



# Sustainable capitalism: Full-employment flexicurity growth with real wage rigidities<sup>☆</sup>

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## ABSTRACT

In this paper we present a model of flexicurity capitalism that exhibits a second labor market with the government as an employer of first resort, where all workers not employed by firms in the private sector find meaningful employment. We show that the model exhibits a unique interior steady state which is asymptotically stable under real wage adjustment dynamics of the type considered in Blanchard and Katz (1999), and under a type of Okun's Law that links the level of utilization of firms to their hiring and firing decision. The introduction of a company pension fund can be shown to contribute to the viability of the analyzed economic system. However, when credit is incorporated in the model, in place of savings-driven supply side fluctuations in economic activity, investment-driven demand side business cycle fluctuations (of a probably much more volatile type) can take place.

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## 1. Introduction

In the US unemployment rates had been relatively low until the beginning of the financial crisis in the late 2000s, in contrast to Europe where a great many countries have been suffering from high and persistent unemployment over the last decades. But there are also European countries that were successful in maintaining high employment rates. These are, on the one hand, the Netherlands and the Nordic Welfare states, such as Denmark, Finland and Sweden, and, on the other hand, Great Britain and Ireland. While Great Britain and Ireland have pursued an Anglo-Saxon approach with respect to their economic policy, mainly characterized by flexible hiring and firing conditions and by little social spending, the Nordic Welfare states and the Netherlands have followed a different policy. The latter allows flexible hiring and firing, too, but they have adopted high standards of social security. Thus, these countries demonstrate that flexibility and security need not be contradictory but may well be compatible and that social security does not necessarily lead to high unemployment rates or instability of the economic system. Often, the Nordic welfare system is referred to as the flexicurity model, with the term flexicurity obtained by merging the terms flexibility and security.

It is in particular in public debates that the flexicurity model has attracted great attention, although there is no clear consensus on its definition (cf. Zhou, 2007). According to Wilthagen (1998) the concept of flexicurity was launched by the sociologist and member of the Dutch Scientific Council for Government Policy Hans Adriaansens in speeches and interviews.

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According to Adriaansens flexicurity means a shift from 'security within a job' towards 'security of a job' (cf. Wilthagen, 1998, p. 13). In any case, an important aspect as regards flexibility on the labor market is that there is both external flexibility, i.e. hiring and firing, as well as internal flexibility, such as flexible working hours and the possibility of working overtime and part-time work (see Wilthagen and Tros, 2004; Wilthagen et al., 2004). Essential characteristics with respect to security are income security (that is income protection in the event of job loss and after retiring from work) on the one hand, and the ability to combine paid work with other social responsibilities and obligations, on the other hand. Our goal in this paper is to integrate some ideas of the flexicurity model into the basic neoclassical growth model as presented by Solow (1956) and to analyze the resulting model with respect to its dynamic properties.

Solow's (1956) model of economic growth provides the basis for a variety of subsequent models analyzing the phenomenon of economic growth in Western capitalist economies. An important aspect in Solow's growth model is the assumption of a neoclassical production function with smooth factor substitution characterizing the input–output relationship that determines the laws of motion of the economy, in place of a fixed proportions technology. Solow assumed full employment and considered homogenous labor as one of the factors of production. In contrast to that, Goodwin's (1967) growth cycle model had quite a different starting point (Marx's reserve army mechanism): it assumed – as in Marx (1954, ch. 23) – a real wage Phillips curve and considered its interaction assuming an extreme variant of classical savings behavior in a technological framework with fixed proportions in production. Instead of monotonic convergence to the steady state, the Goodwin model gave rise to persistent cycles around its steady state position of a structurally unstable center dynamics type that could be easily modified towards the occurrence of stable limit cycles (as in Rose's (1967) employment cycle model).<sup>1</sup>

It is not difficult to combine the Solow growth model with the Goodwin growth cycle model, since the latter introduces only real wage rigidities into the Solovian framework (or smooth factor substitution into the Goodwin growth model). The resulting model features damped oscillations (close to Goodwinian cycles if the elasticity of substitution between capital and labor is low) and even monotonic convergence of the state variables (labor intensity and real wage) to the steady state in the opposite case. However, one problem of this integrated model is – if it creates periods of mass unemployment – that it implies the possibility of unemployed workers losing their skills and, thus, leading to labor market segmentation, with older workers subject to long-term or never ending unemployment and workers' families becoming degraded in their social and emotional status (a situation that is difficult to reverse). Further, there may be counteracting unemployment benefits, low wages for the degraded part of the work force and more that must be analyzed with respect to their consequences for the evolution of capitalist economies.

In this paper we will not engage into such an analysis of the consequences of mass unemployment but we will augment the above Solow–Goodwin synthesis by an employer of first (not last) resort, where all workers (and even pensioners) find reasonable employment if they are temporarily dismissed from the private sector of the economy, the sector of capitalist firms. In our model economy, that is to be seen as ideal in that respect, we only allow for two types of skill characteristics: skilled and high-skilled labor instructed in primary/secondary education and in tertiary education, respectively. Thus, by speaking of an employer of first resort we intend to underline that the skilled or high-skilled work profiles are employed in the public sector as well as in the private sector. Hence, we abstract from an employer of last resort and from the corresponding labor market where all labor is employed that is either unwilling or unable to work as skilled or high-skilled worker. By modeling the government as an employer of first resort we want to emphasize that the government needs qualified employees in order to organize the complex social security system in a flexicurity economy. This fact holds true for industrialized countries and, therefore, for Nordic countries as well so that one cannot call the government an employer of last resort. The model we build on this basis is providing a stylized theoretical basis for the Nordic Welfare approach to flexicurity, but one that is not subject to the pejorative reformulation of flexicurity as 'flexploitation' as it is sometimes referred to in evaluations of the concept of flexicurity in the political debate. Instead, we use the Solow model with the Goodwin real wage rigidity to construct full employment in this framework by means of (decentralized) government actions, with wage bargaining in the private sector and with two implied laws of motion (for employment and for the real wage) that will guarantee even monotonic convergence to the steady state in such a framework with flexible hiring and firing.

We view this model as an ideal economic system that a democratic and egalitarian society should aspire to, and towards which progress paths have to be found, confirmed by elections in a democratic society introducing ratchet effects when some parties propose to abolish such an evolution (if it has been by and large successful). It is ideal in that it combines flexible hiring and firing (and job discontinuities in the first, the private labor market) with income and employment security through a pension scheme and a second labor market that preserves the skills of the workforce and prevents their human degradation. Although being an ideal system, some elements have already been integrated in real-world economies. For example, in Europe the three main pillars on which the social security system rests are the health care system, the unemployment insurance and the pension system. In our model we will take into account two of these pillars, the unemployment insurance and the pension system while neglecting health insurance. Thus, we present a model where the aspect of income security is modeled with respect to unemployment and with respect to old age. By demonstrating that our model economy is stable, meaning that it converges to a steady state, we can show that an economy with a relatively elaborate social security system may well be a sustainable one.

<sup>1</sup> See also Solow (1990) for an interesting discussion of the Goodwin (1967) growth cycle model.

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