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## **Fighting Unemployment: Why Labor Market ‘Reforms’ Are Not the Answer**

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It has been the conventional wisdom for at least a decade the source of persistent high unemployment is found in the rigidities imposed by labor market institutions and that the solution is labor market deregulation – the ‘reform’ of institutions designed to protect workers and their families against the loss of employment and earnings. This paper critically assesses this orthodox view. It then outlines an alternative political economy perspective, one that highlights the interplay of country-specific macroeconomic and industrial relations policies with longer term sectoral employment (agricultural, industrial, service) and demographic (age, gender) trends.

Unemployment remains extremely high in much of Europe and it has been the conventional wisdom for at least a decade now that the solution can only be labor market deregulation – the ‘reform’ or dismantling of institutions designed to protect workers and their families against the loss of employment and earnings. The strength of these employment-related social protections expanded dramatically from the end of World War II to the mid-1970s across the world’s most developed countries, and coincided with impressive real wage and employment growth. It was, notably, the strong welfare states of northern Europe and Scandinavia that showed the best employment performance, while the relatively laissez-faire U.S. ranked among the countries with the highest unemployment rates.

But since the 1970s a dramatically different pattern has emerged. Figure 1 shows that unemployment rates for the entire set of 19 countries shifted upward in 1975-79 and again in 1980-84. While unemployment remained at high levels for most of these countries over the next three 5-year periods (1985-89, 1990-94 and 1995-99), the U.S. rate steadily fell, reaching just 4% in 2000. The improvement in this measure of relative U.S. employment performance coincided with a sharp ideological shift away from government action and towards market solutions. The dominance of free market prescriptions was most striking in the U.S. and U.K., but was evident in the politics of many European countries as well.

The ascendancy of free market fundamentalism reflects a return to what Keynes in the 1930s called “nineteenth century orthodoxy” (in the *General Theory* this became the “classical” view) – the belief that if only wages were left free to adjust and workers had little or no public safety net, markets would produce full employment. As Keynes put it, “the heretics” who challenge this 19<sup>th</sup> century free market orthodoxy “reject the idea that the existing economic system is, in any significant sense, self-adjusting... (the heretics) believe that common observation is enough to show that the facts do not conform to the orthodox reasoning.... Now I range myself with the heretics” (Keynes, 1973: 487-9). The Keynesian critique moved mainstream thinking away from 19<sup>th</sup> century orthodoxy through until the 1960s. But by the 1980s, free market orthodoxy was again the prevailing view among economists and among many opinion leaders, policy makers and politicians.

With this ideological shift, timed as it was with the impressive mid-late 1990s employment performance of the U.S., the American deregulated labor market and residualist welfare state became widely acknowledged as the model for good employment performance. Often referred to as the “Unified Theory,” high U.S. inequality has been held to be the flip side of high European unemployment: policy makers must choose one or the other.<sup>2</sup> The OECD’s highly influential *Jobs Study* (OECD 1994) highlighted the importance of downward wage flexibility, the dangers of employment protection, and the need for limited unemployment-related benefits. The extent to which this became the conventional wisdom is illustrated by the following passage from a recent report by the International Monetary Fund:

“A wide range of analysts and international organizations – including the European Commission, the Organization for Economic Cooperation and Development (OECD), the International Monetary Fund (IMF) – have argued that the causes of high unemployment can be found in labor market institutions. Accordingly, countries with high unemployment have been repeatedly urged to undertake comprehensive structural reforms to reduce “labor market rigidities” such as generous unemployment insurance schemes; high employment protection, such as high firing costs; high minimum wages; noncompetitive wage-setting mechanisms; and severe tax distortions” (IMF 2003: 129).

There is, in this view, no alternative to the pain that must come with swallowing the deregulation medicine in a coordinated, systematic fashion is widely acknowledged: lower wages, less job security, and reduced income support during unemployment.<sup>3</sup>

How compelling is the orthodox analysis, and how therapeutic the prescription? To paraphrase Keynes, does ‘common observation’ of the 1980-90s facts conform to the orthodox reasoning? Does the evidence convincingly establish the orthodox proposition that the rigidities imposed by protective labor market regulations explain the pattern of unemployment since the 1970s?

This paper critically assesses the orthodox view and outlines an alternative explanation for cross-country trends in employment performance since the 1970s. As such, it aims to summarize and update my recent edited volume, *Fighting Unemployment: The Limits of Free Market Orthodoxy*. The alternative perspective suggested below rejects the simple rigidity explanation in favor of a more complex interplay of country-specific economic, demographic, and policy developments.

The first section presents an overview of recent cross-country unemployment trends and relates these to alternative social models<sup>4</sup> and the standard labor market institutions. Section 2 surveys the recent empirical literature to assess three key predictions of the orthodox labor market rigidity view. The available evidence offers remarkably little compelling support for them, and Section 3 suggests why: institutions that regulate and insure against low wages and job loss can promote efficiency. As a result, different mixes of institutions and market forces (“social models”) are capable of producing good employment performance. Section 4 then outlines an alternative ‘political economy’ explanation for recent cross-country unemployment trends. It is argued that much of the recent pattern of unemployment across the OECD can be explained by three country-specific sets of factors not directly related to protective labor market institutions: the nature of the macroeconomic policies adopted in the aftermath of the price shocks of the 1970s; the coherence of these macro policies with industrial relations (wage-setting) and social policies; and the timing of demographic and sectoral employment shifts.

It should be understood that the alternative “explanation” for the pattern of employment performance in recent decades does not deny that there have been instances of “too much” regulation and benefit generosity for good performance – just that the deregulation explanation does a poor job of accounting for the actual pattern of unemployment across countries over time. It should also be noted that the alternative proposed here is quite provisional, amounting more to a call for a shift in the research agenda from the one-size-fits-all orthodox story (and its critique) to an alternative whose three main components (macro policy, policy coherence, and the timing

of demographic/sectoral shifts) must be analyzed together on a country-by-country basis. This is a much tougher agenda, and one unlikely to produce simple “unified” theories or easy sound-bite prescriptions. But it beats prescribing the wrong medicine, particularly when the patients consist of millions of workers and their families.

## 1. Employment Performance and Social Models

Figure 1 shows the levels and spread of unemployment rates for 19 OECD-member countries for each 5-year period between 1960 and 1999, and adds rates for 2000, 2002 and 2004. The line that runs from left to right marks the U.S. rate.

This figure highlights some key facts that are at the center of the unemployment policy debate. First, there was a general trend of increasing unemployment rates through the 1980s and peaking in 1990-94 (at a median of 8.8%). Second, the dispersion of rates rises with the median: the range of unemployment rates is extremely compressed in the four 1960-79 periods; they became much more dispersed in the 1980s-90s, led by the sharp increases for Spain, Ireland, Finland, France and Canada; and they show a clear convergence (to a lower level) since the late 1990s. Third, the employment performance of the U.S. has varied dramatically over this period: as the line shows, it was among the very highest unemployment countries in the 1960s and 1970s; by the late 1990s it was among the best performers; but by 2002-4 the U.S. has fallen back to the middle of the distribution.

### Figure 1 and 2 about here

Figure 2 shows that no fewer than 9 of these 19 OECD countries matched or outperformed the U.S. in 2004. Of these, three (Austria, Netherlands and Norway) are strong welfare states with unemployment rates at least a full percentage point below the U.S. figure of 5.5%. Even at its best (4% in 2000), the U.S. was outperformed by these three European welfare states. Four large continental countries performed poorly: Spain, France, Germany, and Italy.

Table 1 provides demographic detail for 2003 for countries in three groupings: the market-oriented Anglo-Saxon countries; the continental European countries, of which two have had very low unemployment (Austria and the Netherlands) and five have been plagued by high unemployment (Germany’s rate rose above the U.S. rate only after 1993); and the Scandinavian

countries with strong universalistic welfare states (Denmark, Norway and Sweden). This table shows that for all four demographic groups – male and female by young and prime age - Austria and Holland were by far the best performers, followed by the Scandinavian and Anglo-Saxon groups, which had nearly identical rates for each demographic group. The five high-unemployment Continental countries show substantially higher unemployment for each age-gender group, and in all but Germany, youth unemployment is extremely high. Female youth show rates of 17.5% in Belgium, 22.8% in France, 27.2% in Spain, and 30.9% in Italy; male youth rates range from 18-23%. Clearly, young people in these four countries account for a very large part of the European unemployment problem.

### **Table 1 about here**

When a European country with strong welfare state stumbles, it is typically the welfare state that is blamed (particularly it seems in the English speaking press), and invariably the solution is claimed to be some variant of the “American Model.” In the 1990s the example was Sweden. As Peter Lindert (2004: 264-5) writes, “That Sweden’s economy was falling behind and that its welfare state was to blame were repeated themes in the Anglo-American press in the period 1977-98.... In Sweden’s darkest postwar hour, the London-based Economist joined the leading U.S. newspapers in pronouncing the Swedish model a failure, in a string of articles in the 1990-1994 era.” But as Sweden’s unemployment rate converged, and then fell below the U.S. rate, the focus has now shifted to France and Germany. For example, the prominent journalist Thomas Friedman (New York Times, July 1, A17) has promoted the view that the real source of the problem is their choice of a defective social model: the choice is between the “Franco-German *shorter workweek six weeks’ vacation never fire anyone but high unemployment* social model” and the “less protected but more innovative, high employment Anglo-Saxon model preferred by Britain, Ireland and Eastern Europe.”

Can we understand the pattern of unemployment in recent decades by reference to social models? Table 1 strongly suggests that the answer is no. Two continental/corporatist countries – Austria and the Netherlands – and all three Scandinavian countries had similar or lower unemployment rates than the Anglo-Saxon countries for all demographic groups in 2003.

Table 2 presents OECD measures of the protective institutions that are blamed for the rigidities presumed to be at the root of high European unemployment for the most recent dates available (2000-3). Column 1 shows that differences in the generosity of cash income support for

working age households were far greater between the U.S. (at just 1.6% of GDP) and its Anglo-Saxon cousins than between the latter and the three high unemployment European welfare states. Even setting aside the U.S., this measure provides no support for the orthodox thesis of the supply side employment disincentives of generous redistribution to those of working age: spending is about the same in Germany and Ireland (4.5% and 4.4%); less in France than New Zealand (6% vs. 6.7%); and much less in Italy than the U.K. (3.3% vs. 5.9%). In fact, four of the five low-unemployment northern European welfare states had much *higher* redistribution rates in 2001 than France. On this measure, there are really only two models: the American and all others.

### **Table 2 about here**

It is widely accepted that a large part of the high unemployment problem lies in the generosity of unemployment benefits. Column 2 of Table 1 shows that 1<sup>st</sup> year replacement rates were much higher in France and Italy than in the Anglo-Saxon countries (Germany is only modestly higher). On the other hand, low-unemployment Denmark, Holland and Sweden all had much higher 1<sup>st</sup> year replacement rates. Further, based on recent empirical work, most analysts now believe that it is the duration of benefits, more than the 1<sup>st</sup> year level, which matters most – which makes sense since much of the problem in the high-unemployment countries is long-term unemployment. And on this score (average rates in years 4-5), Germany and France are not distinctive, but Italy is: *it provides no long-term benefits*. Nor do the rates for the high unemployment central European countries stand out from the five low-unemployment Northern European countries. In fact, using the OECD's generosity score over the full 60 months, Denmark and Holland (51% and 53%) are far more generous than Germany and France (28% and 44%), while the welfare states of Sweden and Austria (24% and 31%) show about the same generosity as the presumably less protective Anglo-Saxon Ireland and New Zealand (30% and 28%). On unemployment generosity, there is no obvious pattern across these country groups. It should also be noted that in the two countries with the highest rates of youth unemployment – Italy and Spain (see Table 3) - young people are not generally even eligible for unemployment benefits.<sup>5</sup>

What about collective bargaining? The explicit purpose of this institution is to replace the decentralized, uncoordinated flexibility of individual employer-employee bargaining with varying degrees of centralized and coordinated bargaining. It is well-established that trade unions

tend to raise the overall wage level, particularly by raising the relative wages of the least skilled, which may “price” them out of jobs. It is precisely the rigidities of centralized bargaining (Heckman, 2004) and wage compression (Siebert, 1997) that make collective bargaining a key culprit in the orthodox account. But Table 1 shows that, again, there is no clear pattern between or within the Anglo-Saxon and central European “models”: while New Zealand and the U.K. get the same low score on centralization and coordination as the U.S., much higher shares of workers are union members and covered by collective contracts; and Ireland shows more centralization, more coordination, and a higher share of union members than either Germany or France. It is more likely that the problem is intermediate levels of bargaining (levels 4-5) combined with high collective bargaining coverage in France and Germany – all five of the much more successful northern European countries have high coverage rates but show higher centralization-coordination scores. The fact is, one would be hard pressed to explain the pattern of unemployment shown in Figure 2 with these three measures of collective bargaining systems, a conclusion that is consistent with the OECD’s own surveys of the literature on collective bargaining and unemployment (OECD, 1997; 2004a).

Finally, the ability to easily dismiss workers is a form of employment flexibility commonly cited as a source of the European unemployment problem, though the empirical evidence is mixed at best, as both major recent OECD surveys of this literature have found (OECD, 1999; 2004b). The last column in Table shows that Ireland, New Zealand and the U.K. all offer substantially more employment protection than the U.S. but have lower unemployment rates. But it is also true that, while Italy and New Zealand get similar scores on this OECD measure, France and Germany (3.0 and 2.2) score well above both the U.K. and Ireland (.7 and 1.1). It should be recognized, however, that what pushes the French score up so high is the relatively high protection afforded French temporary workers, who comprise about 15% of all employed workers. For the vast majority of workers (“regular employment”), France gets a score of 2.5, which is in the same neighborhood as the scores for many low unemployment northern European countries (Austria, 2.4; Netherlands, 3.1; Norway, 2.3; Sweden, 2.9). With by far the greatest employment flexibility as measured by the strictness of employment protection laws, the U.S. has been persistently outperformed by Austria, Norway and the Netherlands, countries with among the most protective laws, which suggests that there must be much more to good employment performance than the ease with which workers can be fired.

Any assessment of employment performance must take into account employment as well as unemployment rates. After all, reducing unemployment by discouraging participation in the labor market is hardly a model countries would want to emulate. Interestingly, Schmitt and Wadsworth (2005) attribute much of the drop in U.K. unemployment to this factor,<sup>6</sup> and the impressive decline in U.S. unemployment since 2002 has coincided with a declining employment rate. Using data for 2003 (not shown), the high unemployment central European countries show lower employment rates than the U.S., U.K. and New Zealand. But it is also the case that the welfare states of northern Europe (Denmark, Norway, Sweden and the Netherlands) have succeeded in producing employment rates at least as high as the Anglo-Saxon countries. Ireland has achieved low unemployment with an employment rate not much above that Germany's for male workers and well below both the German and French rate for female workers.

In sum, while the four Anglo-Saxon countries considered in this section all achieved low unemployment levels by the end of the 1990s, and France and Germany remain plagued with high unemployment, Keynes' "common observation" does not support a simple orthodox rigidity story, any more than it probably did in the 1920s. On most measures, there is no uniformity within the Anglo-Saxon countries, and the strong welfare state countries of northern Europe have shown that low unemployment – and equally important, a high employment rate – is fully compatible with substantial social protection, high collective bargaining coverage, and medium to high bargaining centralization and coordination.

## **2. Orthodox Predictions and the Evidence<sup>7</sup>**

A number of specific predictions follow directly from the orthodox labor market rigidity story. We should observe, to begin with, a reasonably strong tradeoff between unemployment and inequality (or between employment and equality) across affluent countries. Too much wage compression is claimed to be a key culprit (Siebert, 1997), so countries with highly compressed wage structures (more equality) should have higher unemployment and lower employment rates. Second, and closely related, the least skilled should be relatively worse off in the more regulated countries, since they are, it is argued, prevented from "pricing" themselves into jobs. And third, if the pattern of unemployment across countries is wholly explained by the regulatory strictness and benefit generosity (IMF, 2003), we should find reasonably strong, robust support in the econometric evidence.



### *Unemployment-Inequality Tradeoffs*

Howell and Huebler (2005) examine the evidence for a variety of tradeoffs: between unemployment rates and earnings inequality; between the change in unemployment rates and the growth in earnings inequality; between unemployment inequality (the ratio of high skill unemployed to low skill unemployed) and earnings inequality; and between employment rate inequality (again, high vs. low skill) and earnings inequality. They find little evidence of these predicted tradeoffs.

To take just one example, Howell and Huebler (2005) compare the level unemployment and a standard measure of earnings inequality, the D5/D1 ratio (median earnings (D5) to average earnings in the 10th percentile (D1)). They do this for four 5-year periods (1980-84, 1985-89, 1990-94, and 1995-99) for 15 OECD countries for which data were available (55 country-time periods). The result is a simple correlation coefficient of +.028, which has the wrong sign (a tradeoff would produce a negative sign) and is statistically insignificant by any conventional standard.

The tradeoff prediction follows directly from the simple competitive (supply/demand) model – constrain downward wage adjustments and employers will respond with fewer jobs. But in fact this model can also accommodate the evidence of little or no unemployment-inequality tradeoff. If OECD labor markets are fairly competitive in the textbook sense, differences in inequality across OECD-member countries should mainly reflect differences in skill distributions. According to this “skill dispersion” view, institutions are not as responsible for high unemployment as the conventional wage rigidity view suggests since the compressed wage distributions mainly reflect compressed skill distributions. For example, it is Sweden’s skill distribution, not necessarily the rigidities imposed by its welfare state, which in this view accounts for the relative compression of its wage distribution. In the skill dispersion view, institutions may contribute to the unemployment problem by limiting incentives to hire (employment protection laws) and supply labor (generous unemployment benefits) but not primarily because wages are too compressed.

While there is some evidence for this skill dispersion effect, Howell and Huebler’s results support other recent research – it is differences in institutions, not differences in the skill distribution, that largely account for cross-country differences in the distribution of earnings.<sup>8</sup>

They conclude that the failure of the data to show the predicted unemployment-inequality tradeoffs is not because competitive labor markets have ensured that wage distributions reflect productivity-related skill distributions, but because the institutions that do in fact compress wages do not have a direct and necessary adverse effect on employment performance.

### *Relative Well-Being of the Least Skilled*

Closely related to the tradeoff prediction, the orthodox account predicts that countries with greater labor-market flexibility should show lower unemployment and higher employment of less-skilled workers, particularly young workers and those with lower levels of formal education. The reasoning is straightforward: downward wage and employment flexibility lowers the relative costs of hiring less-skilled workers, which is supposed to “price” them back into jobs.

Schmitt and Wadsworth (2005) test this prediction for the U.S. and U.K. They find that the labor market outcomes of both young and less-skilled workers in the flexible United States and United Kingdom are no better, and frequently far worse, than those of their counterparts in most of the rest of the OECD. Regarding the U.K., Schmitt and Wadsworth conclude that “the serious restructuring of the country’s labor market since the early 1980s appears to have produced no noticeable improvement in the labor market prospects facing less-skilled workers in the 1990s relative to the 1980s.” Indeed, they find that the improvement in U.K. unemployment rates is accounted for, not by workers being priced into jobs, but by workers dropping out of the labor market. And after all the applause for the U.K.’s anti-union, deregulation policies as the source of the impressive declines in unemployment, Edmonds and Glyn (2005) find that the U.K.’s “public expenditure programme has been directly responsible for all the growth in UK employment since 2000. The experience of the last four or five years certainly does not support the idea that the UK’s recent jobs growth has been the creation of a deregulated and vibrant private sector. A good old-fashioned Keynesian expansion seems much closer to the mark. Perhaps this is the lesson Europe should learn from the British experience.”

### *The Econometric Evidence*

Given the results presented so far, it should not be surprising that simple cross-country correlations of the best measures of the labor market institutions deemed the main culprits for

high unemployment show no support for the orthodox rigidity explanation. Baker et al. (2005) present scatterplots for six institutions against standardized unemployment rates for four 5-year periods (1980-84, 1985-89, 1990-94, and 1995-99) for 19 OECD countries. They found no statistical relationship for any of them.

It is best of course, to control for various factors to see the true relationships. Research using various kinds of multiple regression techniques took off in the 1990s, led by the work of Stephen Nickell and several colleagues (Layard, Nickell, and Jackman, 1991; Nickell and Bell, 1994; Layard and Nickell, 1996).

In what is perhaps the most influential of these papers, Nickell (1997) examined the link between institutions and unemployment with a sample of 20 OECD countries for two six year periods, 1983-88 and 1989-1994, and found strong support for the conventional wisdom – union coverage, unemployment benefits, and employment protection all substantially increased the unemployment rate. But notably, two other institutions had strong “good” effects: according to Nickell’s results, bargaining coordination and active labor market policies both tended to *reduce* unemployment. It is often overlooked that part of the explanatory power of these regressions derives from the unemployment-reducing effects of labor market institutions. In sharp contrast to another paper in the same symposium, which argued that labor market rigidities alone accounted for high European unemployment (Siebert, 1997), Nickell’s (1997) conclusion was cautious: “the broad-brush analysis that says that European unemployment is high because European labor markets are too ‘rigid’ is too vague and probably misleading.”

In retrospect, caution was certainly appropriate. Using Nickell’s (1997) time invariant measures of institutions (the average for 1983-88 and 1989-94) and accounting for time and country effects, Blanchard and Wolfers were able to get results for the entire 1960-96 period that were similar to Nickell’s for the late 1980s and early 1990s. But the authors point out that the results were quite sensitive to the specification. Indeed, it appears that the use of alternative superior OECD-generated measures of unemployment benefit replacement rates and the severity of employment protection laws actually *worsens* the results. The table they present “suggests two conclusions, both worrisome: replacing the Nickell measures by alternative, but time invariant measures, substantially decreases the  $R^2$ . Going from the time invariant to the time varying measures further decreases the fit.”

The same fragility in the Nickell (1997) results is found by Baker et al. (2005). They simply substitute the more recent, better quality data used by Nickell and his colleagues in a more recent study (Nickell et al, 2001):

Using the Nickell et al (2001) data in the Nickell (1997) regression produces results that differ markedly from those obtained in the original study. In Nickell (1997), seven of the eight institutional variables had the correct sign and were statistically significant at standard levels. The only exception was the employment protection variable, which was close to zero and not statistically significant. Using the Nickell et al (2001) data, however, three of the six institutional variables have the wrong sign (employment protection, union density, and the tax wedge) and none are statistically significant.

Just as Blanchard and Wolfers found, the use of better quality measures of the “employment unfriendly” institutions produces notably worse results. Indeed, Nickell’s 1997 results entirely disappear with the better Nickell et al. data.

By the late 1990s, a number of studies made use of improved institutional measures (developed mainly by the OECD), added various control measures, changed the time periods covered, and experimented with the specification and econometric method (see Baker et al. (2005) for a detailed review of this literature). Among the most influential was Blanchard and Wolfers (2000), which shifted the focus from simple institution effects to the interaction of institutions with macroeconomic shocks, represented by the slowdown in total factor productivity growth, trends in long-term real interest rates, and shifts in labor demand. The authors argued that labor market institutions may produce higher unemployment by limiting the ability of labor markets to respond to adverse shocks, and this helps explain why the same institutions were not employment-unfriendly in previous decades.

Blanchard and Wolfers’ emphasis on the importance of the *interaction* of macro shocks and institutions follows from their view that “while labor market institutions can potentially explain cross country differences today, they do not appear able to explain the general evolution of unemployment over time” (p C2). In a recent study, Nickell and colleagues (2003) directly take up the challenge. As they put it, “our aim is to see how far it is possible to defend the proposition that the dramatic long term shifts in unemployment seen in the OECD countries over the period from the 1960s to the 1990s can be explained simply by changes in labor market institutions in the same period” (396). The new paper concludes that the data support their proposition: “broad movements in unemployment across the OECD can be explained by shifts in

labor market institutions (426).” This represents a striking shift from Nickell’s (1997) earlier, more cautious assessment.

But there is reason for considerable skepticism about such a strong conclusion. First, the statistical results appear far more fragile than the authors suggest. As Baker et al. point out, Nickell et al. put out two working paper versions (2001 and 2002; the published version of the 2002 version has since appeared as Nickell et al., 2003<sup>9</sup>), and the main difference is that the more recent one extends the data from 1992 to 1995. This change appears to have had quite large effects.<sup>10</sup> The fact that the inclusion of three additional years (from 31 to 34 years in the time series) leads to substantial changes in the regression results – suggesting entirely different conclusions about the effects of key institutional measures – raises serious questions about the robustness of their findings.

Alternative tests using the same or similar data suggest far less impressive results. Baker et al. (2005) run a number of tests of the full 1960-99 period, using measures drawn from the OECD, Blanchard and Wolfers (2000), Belot and Van Ours (2001), and Nickell et al (2003), and consistently find weak and even wrong signed results for the key measures – unemployment benefits, employment protection and union coverage. Indeed, they find that, comparing the results before and after the mid-1980s, “if anything the results for the more recent period offer even weaker support for the deregulationist position than does the 1960-84 period.”

In his “Comment” on the Nickell et al. study, Fitoussi (2003) voices similar skepticism. Referring to separate country tests he ran on the Nickell et al. data, he concludes that “What is striking is the weak, to say the least, explanatory power of the institutional variables, especially those considered as being the more important, namely, the benefit replacement rate and employment protection...” (Fitoussi, 2003, p. 434). According to Fitoussi, “Until now, there has been no convincing evidence that labor market institutions are responsible for the high level of unemployment in Continental Europe or for the disappointing macroeconomic performances for Europe during the 1990s.”

The econometric results to date appear quite fragile at best, and Fitoussi’s assessment of the literature seems on target. Neither common observation nor professional analysis offers much support for the orthodox rigidity explanation, much less its one-size-fits-all deregulation prescription.

### 3. The Efficiency of Labor Market Institutions

It is perhaps because of the overwhelming dominance of free market ideology in recent decades that it should be surprising that the empirical evidence for the rigidity view is so weak. In the words of Gregg and Manning (1997: 395), the orthodox stance reflects less a balanced assessment of the evidence than the “touching faith that many economists have in the view that the de-regulation of the labour market moves it towards the perfectly competitive ideal in which everyone who wants a job can find one at a wage equal to the value of their contribution to society.” This is a classic example of theory-driven analysis, in which empirical work is designed and the results interpreted to confirm pre-existing theoretical (or ideological) views, not challenge them (see Blaug, 1992: 241).

But once it is recognized that the textbook assumptions of perfect competition do not (and could not possibly) adequately characterize developed world labor markets, the case for the efficiency of full wage and employment “flexibility” is substantially weakened, and labor market institutions (e.g., collective bargaining, unemployment benefits, and employment protection laws) may be preferred on both efficiency and equity grounds. Indeed, even the IMF (2003, p.131), citing Blanchard (2002), notes that “it is generally agreed that ‘the labor market will not function well without proper institutions,’ that is, without an appropriate mix of regulations, taxes, and subsidies affecting the relation between workers and employers.” Once we move out of the realm of textbook free markets, the issue becomes a question of the most efficient mix of institutions.

There has long been recognition by economists that imperfect information and bargaining power are inherent to labor markets (Barr 1998; Agell 1999). In real world labor markets, the right to join a union and bargain collectively can increase worker voice, encourage stability in industrial relations, promote on-the-job training, and reduce the pressure on taxpayers to maintain acceptable standards of living by placing the responsibility for decent income and benefits on the firm (and consumer). Co-ordination of bargaining, which moves wage-setting far from the competitive ideal, can cause the externalities from wage pressure to be internalized (Calmfors and Driffil 1988, Soskice 1990). The provision of unemployment insurance and assistance not only can help workers in time of need, but can facilitate job search, and thereby potentially improve the match between jobs and worker skills and interests. From this

perspective, the direction of causation runs mainly from uncertainty (unemployment) to response (institutions), whereas the thrust of the orthodox proponents of deregulation have this reversed.

To achieve competitive advantage in real-world dynamic labor markets, a broader and perhaps more relevant understanding of flexibility than the *laissez-faire* notion is the *ability to quickly and effectively respond to change* (Stanford, 2005). This kind of flexibility may require the kinds of skills and knowledge that comes only with extensive organizational experience. For example, workers with state guaranteed health benefits become freer to move from job to job. And successful, flexible organizations, may require longer term planning, the antithesis of atomistic market flexibility. As Soskice and his colleagues explain it, “Contrary to conventional neo-classical theory, which sees efforts to increase protection against job loss as an interference with the efficient operation of labor markets, measures to reduce future uncertainty over employment status – hence uncertainty over future wage premiums – can significantly improve firms’ cost effectiveness” (Estevez-Abe et al., 2000: 7-8).

The country case study evidence strongly suggests that good employment outcomes can be achieved with a variety of combinations of labor market institutions, with social spending far more generous, and regulations far stricter, in some countries than others. This position has been argued recently by a number of leading labor market specialists (Freeman 2000; Hall and Soskice, 2001). In sum, there is no particular level of social spending and regulation that is the “right one.” Rather, as the next section will argue, successful employment performance appears to require well-timed macro policies that are effectively coordinated with social policies and the wage bargaining system – an achievement that appears to require both strong employer and union associations and a relatively stable and consensual political environment.

#### **4. Beyond Labor Market Rigidities<sup>11</sup>**

A convincing story of OECD area unemployment must be reasonably consistent with the empirical evidence surveyed in sections 1 and 2. Perhaps most important, the pattern of unemployment – levels and the timing of the trends – has varied greatly across OECD countries (figure 1). This suggests that much of the effects of “global” factors, such as technological change, demographic shifts, and global price shocks and production and trade patterns, manifest themselves through country-specific policies, institutions and social norms. As a result, we should be careful about making judgments about aggregations of countries (“Europe”, “EU

countries”), and especially about drawing conclusions about the performance of alternative social models based on comparisons with the U.S. *at particular points in time*. Thus, the orthodox view became increasingly dominant in the professional and popular literature in the mid 1990s, reflecting both ideological shifts and a dramatic improvement in the performance of the U.S. labor market. But the recent data show that the U.S. advantage of the late 1990s was quite short-lived, and reflected in part the timing of the business cycle (Europe’s downturn was later, in the mid-1990s), partly the benefits of the exceptional U.S. technology boom of the late 1990s, and partly the legacy of several country-specific political and policy-related crises in the early 1990s (the collapse of the Soviet Union on Finland, the fiscal crisis in Sweden; and the reunification of Germany).

Second, as Section 3’s summary of the empirical literature concluded, among the country-specific characteristics that matter most do not appear to be the orthodox ones - protective labor market institutions like the extent/strength of collective bargaining, the generosity of unemployment benefits, and the strictness of employment protection laws. We need to look elsewhere.

And third, the countries with the worst employment performance over the last two decades have tended to be those with exceptionally high youth unemployment, relatively low female participation, and feature late de-ruralization that overlapped substantially with deindustrialization (Spain, Italy, France). This suggests that the level and timing of changes in economic development (manifested in large sectoral employment shifts) and the demographic composition of employment and unemployment are likely to be important parts of the explanation. Good luck and social norms matters, as do public policies that have facilitated female participation (e.g., child care support) and the growth of the service sector.

The remainder of this section outlines the case that the combined effects of three quite different sets of factors can go a long way towards accounting for trends in unemployment across the most developed OECD countries since the late 1970s. The first is macroeconomic policy. The monetary and fiscal policy responses to the 1970s price shocks – mainly in energy – ranged from quite loose and employment friendly (U.S.) to quite tight and employment constraining (Germany). The second is the coherence of wage bargaining, labor tax, and social policy within the context of existing monetary and fiscal policies (e.g., Austria, Ireland, and the Netherlands vs France and Belgium - and Germany since 1993). And the third is the timing and intensity of



demographic and economic changes (sectoral employment shifts), and each country's ability to effectively respond to them given prevailing social norms and public programs related to work and family (mainly Northern Europe and Scandinavia vs. Southern Europe).

In sum, whereas the orthodox explanation for the cross-country pattern of unemployment highlights the role of competitive market forces (work incentives on the supply side, employment incentives on the demand side) and prescribes a uniform policy of labor market deregulation, the alternative "political economy" account outlined here emphasizes the intersection of economic and social policy with social norms and institutions in the context of longer term structural and demographic shifts, and suggests that there are equally viable alternative models ("varieties of capitalism") for good employment performance.

#### *Employment Friendly Monetary and Fiscal Policy*

In contrast to the recent conventional wisdom in macroeconomic theory, the effects of fiscal and monetary policies on aggregate demand seem to matter a great deal for long-run trends in unemployment (Ball, 1999; Akerlof, 2002; Blanchard 2003). And maintaining strong aggregate demand appears to be particularly effective if tax, spending and monetary policies are closely coordinated with both wage bargaining and social policy. This, in turn, requires high levels of social consensus and a stable political environment, features that characterize the countries that showed the best employment performance in late 1990s - ranging from the U.S., U.K. and Ireland to Austria, Norway and the Netherlands (see below).

In the orthodox view, a country's "natural rate" of unemployment, or the NAIRU (the nonaccelerating inflation rate of unemployment), is determined by the flexibility of the labor market, not by aggregate demand. So, for example, extremely tight monetary policy of the sort practiced by the German Bundesbank and the European Central Bank in the 1980s and 1990s (but emphatically not by the U.S. Federal Reserve!) cannot be blamed for *persistent* high unemployment. Although such tight monetary (and fiscal) policy can push the actual unemployment rate above the NAIRU temporarily, labor market forces (reflecting the prevailing institutional mix) will ensure the return of unemployment to its "natural" rate (higher in the presence of more employment-unfriendly institutions). As the banks, the OECD, and the IMF continually point out, the real unemployment problem is the persistence of high unemployment,

and persistence can only be explained by sclerotic labor markets, which in turn reflects, of course, institutional interventions.

Increasingly, this conventional wisdom is cracking. Laurence Ball (1999: p. 189) puts the matter simply: “this conventional view is wrong. Monetary policy and other determinants of aggregate demand have strong effects on long-run as well as short-run movements in unemployment.” Similarly, Olivier Blanchard (2003: 4) argues that, in contrast to what he terms the “traditional literature,” “monetary policy can and does affect the natural rate of unemployment.” And in his Nobel Lecture, George Akerlof makes the same case.<sup>12</sup> In this alternative view, macro policy matters and there is much more to the high, persistent unemployment problem than simply labor market rigidities.

A plausible macro story begins with the productivity and energy price shocks of the 1970s. Faced with rising inflation, most countries responded with tight fiscal and monetary policies which in turn contributed to the high unemployment experienced by nearly all OECD countries in the early 1980s. As Lawrence Ball (1999 189) puts it:

In some countries, such as the United States, the rise in unemployment was transitory; in others, including many European countries, the NAIRU rose and unemployment has remained high ever since. I argue that the reactions of policymakers to the early-1980s recessions largely explain these differences. In countries where unemployment rose only temporarily, it did so because of strongly counter-cyclical policy.... In countries where unemployment rose permanently, it did so because policy remained tight in the face of the 1980s recessions.... labor market policies are not important cases of the unemployment successes and failures since 1985” (ibid. 190-91).

Decisions to use monetary policy to increase unemployment above the “natural rate” for extended periods of time - to minimize the threat of inflation and perhaps also to reduce worker bargaining power and increase profitability. Over time, “hysteresis” effects may tend to raise the NAIRU for various reasons (e.g., the long term unemployed lose skills or access to job search networks). Ball identifies six “failure countries” whose tight and poorly timed monetary policies contributed to rising unemployment that persisted for long periods – Belgium, Denmark, France, Italy, Canada, and Spain. He shows that the first four of these failure countries “saw sharp increases in rates that occurred largely after the mild runups in inflation, when inflation was stable or falling... In the success countries, by contrast, tightenings occurred only when inflation was rising substantially” (225). Ball cites “historical accounts” (mainly the OECD’s country

surveys) to make the case that both Canada and Spain pursued “highly contractionary policies” right through the early 1990s recession. The importance of tight monetary policy for Canada’s poor employment performance appears well established (Stanford, 2005; Riddell and Sharpe 1998). Ball’s conclusion for Spain is supported by Bustillo’s (2005) case study. And as the home bastion of tight monetary policy, Germany could be added to the list (Schettkat, 2005; Hein and Truger, 2005). As Manow and Seils (2000 288, 301) put it, “Even in the face of such an extraordinary challenge as unification, the Bundesbank continued to follow its hard money policy... The government’s fiscal austerity in the service of monetary rigor came partly at the expense of social insurance, where contribution rates were forced up even higher.”

The cross-country statistical evidence for this aggregate demand story is admittedly limited. Studies by Ball (1999), Schmitt and Baker (1998), Blanchard and Wolfers (2000), Palley ( ) and Bertola, Blau and Kahn (2002) offer some empirical support for aggregate demand effects. Part of the problem with demonstrating these effects may be simply technical. As Fitoussi (2003: 438) points out, the difficulty of fully representing the effects of monetary policy in a regression framework makes it difficult to statistically link monetary policy to unemployment in cross-country analyses. Despite this, the evidence is highly suggestive: “how can we believe that the course of unemployment in Europe has been unaffected by the fact that the short-term real rate of interest has been higher than 5 percent in a period (1991-1995) in which the rate of growth was about 1 percent?” (Fitoussi, 2003: 438).

### *Coherent Wage Bargaining, Fiscal, and Social Policy*

But there is surely more to the story. Country case studies suggest that a key ingredient to good employment performance is a coherent policy mix, and the evidence suggests that in developed world democracies, this requires high levels of social consensus and political stability. Successful countries of the last decade or so, like Denmark, Ireland, the Netherlands and Austria (and Sweden at the end of the 1990s), show much more consensus on how to balance macro policy, social protection and pro-work policies for workers, and pro-competitive policies for employers than do the poorer performing countries in the same period – say, France and Belgium. At the same time, poorly coordinated policy making has been blamed for the Swedish and German unemployment crises. Critically, the successful countries have demonstrated that a competitive private sector can be maintained without dismantling their highly protective,

universalistic welfare state institutions. Success seems to demand a stable political system and effective structures of cooperation and negotiation between the major “social partners”: unions, employers, and the state.

France provides an example of the importance of coherent decision-making. The French government’s generally pro-business policy orientation fractured after the 1968 protests, giving way to an expansion of social spending (e.g., the minimum wage and unemployment benefits) that reflected, according to Levy (2000: 320) “the contested political environment of the 1970s... French leaders would become extraordinarily conflict-averse, often backing down at the first sign of street resistance – whether from shopkeepers, farmers, or workers.” Inconsistency was disastrous. Faced with rising unemployment following the shocks of the 1970s, the state first swung to the left under Mitterand, pursuing “a sweeping program of nationalizations, covering twelve leading industrial conglomerates and some 38 banks” that required enormous subsidies (Levy: 321). Then, in 1983, with unemployment rising and budget and trade deficits exploding, the French government sharply reversed course and “accepted the logic of the EMS (European Monetary System) with a vengeance.” With the developed world still in recession, “redistributive Keynesianism gave way to austerity budgets, wage indexation was abandoned, and most important, monetary policy was tightened, with real interest rates ranging from 5 percent to 8 percent for over a decade” (Levy 2000: 324). It is worth noting again that this tightening was just the reverse of the expansionary policy adopted by the U.S. in the early-mid 1980s.

A second component of this U-turn in policy was the drive to privatize. But this threatened workers in the nationalized firms with job loss and lower wages in an economy that was already in recession. Despite the pro-market policy shift, French unemployment rates continued to rise, and in response to political protests, “the authorities expanded social spending to help protect workers from dislocation and to undercut resistance to measures of economic liberalization” (Levy 309). In contrast to the orthodox story, more generous unemployment benefits and stricter employment protection followed, rather than precipitated, rising unemployment. The strengthening of protective institutions reflected the need to make the broader pro-market policy shifts politically palatable.

France may be, as the conventional wisdom contends, the quintessential example of the “Eurosclerosis,” but even if there is some merit to this conclusion, it does not appear to rest on the presence of an exceptionally rigid labor market. France stands out from its neighbors only on

the strictness of its employment protection laws, and this, as mentioned above, is due mainly to the greater protection for temporary workers – about 15% of France’s workforce (OECD, 2004: Chapter 2).

A recent case study of Austria, the Netherlands, and Belgium powerfully illustrates the importance of consensus and coordination (Hemerijck, Unger and Visser 2000). These are three small continental European countries in close physical proximity with strong welfare states and highly regulated labor markets. As the authors point out, “The three countries reveal similar trends in terms of total government outlays, resources spent on social expenditure, the share of social transfers, the financial basis of the welfare state, and taxation... The non-wage share of total labor costs is around the average of all OECD countries” (188). Yet, their unemployment experiences are dramatically different. Austria has reported extremely low unemployment since the 1960s, consistently outperforming even the U.S.; the Netherlands performed poorly (the “Dutch disease”) in the 1970s and early 1980s but has had among the lowest unemployment rates in the OECD in the 1990s, outperforming the U.S. in recent years; Belgium has been, with France, among the OECD countries with the highest unemployment rates since the late 1970s.

What accounts for such divergent unemployment patterns? Hemerijck et al. argue that the key lies in the “relationship between the state and social partners,” which ranges from “a very stable, uncontested, and consensual pattern in Austria, through a narrower, and variable though (in major areas) renewed cooperative style in the Netherlands, to a troubled and conflictual mode in Belgium” (2000: 193). Austria responded to the economic crisis of the 1980s by spurring demand (public sector employment grew substantially) and by restricting supply (sending foreign workers home). Wage moderation was not a problem either: “The homogeneity of policy priorities is most prominently demonstrated by the amazing fact that income inequality was never a major topic in Austria, while wage moderation proved much easier to maintain than in Belgium and the Netherlands” (251). In the Netherlands, a series of agreements (the most prominent being the Wassenaar Agreement in 1982) between Dutch employers and workers, with State involvement, has provided the basis for economic policy in the Netherlands since the early 1980s.

Belgium, on the other hand, faced political conflict, partly driven by linguistic divisions, which made a coherent and consensual response to the economic crisis of the 1970s and early 1980s impossible. Hemerijck et al. (2000, 250) argue that

organized actors in Belgium – inside and outside the government – failed to agree on the causes of the job crisis and its therapies, and ... continued to work at cross-purposes... The upshot was that Belgian governments had to impose conditions on trade unions and firms that were mutually negotiated in the Netherlands.... In the ten crucial years between 1972 and 1982, when two major economic shocks needed a response, Belgium had no less than thirteen governments (compared to five in the Netherlands and only three in Austria). The weakening of the state was compounded by the partisan use of the state, with recruitment practices not based on merit but on party membership and the right combination of language and region.

Part of the problem can also be traced to public finance. Political dysfunction contributed to large budget deficits and the need for severe fiscal austerity. This in turn closed off a key element of the Dutch solution. “Unlike the Netherlands, Belgium was unable to support wage moderation in the 1990s with tax rebates” (Hemerijck 2000: 254).

The rapid rise in German and Swedish unemployment rates in the 1990s can also be traced to mistaken and uncoordinated policy making that produced fiscal crises. In the German case, the unification process was determined by a “political logic” that turned out to be much more costly than the Kohl government projected. In combination with conservative tax reforms that led to a collapse in individual and corporate tax receipts (despite rising company profits), the federal budget deficit soared. At the same time, as the German economy (with the rest of Europe) slid into recession, the Bundesbank “raised the bank rate to record postwar levels,” which further contributed to declining tax receipts and the budget crisis (Manow and Seils 2000: 288).<sup>13</sup> This suggests that it was tight monetary policy and policy mistakes after unification, not labor market rigidity (much less the welfare state in general) that led to the German employment crisis. It is instructive that German exports remain highly competitive, indicating that unit labor costs could not be hugely out-of-line (Hein and Truger, 2005). Much of the German employment problem seems solidly in the domestic effective demand corner, with much lower growth rates of real total government expenditure (and slower real government investment) and compensation per employee than the EMU average over the 1995-2004 period (Hein and Truger, 2005: Table 4).

In the mid 1990s, advocates of the orthodox free market policy jumped on Sweden’s massive employment crisis in 1991-93 as evidence of the bankruptcy of the Swedish model (see Lindert, 2004: chapter 11 for a devastating critique of the ideological use of the Swedish crisis in the business press). But the subsequent modest labor market reforms and dramatic improvement

in employment performance suggests a much more complicated story. Indeed, Brenner and Vad (2000 455) argue that, while the Swedish economy required adjustments in the 1980s to cope with a changing international environment, “the problems confronting the Swedish economy between 1985 and 1990 were solved in the wrong order.” Making matters worse, the 1991-93 crisis “elicited only weak and uncoordinated responses” (456) by government and bank authorities. Indeed, the lack of coordination can be traced to a decision to replace the centralized approach to economic policy making, which characterized the 1950s and 1960s, with a decentralized model (456). Interestingly, the immediate source of the crisis was the decision by the Swedish central bank – without coordination with government fiscal policy - to follow the lead of the U.S. and U.K. with financial deregulation. With the post-1986 reduction in oil prices, this helped produce a speculative boom in the home market in the late 1980s. With rising inflation, wage demands rose. The overheated Swedish economy was then crushed with tax reform and tightened monetary policy just as the developed world headed into recession. Decentralized policy making produced a series of uncoordinated and untimely decisions that proved disastrous. As Brenner and Vad put it, between 1985 and 1993 “the economy was stimulated when it was in need of cooling and put on ice when it needed a modest degree of stimulation” (456).

There can be little doubt that the last two decades have posed particularly tough challenges for those making economic policy in countries committed to limiting economic insecurity and social inequality. With tight monetary policy imposed first by the Bundesbank and then by the European Central Bank, and faced with increasingly open borders and competitive product markets, it has been essential to keep wages moderate and budget deficits limited. The options for both macroeconomic policy and social policy at the country level are more constrained than in the “golden age” of the 1960s and early 1970s. In this new, increasingly global economic environment, successful employment performance appears to require well-timed macro policies that are effectively coordinated with social policies and the wage bargaining system – an achievement that appears to require both strong employer and union associations and a relatively stable and consensual political environment.

*Sectoral and Demographic Shifts, With Female Friendly Employment Policies*

The third component of our political economy explanation focuses on the timing of structural (sectoral) and demographic shifts, and the ability of countries to effectively respond to them, given prevailing social norms and social benefits related to work and family. The timing of the shift away from agricultural and industrial production (which requires much heavy manual work) and towards service production (which requires lighter manual and office work) has varied considerably across the OECD, and countries that experienced rapid and concurrent de-ruralization and deindustrialization in the weak world economy of the 1980s, just as the baby boomer generation was coming of age, faced special employment challenges. Much work needs to be done in this area, and the remainder of this section will just outline the argument with reference to some preliminary evidence.

As Table 1 showed, with the exception of Germany the high unemployment countries,— Spain, Italy, France and Belgium – have had disproportionately high youth and female unemployment rates: the average male youth rate for these four countries was 20.2% in 2003 (unweighted); the female youth unemployment rate was 24.6%. Clearly, youth unemployment accounts for a substantial share of the number of unemployed in these countries.

Part of the problem has been demographic - the timing of the baby boom, which resulted in higher shares of young people in the population. Whereas the ratio of 15-19 to 25-59 year olds in the population dropped by 6.6 percentage points between 1980 and 1990 (from 21.2% to 14.6%) in the U.S., the decline was just .7 percentage points for Spain (20% to 19.3%), 1.8 points for Italy (17.8% to 16%) and 1.5 points for France (17.9% to 16.4%).<sup>14</sup>

With higher levels of education and sharply declining agricultural and industrial job opportunities, job growth at the end of the 20<sup>th</sup> century, particularly for youth and female workers, had to occur in the services. But in several of the high unemployment countries – most notably Spain, Italy and France – service sector employment has remained low. For example, the French employment rate for services relative to the U.S. (French service workers as a share of the total, divided by the same for the U.S.) was just 72%. It was 71% for Germany and just 58% for Spain (Schettkat, et al., 2005). While the Dutch rate was also quite low (73.4%), presumably the much greater opportunities for part-time employment has helped keep the Dutch female unemployment rates quite low (see Table 1).



Why is the U.S. so far ahead in the generation of service sector jobs? According to research by Glyn et al. (2005) on the retail sector, *it is not due to low wages*. They conclude that “differences between the USA and Europe are not consistently in the direction anticipated by the rigidities/wage-compression hypothesis. The wage penalties for employment in retail are not much more important in the USA. American retail has kept down wage costs more by focusing the composition of its work force on cheaper workers, e.g. part-time workers, rather than by paying them less than in other industries. “ They find the explanation in the “much lower European level of goods consumption” caused in part by “low levels of aggregate hours worked and thus aggregate consumption rather than specific labour-market constraints on the service sector itself” (33).

It may also be the case that rising workforce literacy, the availability of part-time jobs, access to affordable child care and changes in social norms regarding the division of labor in the family have facilitated female employment and two-earner households, and consequently the “marketization” of traditional household services, which has in turn spurred employment growth in the retail, restaurant, and personal and household service sectors (Esping-Andersen, 1999; Freeman and Schettkat, 2004; Freeman, 2005). Conversely, this avenue for job growth is constrained in regions with low educational levels and traditional paternalistic and familialistic social norms – where workplace and family policy is designed to support a male earner and a female nonearner (so, for example, there is little publicly subsidized child care). This confluence of structural, demographic and social factors appears particularly germane to the countries of southern Europe, most notably Spain and Southern Italy, but has probably also been a factor for France and Germany.

This seems quite plausible as part of the story, and Esping-Andersen (1999) and Freeman (2005) provide some supporting evidence. On the other hand, Kalwij and Machin’s (2005) analysis of expenditure patterns across 6 countries does not find higher U.S. spending in personal services, household services, or “food and beverages away from home,” as the marketization hypothesis would suggest. Rather, the U.S. stands out in health, education, communication (telephone and mail), and miscellaneous (insurance) services. This suggests that, in addition to the much greater retail employment that comes with greater goods consumption, part of the U.S. job advantage may be the result of inefficient service production (decentralization in health and education) and unnecessary services (paperwork handling jobs in private health insurance).

## 5. Conclusion

The empirical evidence outlined in the first part of this paper challenges the reigning orthodoxy - that rigidities imposed by too much social protection explain the pattern of employment performance over the last several decades. In fact, neither differences in levels of social protection nor their change over time offer a good account of the levels and trends of unemployment across the major OECD countries. The orthodox story greatly exaggerates the distinctiveness of the U.S. unemployment record as a “success story” by not taking a longer term perspective, one that should now include the recent strong convergence across the OECD towards U.S. levels since 1999. It relies on a “collapsing demand for the less-skilled” thesis in the face of the evidence on unemployment and employment rates by skill, which shows that where unemployment rates have risen they have done so for all skill groups. It points to wage rigidity despite the lack of any cross-national association between unemployment levels (or changes) and levels (or changes) in wage inequality and labor costs. It attributes the pattern of unemployment across countries to specific “employment unfriendly” labor market institutions based on, at best, mixed evidence from remarkably unrobust statistical tests.

Common observation, as Keynes put it over seven decades ago, powerfully challenges the orthodox deregulation prescription for high, persistent unemployment. Countries have reduced unemployment substantially without major changes in either labor market regulations or the generosity of unemployment-related benefits (Ireland, Netherlands, Denmark, Sweden, and Spain). Germany, on the other hand, has experienced rising unemployment even though its social model (labor market regulations and benefit generosity) is quite similar to their low-unemployment neighbors, Austria and the Netherlands.

Stepping outside the confines of a simple demand-supply framework, it is possible to imagine that much more is at work in countries with poor employment performance than inflexible labor markets. There is a less elegant but more convincing story to be told about the declining economic well-being of the less skilled in developed countries, a story in which low-skilled workers have borne the brunt of policy-induced weak aggregate demand, policy mistakes and poor policy coordination, disadvantageous timing of large-scale economic and demographic shifts, and, perhaps, labor market deregulation itself.

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**Table 1: Standardized Unemployment Rates by Gender and Age, 2003**

	MALE		FEMALE	
	15-24	25-54	15-24	25-54
<i>Anglo-Saxon/Market</i>				
US	13.4	5.2	11.4	4.8
Australia	12	4.4	11.1	4.7
Canada	15.6	6.6	11.9	6.4
Ireland	8.6	4.4	6.5	3.4
New Zealand	10.1	3.2	10.4	3.9
UK	13.2	4.2	9.5	3.3
average	12.2	4.7	10.1	4.4
<i>Continental/Corporatist</i>				
Austria	8.1	4.4	6.8	3.9
Netherlands	6.7	3	6.5	3.3
low unempl. average	7.4	3.7	6.65	3.6
Belgium	20.1	6.6	17.5	7.4
France	18.2	7	22.8	9.4
Germany	12.3	9.4	8.6	8.8
Italy	23	5.4	30.9	10
Spain	19.4	6.9	27.2	14.8
high unempl. average	18.6	7.1	21.4	10.1
<i>Scandinavian/Universalistic</i>				
Denmark	10.6	4.4	9	5.6
Norway	12.7	4.3	10.7	3.3
Sweden	14.8	5.3	12.7	4.4
average	12.7	4.7	10.8	4.4

Source: OECD (2004), Statistical Appendix, Table C.

**Table 2: Measures of Social Protection and Collective Bargaining for Selected OECD Member Countries**

	Cash Income Support to Working Age Pop. as Share of GDP <sup>1</sup> (%)	Unempl. Benefit Replacement Rates for the 1st Year as Share of APW <sup>2</sup> (%)	Unempl. Benefit Replacement Rates for the 4 <sup>th</sup> and 5 <sup>th</sup> years as Share of APW <sup>2</sup> (%)	Trade Union Density (%) <sup>3</sup>	Collective Bargaining Coverage <sup>3</sup> (%)	Collective Bargaining Structure Index <sup>4</sup>	Summary Indicator of Strictness of Employment Protection Laws <sup>5</sup>
	2001	2001	2001	2000	2000	1995-2000	2003
U.S.	1.6	29	6	13	14	2	.2
Ireland	4.4	30	30	38	---	8	1.1
New Zealand	6.7	31	31	23	60+	2	1.5
U.K.	5.9	18	18	31	40+	2	.7
France	6.0	61	27	10	90+	4	3.0
Germany	4.5	38	34	25	80+	5	2.2
Italy	3.3	59	0	35	80+	6	1.9
Austria	6.0	40	38	37	95+	7	1.9
Denmark	8.7	65	33	74	70+	6	1.4
NL	6.9	70	23	23	70+	7	2.1
Norway	6.8	62	0	54	70+	9	2.6
Sweden	7.0	74	0	79	80+	6	2.2

1. OECD, 2005. *Society at a Glance: OECD Social Indicators*, (Paris: OECD), Table EQ5 (p.61).

OECD, 2004. *Benefits and Wages: OECD Indicators* (Paris : OECD), Table 3.4. The figures show Gross Replacement rates for Three Family Types Over a Five-Year Period, (average of 2/3 and 100% average production worker (APW) earnings levels).

2. OECD, 2004. *Employment Outlook*, Chapter 3 : Table 3.3.

3. OECD, 2004. *Employment Outlook*, Chapter 3: Table 3.5. This is a sum of the OECD's Centralization and Coordination indices. Each ranges from 1-5.

4. OECD, 2004. *Employment Outlook*, Chapter 2: Table 2.A2.4 (overall EPL, version 1).

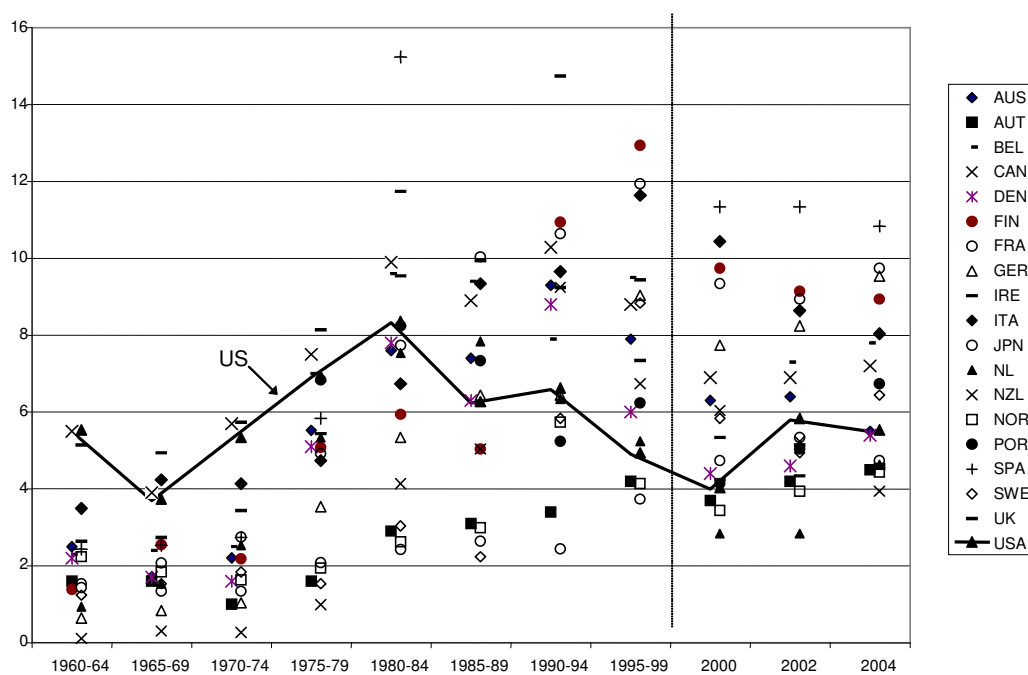


**Table 3: The Agriculture and Service Shares of Total Civilian Employment in Selected OECD Countries, 1978-2001**

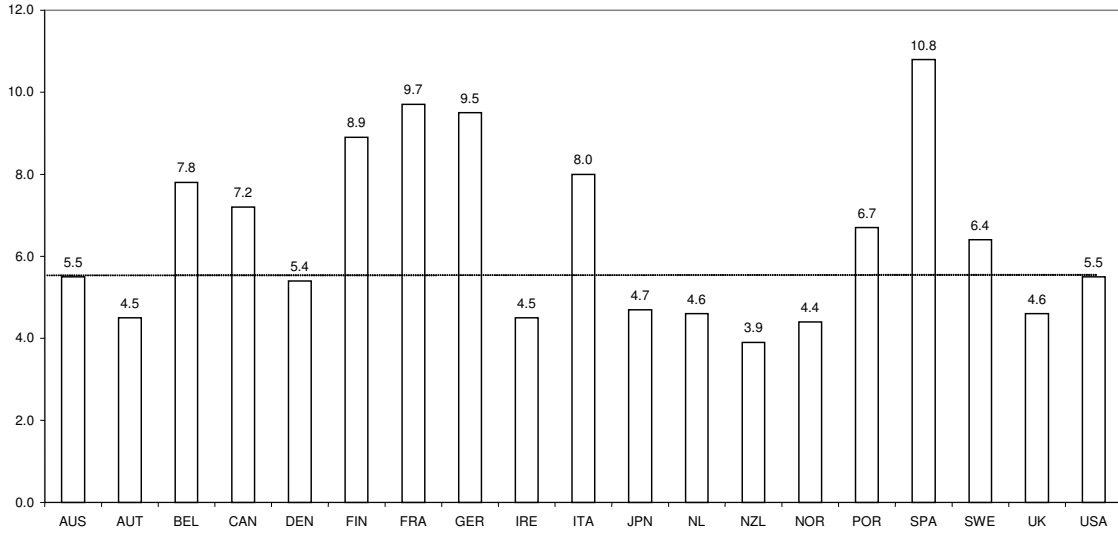
High Unemployment	Agriculture			Services		
	1978 (%)	2001 (%)	Change (pct pts)	1978 (%)	2001 (%)	Change (pct pts)
France	9.2	3.7	-5.5	54.1	72.2	18.1
Germany	5.8	2.6	-3.2	49.9	64.8	14.9
Italy	15.5	5.3	-10.2	46.4	62.6	16.2
Spain	20.4	6.4	-14	43	61.9	18.9
Low Unemployment						
Netherlands	5.4	2.9	-2.5	61.6	75.9	14.3
Sweden	6.1	2.3	-3.8	60.9	74	13.1
UK	2.8	1.4	-1.4	58.2	73.7	15.5
US	3.7	2.4	-1.3	65.2	75.2	10

Source: OECD, *Labour Force Statistics 1981-2001* (2002).

**Figure 1: The Pattern of Unemployment for 19 OECD Countries, 1960-2004**



Sources: 1960-99: Baker et al. (2005); 2000-03: OECD Employment Outlook, 2004; 2004: OECD online.

**Figure 2: Standardized Unemployment Rates for 19 OECD Countries, 2004**

Source: OECD online.

## Endnotes

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<sup>2</sup> As Blau and Kahn 2002: 255) have recently explained, “We hypothesized that the flexible U.S. labor market was able to accommodate these strains (shocks in the 1970s and 1980s) by letting absolute and relative real-wage levels adjust, thus permitting the unemployment rate to stay low. In contrast, according to this framework, in most other OECD countries, collective bargaining and other labor-market institutions and government regulations kept overall real wages rising and prevented the relative wages of unskilled workers from falling as fast as they did in the less-interventionist U.S. labor market or, in some cases, preventing any decrease at all in the relative pay of low-skilled workers (255).

<sup>3</sup> According to three senior OECD economists (Elmeskov et. al, 1998), the key lesson of the 1990s is the need for comprehensive labor market deregulation: “Some of the medicine prescribed under the OECD recommendations is bitter and hard for many countries to swallow, especially insofar as it appears to raise concerns about equity and appears to threaten some of the rents and privileges of insiders.... It requires strong political will and leadership to convince electorates that it is necessary to swallow all of the medicine and that it will take time before this treatment leads to improved labor market performance and falling unemployment. But the success stories show that it can be done!”

<sup>4</sup> I follow Esping-Andersen’s (1990; 1999) categorization here, the most influential in the literature.

<sup>5</sup> According to a recent OECD study, “Greece, Italy, and Spain are among the four countries with the highest incidence of very-long-term youth unemployment, yet benefits are not generally available to unemployed youths in these countries” (OECD 2002: 203).

<sup>6</sup> Glyn and Edmonds (1995) have shown that employment growth in the U.K. is attributable almost entirely to the public sector.

<sup>7</sup> This section is a revision of material that appears in earlier work (Howell 2002, 2005a).

<sup>8</sup> See Freeman and Schettkat (2000); Devroye and Freeman (2000); and Lucifora (2000).

<sup>9</sup> Actually, it appears that the new results (through 1995) are published in Table 13 of Nickell et al. (2003) with a heading that mistakenly reads 1961-92 instead of 1961-95.

<sup>10</sup> In the 2001 version, the employment protection legislation variable was highly significant in all three of the published unemployment regressions (table 13) and quite large in its economic impact. In contrast, the coefficient of this variable in the regressions in the more recent version is not close to being significant. The additional three years also seems to have a substantial affect on the impact of other variables. In the 2002 version, the effect of higher taxes is more than 30 percent lower, the effect of coordination is nearly 40 percent lower, and the effect of benefit duration is cut by more than 50 percent. The additional three years of data also now make the coefficient of the interest rate variable significant. It had been very close to zero and not close to significant in the earlier regressions. In the EPOP regressions in the earlier version, only the replacement rate and benefit duration variables were found to have significant negative effects and the employment tax variable was not close to being significant.

<sup>11</sup> The following is a revised version of parts of “Labor Market Institutions and Unemployment: An Assessment,” Chapter 10 of Howell (2005).

<sup>12</sup> As George Akerlof explains, “A central proposition of the New Classical economics is that monetary policy, as long as it is full perceived, can have no effect on output or employment...”

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This New Classical hypothesis conflicts, however, with empirical evidence on the impact of monetary policy and the widespread popular belief in the power of central banks to affect economic performance” (2002 416).

<sup>13</sup> As Manow and Seils (2000: 292, 290) explain, “The failure of proper coordination among fiscal, monetary, and wage policy resulted in a labor market catastrophe for eastern Germany and a dramatic decline in employment in the west. At the end of the day, the brunt of adjustment had to be borne by the welfare state... At a time when the government had to rule out higher deficits, could not rely on corporate and personal income taxes, and found it impossible to reduce expenditures for the east, it was tempting to finance unification via social insurance. This is exactly what happened.”

14. Calculated by the author from the UN’s Women in Statistics database, generously provided by John Schmitt.