Some thoughts on unemployment

The Rise of Unemployment in Europe: A Keynesian Approach. Engelbert Stockhammer, Northhampton, MA, Edward Elgar Publishing, 2004, 232 pp., $130.00/hardback.

Professor Stockhammer wrote his PhD thesis while a student at the University of Amherst using the material in this book. The thesis became a book at the behest of a friend who told him "a real economist ought to publish a book." However, this book is not for the layman. Only professional economists imbued with the theories of economic growth, with the intricacies of modern macro and labor economics, a good understanding of Keynesian economics, and the patience to persevere through the model building, regression equations, statistics, and the many acronyms unique to economics will fully appreciate what the book intends to show.

But there is relief for the lay reader. Sufficient introductory material at the beginning and a summary at the end of each chapter spell out the principles to be covered and learned. The Synopsis in Chapter 1 is especially helpful and chapter 7 includes a useful fourteen page summary of the entire book, albeit it does digress to include a plea for the leadership of the European Union to democratize its governing structure.

In true Keynesian tradition, this book attempts to provide the reasoning and statistical proof for policies Stockhammer feels are necessary to counteract deleterious high unemployment rates Europe experienced in the late 20th and early 21st centuries. Paradoxically, despite low interest rates, prices have risen even as income, investment, and consumer spending have fallen. The book stands as an indictment of what Stockhammer calls "financialization"—investing the profits of business in financial markets rather than in capital stock. Per Stockhammer, like an epidemic sweeping the world, "the more firms are engaged in financial activities, the less they invest in physical capital." The book also serves as an important reminder that it is new capital investment, consumer and government spending, net exports, and, most of all, rising wages that create the demand necessary to maintain full employment.

Fundamental to Keynes is the idea that investment is autonomous. Despite the long-term benefit of capital investment, it may not be undertaken if the prevailing rate of return on that investment is less than the earnings obtainable in financial markets. This is much more likely to occur when the economy is propped up with near zero interest rates, increased money supply, and gambling in the stock market to finance the booming housing market and the profits generated in the mortgage industry—in other words, what we just experienced. Per Stockhammer's way of thinking, in hindsight higher taxes on the wealthy and greater government spending would have been a much more appropriate remedy.

Most of the theoretically derived parameters in Chapters 2 and 3 were not employed in the regression equations of Chapter 4. Instead, the author employs available proxy variables to show that it was the decline of capital investment that caused the growth of unemployment in Europe, not reduction of labor market inflexibilities associated with the lowering of wages and "union busting," increased hiring and firing, the diminished bargaining position of labor (eliminating wage pressure), wage setting, lowering of the minimum wage, and decreasing unemployment benefits and labor productivity.

While the theory Stockhammer develops in Chapter 5 is highly plausible for explaining financialization as the culprit, the regression results in Chapter 6 to prove the point leave much to be desired. The book does show the historical downward trend in capital accumulation and a significant upward movement in the ratios of income received by the financial sector from non-financial businesses (NFBs). However, the regression results are mixed when it comes to explaining why capital accumulation decreased and the income of NFBs transferred to the financial sector increased. The exploratory equation also uses almost all the independent variables in one and two lag periods because of the "a priori assumption that the growth rate of capital stock is stationary" over the long run, and because of "the time lag between investment decision and investment expenditure." The author uses several equations and reduces the number of parameters to obtain t-values that are at least free of spurious correlation, but suffer from multicollinearity, because of the many interrelated variables used (ten in the original formulation). He weeds out the variables with the lower and insignificant t-values, and is left with a regression that still has seven explanatory variables (one reason for the relatively high R^2).

The dependent variable is capital accumulation (rate of growth of gross business capital stock); the explanatory variables are gross profit share, capital productivity, the cost of capital, the ratio of interest and dividend income received by NFBs over their value added renter's share of nonfinancial business (RSNF) and the intercept. For lack of data Italy is not included in the country regressions.

The financialization argument worked for some but not for other countries. The author's conclusion: "Our tests can hardly be conclusive of our hypothesis that financialization has caused a reduction in (capital) accumulation rates, but they certainly provide strong initial support." And once an autocorrelation variable was introduced, the one-period lag in the RSNF variable has the negative sign and significant t-values in the countries tested, except for Germany and Italy, leaving only France and the United Kingdom as the European representatives. But one suspects this lack of fit may be due to the data employed rather than the theory.

Nonetheless the theory is plausible. The data at hand show that the amount of operating surplus of NFBs transformed into dividends and interest payments in France, the UK, and the U.S. were a staggering 80 percent or more; there were even years when the entire surplus was transferred to owners of financial assets. The capital accumulation rate decreased in all countries, while unemployment; the ratio of financial income to the share of operating surplus for NFBs; the ratio of operating income of NFBs to operating surplus of the entire economy; dividend and interest income as a share of total household income (renters household income share); renters' share of NFBs; renters' payments over operating surplus of NFBs; and the ratio of operating surplus of NFBs divided by the operating surplus of the entire economy all increased substantially. Even the rate of technical progress experienced a substantial decline beginning in the mid-1970s, probably because of the decline in capital accumulation.

The Rise of Unemployment in Europe: A Keynesian Approach offers in-depth empirical data to make the case that the high unemployment rates in some western European countries were a result of insufficient capital investment. Although the book mentions only Europe in the title the analysis pertains to the U.S. economy as well (with slightly different results then), and no harm would have been done (in light of what we know now) if the title were instead "*The Rise of Unemployment in Europe* ***and in the U.S.***: *A Keynesian Approach*."

For those up to the challenge, reading the book is very instructive and highly educational. □

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