiency.

For countries in transition an integrated analysis seems to be of particular importance. Due to high unemployment rates social insurance contributions have reached a high percentage of workers' gross income. Therefore, net wages are only marginally higher than the subsistence level as guaranteed by a basic level of social aid. This reduces the incentives to seek employment and makes it very difficult to fight unemployment. To analyse this interrelation of social insurance and employment this study looks at two countries which are currently in different phases of the transition process: Poland and Bulgaria. In Poland the reform process has been relatively successful. The inflation rate has been reduced and the basic institutional frame which is necessary for the functioning of markets is well in place. In Bulgaria substantial reforms have been delayed, leaving the country in a situation comparable to Poland's situation in 1990, even worse, reforms are endangered because it has become increasingly difficult to gain public acceptance for any reform programme.

An assessment of social, industrial and agricultural policies must take into account the private provision of social security. To some extent social policies will have crowding out effects in the sense that publicly provided social security will diminish its private provision. The main target of the project is an empirical analysis of employment decisions in firms to gather more evidence about labour hoarding and underemployment on the job. It is well-known that the agricultural sector serves as a buffer for the level of unemployment. Usually the functioning of the employment buffer is attributed to the family farm. However, there is evidence for East Germany that restructured cooperative farms do also engage in labour hoarding and thus contribute to at least temporary job security. A comparative study of farm organisation in East Germany and neighbouring regions in Poland may shed light on the influence of structural policies on the employment decisions of non-family farms which dominate agriculture in this region.

In the industrial sector a detailed questionaire study should be carried out in Poland and Bulgaria to explore the provision of social services at the firm level. The study aims to explore the influence of taxes and subsidies on the employment decisions as well as the impact of the governance structure of a firm. The tax and transfer system's impact on the industrial sector with regard to social security deserves a close examination.

From a public choice perspective one would expect that large (former or still) state owned enterprises will seek to influence government's employment policy. Union behaviour and union coverage will also have an inportant impact. From the questionnaire study we expect evidence about firm's activities in the realm of policy making.

The project's objectives can be summarised as follows:

- To some extent job security and social security are substitutes. This needs to be explored in greater detail. Is there a crowding-out?
- Uncertainty and declining job security result from structural change in transition. There is a trade-off between structural change with long run benefits and current employment. The analysis of this trade-off is the main normative issue of the study.
- A delay of structural adjustments lowers the depreciation rate of human and material capital. But it also lowers the rate of investment which is very costly in the long run. How does a balance between short run and long run interests look like? What are the conclusions for agricultural and industrial policies (taxes, subsidies, legal framework)?
- Should the institutional framework that governs taxation and subsidisation in Poland be different from the institutional framework for Bulgaria, due to the stage of transition reached? Which are the general principles for taxation and subsidisation which should be followed by economies in transition?
- The centre-piece of the project is an empirical analysis of determinants of employment decisions on firm level. Scattered observations about labour hoarding need additional analysis on the micro level. A detailed survey of a relatively small number of firms of different types would supplement knowledge from the macro level.
- The focus of the empirical research will be on employment, wages and social benefits to employees. What are the factors determining the provision of social services by firms? In particular, what is the impact of ownership and governance of the enterprise (state or privately owned, differing degrees of employee share ownership, large outside ownership by banks etc.)?
- In the project we will collect and analyse data about sales, wage structure (unskilled, skilled, and white collar workers), employment, working hours, "excess" employment (labour hoarding estimated by management), voluntary quits, redundancies, new hires.
- Redundancies on a large scale will have political impact. How do policy makers intervene in state owned enterprises to avoid job losses? How does management of state owned enterprises seek to influence subsidisation? How does governance of privatised enterprises affect response and performance?
- In rural areas of Central and Eastern Europe the labour market has come under pressure by massive job cuts in agriculture. In Western economies the agricultural sector has served as

a buffer for the labour market. The project should collect and evaluate the evidence for labour hoarding on state-owned and privatised farms.

- Farms in East Germany and neighbouring regions in Poland operate under similar natural conditions. A comparative study can determine the impact of stage of transition, agricultural policy and governance structure of farms on the employment in the agricultural sector.
- An already existing model of structural change in agriculture can be used to assess the impact of various policy measures.
- A number of interesting hypotheses can be tested on the resulting panel data:
  - How do differences in ownership and control affect employment responses to demand shocks?
  - Is there a trade-off between pay and job-security, or do firms with excess labour have lower wages, other factors held constant?
  - Does employee share ownership and participation in the decision making encourage wage restraint, and stimulate productivity?
  - Does labour hoarding facilitate job-search without the stigma of unemployment?
  - Does union behaviour and union coverage have an impact on labour hoarding?
  - How do the social costs of unemployment compare with the costs of labour hoarding?
  - Is work sharing (shorter hours for all workers) used in response to demand shocks?
  - Given low levels of social security and unemployment benefits, can enterprise policy on employment reduce the social costs of inequality in transition?
  - How does enterprise policy and enterprise performance (growth, productivity), depend on ownership and control (governance structures)?
  - Is there any evidence that labour hoarding reduces enterprise growth, e.g. by raising costs?
  - Is there a case for subsidising work sharing temporarily to reduce the social costs of unemployment?
  - Do firms seek to influence policy decisions either directly or indirectly via associations (lobbying, pressure groups)?

Empirical results obtained from such study can be used to draw conclusions for the institutional design of a tax and transfer system as well as a framework of corporate governance that mitigates the social cost of transition without blocking the opportunities for structural change.

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