

7. The Micro-Foundations of High Unemployment in Developed Countries: Are Labor Market Rigidities the Problem?¹

David R. Howell

INTRODUCTION

By the early 1990s, unemployment throughout much of Europe had risen to unprecedented levels and concern over the economic well-being of less-skilled workers appeared at the top of the policy agenda. At about the same time, a broad consensus had been reached about the source of this decline: global forces had generated a protracted imbalance in demand and supply in the labor market, a mismatch caused mainly by computerization in the workplace (Bound and Johnson, 1992, pp. 210–32; Krueger, 1993, pp. 33–60). As Paul Krugman put it, ‘the growth of earnings inequality – and quite possibly therefore much of the rise in structural unemployment in Europe – has been the result of technological changes that just happen to work against unskilled workers’ (Krugman, 1994).

Variously characterized as the ‘Unified Theory’ and the ‘Trans-Atlantic Consensus,’ this account has been enormously influential in policy circles for all the obvious reasons – the story is simple, it is consistent with the economist’s supply/demand model of the labor market, and the policy implications are clear (Blank, 1977; Atkinson, 1998). In our computerized global economy, vastly higher cognitive skills are required of a large fraction of the US workforce and far greater labor market flexibility is needed in Europe. The belief in free market solutions became the orthodoxy of the 1990s.

A central plank of this orthodoxy was that high unemployment in the developed (OECD) countries could be explained largely by the labor market rigidities that follow from Welfare State regulations and institutions. This simple, textbook account of the European unemployment crisis as a labor market problem caused by government policy interventions is held by

economists of wide-ranging political persuasions. For example, the liberal American economist, Robert Haveman, poses the issue as a choice between wage stagnation ('the US model') and double-digit unemployment ('the European model'): 'a European-style policy package comprises generous and accessible social benefit programs, high minimum wage levels, and relatively stringent labor market regulations and constraints. It is accompanied by high unemployment and joblessness, slow employment growth . . .' (Haveman, 1997, p. 3). Similarly, Horst Siebert, a conservative German economist, attributes the unemployment problem in Europe to 'an array of institutional arrangements that form a complex web of incentives and disincentives on both sides of the (labor) market.' The solution can only be to 'undertake major reforms of the institutional setup of the labor market' (Siebert, 1997, p. 53).

Several dimensions of this claim can be addressed with the available evidence: (1) because of the rigidities imposed by European welfare states, the European unemployment experience should be clearly differentiated from that of the US over a substantial period of time; (2) if downward wage rigidities are at the heart of the unemployment problem, as the orthodox view contends, we should observe a clear tradeoff between earnings inequality and unemployment (and employment) rates across countries – relatively high wages for the less skilled will price them out of jobs; (3) since most labor market institutions are designed to protect the least skilled from the most damaging effects of labor market competition, the rise in European unemployment should have been driven by the less skilled, with declining unemployment rates for the more highly skilled (for whom demand has risen); and (4) statistical tests should show convincingly that unemployment is accounted for in large part by 'employment unfriendly' labor market institutions.

This chapter assesses the evidence for this widely accepted Labor Market Rigidity explanation for persistent high unemployment in many OECD member countries. The main conclusion of the chapter is that supportive evidence has remained remarkably thin, particularly given its widespread acceptance. The simple trends suggest numerous anomalies: trends across the OECD are far from uniform; the US did not show distinctively lower unemployment until the late 1980s, and European unemployment rates have lately shown strong convergence towards US levels; the evidence for a tradeoff between unemployment and inequality is ambiguous at best; where unemployment has risen, it has done so across skill groups, not just for the least skilled; and unemployment rates across countries are not impressively accounted for in regression tests by the usual welfare state suspects (e.g., union density, employment protection laws, and the generosity of unemployment benefits) – the results in the literature are widely

acknowledged to be extremely fragile, and our simple regressions show no explanatory power.

This absence of compelling empirical support for the Unified Theory challenges the current policy orthodoxy: that high European unemployment must be addressed with a strong dose of the American model of labor market deregulation, and that any attempt to address high wage inequality in the US with labor market institutions will only produce European levels of unemployment. This review of the evidence suggests that the continued status of the Unified Theory as conventional wisdom can be explained less by the compelling nature of the evidence than by the power of the simple demand/supply vision of the labor market. This vision, in turn, has discouraged research into alternative accounts. I suggest that high earnings inequality in the US and high unemployment in many parts of Europe reflect substantial pro-market ideological shifts on both sides of the Atlantic, which have eroded institutional protections for lower skill workers in the US and constrained the growth in job opportunities in Europe.

‘EUROPEAN’ UNEMPLOYMENT AND THE DISTINCTIVENESS OF THE US

How similar are national levels, trends, and sources of unemployment across Europe? If there is significant heterogeneity in the unemployment experience, a handful of countries with entirely country-specific explanations for rising unemployment may have played a major role in driving up the average unemployment rate for the entire region. Further, to the extent that there are similar levels of unemployment across European economies, this may reflect more the economic integration of the continent than the similarity of labor market institutions and their effects. As Stephen Nickell points out, ‘while it is sometimes convenient to lump all the countries of western Europe together in order to provide a suitable contrast to North America, most of the time it is a rather silly thing to do’ (Nickell, 1997, p. 55).

Figures 7.1a and 7.1b show a wide range of unemployment rates across Europe. Indeed, there is no obvious grouping of European nations in either of these bar charts. In the 1983–88 period, Sweden, Norway, Switzerland, and Austria had rates that were much closer to those of Japan (less than 3 per cent) than such close European neighbors as Denmark, France, the Netherlands, and Belgium (9–12 per cent unemployment). The same holds true for the more recent 1989–94 period, as Figure 7.1b shows: several European nations with highly developed welfare states – Austria, West Germany, Sweden, and Norway – had unemployment rates that averaged

between 4 and 6 per cent, while Ireland and Spain had rates of about 15 and 19 per cent. Clearly, the European unemployment varies enormously across, and in some cases – for instance, the UK, Germany, and Italy – within countries.

These figures also suggest that the US experience is less distinctive than commonly believed. Several European countries with strong labor market institutions had lower unemployment rates than the United States in both the 1983–88 and the 1989–94 periods. These included Sweden, Austria, West Germany, Switzerland, and Norway. At least through the early 1990s, the US was not the outlier in unemployment the way it was for both real wages (low) and inequality growth (very high).

It is also notable that recent data show a marked convergence in unemployment rates across the developed world. Figure 7.2 compares unemployment rates in 1994 and 2001 for 14 OECD member countries. Apart from Austria (3.8 per cent), the standard measure of unemployment was lowest in the US (6.1 per cent) in 1994. But by the first quarter of 2001, six of the countries shown here shared with the US the distinction of rates below 5 per cent. Indeed, three countries achieved unemployment rates substantially below the 4.5 per cent US rate: Austria (3.7 per cent); Ireland (3.8 per cent); and the Netherlands (2.3 per cent). By late 2001, Sweden's unemployment rate was also below that of the United States.

DO THE DATA SHOW INEQUALITY-UNEMPLOYMENT TRADEOFFS?

In the conventional view, strong egalitarian institutions and social policies produce unemployment by promoting wage rigidity and by reducing incentives for effective job search. Societies can choose more jobs or more equality. But the statistical facts tell a more complicated story. Figure 7.3 shows a plot of the change in earnings inequality (D9/D1, or ninetieth percentile divided by tenth percentile) against the change in unemployment for 16 OECD member countries over the 1979–97 period. These data show no simple tradeoff. There are two high inequality growth countries (the US and UK), two low inequality growth countries (Belgium and Germany), and many countries with little inequality growth but widely varying changes in unemployment. For example, despite similar increases in earnings inequality, the Netherlands experienced declining unemployment, Denmark shows modestly rising unemployment, and France and Sweden experienced relatively high increases in unemployment. To view it from another angle, with substantial declines in earnings inequality, Belgium and Germany experienced smaller increases in unemployment than the UK, Canada,

Austria, and New Zealand, countries with at least some increase in earnings inequality.

Another way to examine the tradeoff hypothesis is to compare earnings inequality with unemployment inequality – the ratio of the unskilled unemployment rate to the skilled rate. Protective labor market institutions that produce wage rigidity and limit the incentives for job search lead to adjustments on the employment side. On the other hand, less skilled workers in flexible labor markets respond to shocks mainly through wage adjustments and should therefore have unemployment rates not greatly dissimilar to those of high skilled workers. Thus, faced with the same shocks, the US should show rising earnings inequality and European welfare states should show rising unemployment inequality. More generally, across countries that vary in labor market rigidity we should observe a tradeoff between relative wage inequality and relative unemployment inequality.

If anything, the data show the reverse. Figure 7.4 shows earnings inequality ($D9/D1$) and unemployment inequality (the ratio of low to high skill unemployment rates) for male workers in selected years over the 1979–93 period for the eight OECD member countries for which data were available. The US appears in the upper right with the highest earnings inequality and the highest unemployment inequality. Canada experienced comparable levels of earnings inequality but lower unemployment inequality, while France, the UK, Germany, Australia, and Italy were all superior on both dimensions of inequality.

Figure 7.5 also compares these two measures of inequality, but does so for all workers (male and female) using a different measure of unemployment inequality for the early 1990s.² The pattern is similar. Again, the US had the highest levels of both earnings and unemployment inequality, about twice those of Germany and Sweden. Compared to ratios of about 4.5 in the US, the earnings and unemployment ratios in France were far smaller, around 3.4 for earnings and 2.5 for unemployment. *This evidence directly challenges a fundamental tenet of the conventional wisdom; it shows that countries with lower earnings inequality also tend to have lower unemployment inequality.*

EUROPEAN UNEMPLOYMENT AND SKILL-BIASED DEMAND SHIFTS

At the center of the conventional wisdom is a story about a demand shift away from the less skilled of such magnitude that it is frequently referred to as a ‘collapse’ in the literature. It is also widely recognized that the severity of the unemployment problem in many countries is due to its long-term nature, and the persistence of unemployment may reflect not only wage

rigidity and disincentives for active job search, but also the deterioration of the skills of those out of work for long periods. For these reasons, in this account the unemployment problem should be concentrated among the least skilled. This section addresses three dimensions of this part of the Unified Theory.

Unemployment Rates by Skill

If an important part of the unemployment problem is skill-biased demand shifts in rigid labor markets, we should see at least two empirical patterns. Across countries, unemployment among the least skilled should be greatest relative to those with higher skills in those countries with the most rigid labor markets. After all, workers in countries like the US have, supposedly, adjusted to the new economy with wage cuts. Within countries, if skill-biased technological change is the fundamental problem, we should observe a rising ratio of low-skilled to high-skilled unemployment over time, caused by rising low-skill rates and stable or declining high-skill rates.³

Evidence pertaining to the first of these predictions has already been presented. Figures 7.4 and 7.5 show that the probability of being unemployed for low-skilled workers relative to their high-skilled counterparts is greatest in the US, widely regarded as the country with the most flexible labor markets. This result appears to directly contradict the demand shift/rigid labor markets prediction. Other data confirm this result. For example, the OECD *Jobs Study*, perhaps the most authoritative voice of the conventional wisdom, compares white-collar and blue-collar unemployment rates from the mid-1970s through the early 1990s for eight nations (OECD, 1994). The report finds that lower skilled workers in the US have consistently had far higher unemployment rates relative to skilled workers than has been the case in France or most other northern European nations. The blue- to white-collar ratio remained unchanged from 1982 to 1991 in France (at 1.51) while increasing slightly from 1979 to 1990 in the US (2.08 to 2.28). Given the growth in US earnings inequality by skill group over this period, the unemployment ratio should have declined rather than increasing, according to conventional wisdom.

Like the results for blue- and white-collar workers, the unemployment rate for poorly educated workers was far higher relative to that for highly educated workers in the US than in any other OECD nation examined save the UK, whose labor market is on the US side of the flexibility spectrum. Despite substantial downward adjustments in wages, low-skilled US workers appear worse off in unemployment relative to high-skilled workers than in most other major OECD nations. Depending on the measure, this unskilled-skilled ratio was either stable or worsened in the US over the 1980s. (*ibid.*,

table 1.16). These data offer no support for the conventional view; in contrast to Europe, wage flexibility should have protected low-skilled US workers from relatively high unemployment.

Nor does the evidence support the related prediction, that the unemployment problem is driven by the less skilled. While the OECD *Jobs Study* concludes that ‘the labour market situation for low-skilled workers, as measured by educational attainment, declined over the 1980s relative to that of more skilled workers’ (ibid., p. 41), the same data show that high-skilled unemployment rates also increased over the 1980s for every nation they consider except Japan, for both men and women. For example, the unemployment rate for high-skilled (‘upper secondary or higher’) workers in France increased from 2.6 in 1979 to 4.1 per cent in 1990; in Germany, the increase in this rate was even sharper, from 1.8 in 1978 to 5.0 in 1987. (ibid., table 1.16).

There is even less support in the more comprehensive data for male workers assembled by Nickell and Bell. Seven of the eight nations for which they present data do not even show an increase in the ratio of low- to high-skilled unemployment over the 1979–93 period, and where low-skill unemployment increased, so did high-skill unemployment (Nickell and Bell, 1996, table 1). France shows an upward trajectory in the skill ratio through 1990 and in the low-skilled unemployment rate over the entire period. But even here, in the rigid labor markets of France, the level of low-skilled unemployment is comparable to or below the rates of the more flexible markets of Canada, the UK, and the United States (the high overall unemployment rate in France is due to exceptionally high rates for women).

Of course, as Glyn and Salverda emphasize, low-skilled workers are undoubtedly made worse off relative to high-skilled workers when both experience increasing unemployment rates, since the probability of getting a job for low-skilled workers becomes much lower (Glyn and Salverda, 1999). But this fact does not support the conventional view that the unemployment problem is due to rigidities in low-skilled labor markets. Comparing unemployment rates by education level, an International Labor Organization (ILO) report concluded that

While it is true that unemployment affects the least skilled workers disproportionately, it is difficult to attribute this phenomenon to a shift in the demand for labour towards higher skills, for if this were so the rise in unemployment of the unskilled should have been accompanied by a real shortage of skilled labour. But this has not been in evidence, since the rise in unemployment of skilled workers has also been observed . . . *Skill shortages do not appear to have contributed significantly to the rise in unemployment.* (ILO, 1997, pp. 52–3, emphasis added)

In sum, while the least skilled have borne the brunt of rising unemployment, the trends by skill level do not, by themselves, demonstrate that a ‘collapse in demand’ for low skilled workers is at the heart of the European unemployment problem. Countries with rising unemployment tend to also experience substantial increases in high-skilled unemployment. As Stephen Nickell has concluded: ‘Overall, therefore, there is no evidence that these skill shifts have made a substantial contribution to the rise in European unemployment . . .’ (Nickell, 1997, p. 55). Indeed, the data are perfectly consistent with an alternative story, recently advanced by the International Labor Organization, that ‘in an environment of widespread unemployment, trained workers apply for jobs for which they are overqualified and, given the choice, firms recruit them first, with the natural outcome that unemployment is transferred to the least skilled workers’ (ILO, 1997, p. 53).

Employment Rates by Skill

Drawing conclusions from changes in unemployment rates can be misleading because, faced with worsening job prospects, workers may drop out of the labor force altogether. For this reason it may be more revealing to evaluate the demand shift/rigid labor markets hypothesis by comparing the growth in employment-population rates by skill across countries. Employment rates should be lowest among the least skilled, which is generally true and not something particularly new. But the demand shift/rigid labor markets prediction is different: it suggest that the less-skilled will tend to have the lowest employment rates, and the gap in employment rates between the least and most skilled will tend to be the greatest in countries with labor market institutions that prevent downward wage flexibility. The reasoning is, again, that without wage adjustments, the least skilled will be priced out of their jobs.

Comparing employment rates by skill across different OECD countries using different methodologies, both Nickell and Bell and Card, Kramarz and Lemieux found little support for this fundamental prediction of the conventional wisdom. Comparing growth in employment rates for ‘skill’ groups defined by age and education for the US, Canada, and France, Card et al. leaves no doubt about the lack of support for the conventional view: ‘Taking the evidence for the United States, Canada, and France as a whole, we conclude that it is very difficult to maintain the hypothesis that the ‘wage inflexibility’ in Canada and France translated into greater relative employment losses for less-skilled workers in these countries’ (Nickell and Bell, 1995, pp. 40–62; Card et al., 1995, p. 3). Similar results have been found for Germany and Sweden (Edin et al., 1996). Indeed, Krueger and Pischke point out that ‘If demand fell for less skilled workers, we would

expect to find employment declining most among the lowest wage groups; instead, there appears to be little relationship' (Krueger and Pischke, 1997, p. 13).

These studies attempt to compare skill groups using educational attainment levels, a difficult task – after all, how comparable is a 'high school degree' in France, the UK, Sweden, Germany, and the US? To deal with this problem, Andrew Glyn has examined employment rates for different quartiles of the education distribution. Again, the employment rate gap between the most and least educated should be greatest in the most rigid labor markets. Glyn's (2001) analysis of employment differences using this measure of skill shows that for 25–64-year-old men, the employment rate skill differential (the most skilled quartile rate less the least skilled rate) for the US was 14.6 percentage points in 1999, lower than that for France (19.3 points in 1998) and the Netherlands (17.7 points in 1998), but higher than Switzerland (11.9 in 1998), Sweden (13.4 in 1997) and West Germany (14.3 in 1996). Usually placed at the flexible end of the spectrum, the UK shows a much higher employment rate gap than many European welfare states (23.2 in 2000).⁴ In sum, Glyn's results show that, while the employment rate for the less educated is relatively high in the US, it is also quite high for the most educated workers, and there seems to be little association across countries between employment rates by 'skill' and the strength of protective labor market institutions.

EUROPEAN UNEMPLOYMENT: THE WELFARE STATE AS CULPRIT

Central to the conventional wisdom is the view that what distinguishes the US unemployment experience from the European is the relative rigidity of the European labor market. This rigidity is blamed on 'labor market institutions' that reduce the demand for less skilled labor and reduce the incentives of less-skilled workers to search for jobs. As Blanchard and Wolfers note, 'With the persistence of high unemployment for now more than two decades, explanations based on adverse institutions ('labor market rigidities') have become steadily more popular' (Blanchard and Wolfers, 2000).

A critical problem with the simple rigidities account is that most countries suffering high unemployment in the 1980s and 1990s had these adverse institutions back in the 1960s, when unemployment was well below that of the United States. The solution in the mainstream literature has been to explain the general evolution of unemployment over time by shocks (e.g., the productivity slowdown, oil price hikes, and declining labor demand due to

skill-biased technological change), while ‘cross-country variation’ in unemployment rates is accounted for by ‘employment-unfriendly’ labor market institutions. In the language of mainstream economics, the European welfare state ‘adversely affects the dynamic responses to economic shocks and to increasing turbulence in the economic environment.’ (Lungqvist and Sargent, 1998, p. 517).

Given the focus of this chapter, I only note here that the ‘shocks’ part of this conventional wisdom is not entirely convincing. Perhaps the biggest problem concerns timing. Why did productivity and energy price shocks that took place in the 1970s not translate into a US-Europe unemployment gap until the late 1980s and early 1990s? Indeed, German and Swedish unemployment rates were below the US rate until well after German unification and the Swedish macroeconomic crisis of the early 1990s.

Taking into account a variety of shocks to the developed world, has the case been made that differences in employment performance since the early 1980s are attributable to institutions that interfere with competitive market processes? Not only should these adverse labor market institutions account for the cross-national pattern of unemployment, but they should do so over the course of the last two decades of high unemployment, including the late 1990s convergence (see Figure 7.5). The conventional wisdom answers this in the affirmative. As a major OECD report puts it, ‘Developments in structural unemployment over the 1990s to a large extent reflect the progress made in implementing the OECD Jobs Strategy’ (OECD, 1997a, p. 12). At the core of the Jobs Strategy is the adoption of the ‘American model’ of highly competitive labor markets.

Absent a prior belief in the labor market rigidity story, the empirical case against ‘employment-unfriendly’ labor market institutions as the source of the unemployment problem seems remarkably unconvincing. As noted above, Figures 7.1a and 7.1b show a number of central and northern European nations with highly developed welfare states (Sweden, Austria, Switzerland, West Germany, and Norway) with lower average unemployment rates than the US in both the 1983–88 and the 1989–94 periods. And Figure 7.2 shows the US improved its position in the mid-1990s, but by 2001 Sweden, the Netherlands, Austria, Denmark, and Austria again had similar or lower unemployment levels than the United States. This comparable or superior employment performance in these European welfare states took place despite collective bargaining coverage rates between 77 to 90 per cent in the early 1990s (the US had an 18 per cent rate), unemployment benefit duration rates between 1.2 to 4 years (US: 0.5 year), and employment protection scores that ranged from 11 to 16 on a scale of 20 (US score: 1).⁵ To take just one example, apart from four years in the mid-

1990s, the US has consistently shown higher unemployment levels than the Netherlands.

There is an extensive literature that has attempted to link unemployment levels statistically with measures of various labor market institutions. The results appear quite impressive, with nearly all variables statistically significant with the right signs (effects are in the correct direction). For example, in a recent paper, Fitoussi et al. are able to account for 65 per cent of the variation in unemployment (1983–88) across 19 developed countries with the following variables (coefficient and t-statistic in parentheses): unemployment benefits replacement ratio (.12, 2.95), duration of unemployment benefits (.79, 2.13), union density and coverage (.08, 1.68), union coordination (-3.06, 2.35), employer coordination (-3.95, 3.46), and labor market expenditure (-.09, 2.14) (Fitoussi et al., 2000, table 6). While other measures, such as employment protection and taxation have been employed in some studies, both the theoretical justification and the empirical results for them are rather weak.⁶

It is worth noting that these kinds of tests are used in the literature to support the position that once the shocks pushed unemployment up, the persistence of high rates has been accounted for by ‘adverse’ labor market institutions. But in fact, much of the strength of these regressions – their explanatory power – is due to institutions that *reduce* unemployment. This can be seen above in the last three variables listed above. Institutions that promote coordination and help train workers and provide job search assistance are costly interventions in the labor market, but they tend to *lower* unemployment. The literature that uses empirical tests of this sort tend to conclude that welfare state institutions can provide a good explanation for observed cross-country patterns of employment performance on the grounds that ‘bad’ institutions explain the persistence of high unemployment, but do not distinguish the ‘good’ from the ‘bad’ institutions! For example, in the Fitoussi et al. test reported above, only the results for the two unemployment benefits measures lend support to the conventional institution-as-culprit story.

Second, the key measure of wage rigidity – union density and coverage – is not statistically significant, a common result. According to an OECD study, ‘evidence presented in this chapter does not show many statistically significant relationships between most measures of economic performance and collective bargaining’ (OECD, 1997a, p. 64). Other institutions can compress wages (reduce wage inequality) but there is little evidence that they have detrimental impacts on employment. For example, in cross-country tests, OECD researchers have concluded that minimum wage levels appear to have no effect on young adult employment, and while they find small negative effects on teenage employment, there is no evidence of any

association with unemployment. Since the greatest employment effects should be felt by youth, the conclusion regarding employment rates is telling:

It is important to note that these estimated effects are relatively insignificant in terms of explaining the large decline that has occurred in the teenage employment-population ratio in some countries . . . the substantial difference across countries in teenage employment trends can only be marginally attributed to differences in the evolution of minimum wages . . . (OECD, 1998, p. 48.)

If wage rigidity were as important as claimed by the conventional wisdom, unemployment and its change over time ought to be strongly negatively associated with earnings inequality, unit labor costs, and wage shares (in total income). In fact, as discussed above (Figures 7.3 and 7.4), the data shows no clear tradeoff between changes in unemployment and changes in earnings inequality. Nor is there a negative association for levels. For example, for 17 countries, the simple correlation coefficient between a standard measure of earnings inequality (D9/D1) and unemployment rates for the early 1990s was .101, a statistically insignificant relationship. Substituting an alternative inequality measure, the ratio of median earnings to the 10th percentile level (D5/D1), shows an even lower association (.085). Nor have aggregate wage costs been rising: wage shares in nearly all countries have been on a downward trend since the early 1980s (OECD, 1997, figure 10).

The two unemployment insurance variables are key measures of 'employment-unfriendly' labor market institutions. While the replacement rate and benefit duration variables are usually found to be statistically significant in the published literature, their importance and robustness are open to question. Table 7.1 presents simple OLS regression results for different measures of unemployment over the course of the last decade or so. Panel A shows results for 1989–94 for 20 countries. The institutional variables are the standard ones with one exception. The usual duration measure is subjectively defined, from 0 to 4. Spain provides an example of the difficulty of constructing such a measure. The standard Nickell-Layard data set assigns Spain a benefit duration value of 3.5 years. But as Munoz de Bustillo comments,

The 3.5 years of duration considered is only the maximum, subject to strict eligibility criteria and associated with a much lower benefit replacement ratio. In fact 40% of the unemployed receiving unemployment compensation have benefit duration of 1 year or less. On the other hand 44% qualify for a benefit duration from 1.5 to 2 years . . . (Bustillo, 2001).

This suggests that perhaps a 1.5 value would be more appropriate. Separate results are shown for a duration variable in which Spain's value has been changed from 3.5 to 1.5.

Panel A of Table 7.1 shows a fairly similar pattern to the Fitoussi et. al. results reported above. Union density is insignificant for both total and long-term unemployment. Coordination tends to reduce unemployment, but is insignificant for long-term unemployment. Active labor market policies also show the standard negative effect, but again the effects are not reliably measured (low t-statistics). Typically, the two unemployment insurance benefits (UIB) measures have the expected positive effects on total unemployment. The replacement rate is insignificant for long-term unemployment. A key result for our purposes appears in columns 2 and 5, where Spain's duration measure has been changed from 3.5 to 1.5. The coefficient, 't' statistic, and adjusted R squared all drop, with a substantial decline in the explanatory power of the total and long-term equation (over 10 percentage points in each case). As would be expected, the declines are slightly smaller if a value of 2 is used (not shown). Clearly, the results are highly sensitive to judgments about what duration value to attach to each country.

Panel B shows results for tests of the same equation for unemployment in 1995 and 2001, and for young female unemployment in 1995. For 1995, the standard institutional variables perform poorly. Our alternative duration measure is not significant at the 10 per cent level for 1995, and neither duration measure is statistically significant for young female unemployment in 1995 or for total unemployment in 2001. The predictive power of this key institutional measure declines sharply between the early and late 1990s.

But even in the 1980s and early 1990s, when the benefits duration measure appears to have been most strongly associated with unemployment, and ignoring questions concerning the construction of this variable, the evidence for this lynchpin of the conventional story is less convincing than at first glance. Emphasizing the centrality of this disincentive for job search, Layard et. al. write that 'It is noticeable ... that all the countries where long-term unemployment has escalated have unemployment benefits of some kind that are available for a very long period, rather than running out after 6 months (as in the USA) or 14 months (as in Sweden)' (Layard et al., 1994, pp. 59–62) This is certainly one way to view the data. But their figure can also be read to show that the nine countries with 'indefinite benefits' have widely varying propensities for long-term unemployment, with the share of the unemployed out of work for over a year ranging from 20 per cent (Finland) to over 70 per cent (Belgium). Through this lens, the fit between benefits and long-term unemployment in the mid-1980s does not look very close. Then, of course, there is the problem of causation. It would be

perfectly sensible for countries to make benefits available for longer periods the greater the long-term unemployment problem, particularly in the absence of other safety net programs. The extensive literature review and the regression results reported by Baker et al. (2003) strongly confirm the fragile nature of the cross-country evidence linking institutions to poor employment performance.

EUROPEAN UNEMPLOYMENT: AN ASSESSMENT

This review of the evidence suggests that the conventional labor market rigidity explanation of the European unemployment problem is not strongly supported by the data. The preoccupation by economists with labor market rigidity explanations has inhibited research that takes alternative explanations seriously. While the principal aim of this part of the chapter is a critical assessment of the mainstream account, here I briefly outline an alternative, potentially more convincing story.

Since unemployment increased dramatically and nearly universally across developed countries between the mid-1970s and mid 1980s, it is hard to imagine that productivity and energy price shocks did not play central roles. Faced with rising inflation, countries responded with tight fiscal and monetary policies, and most agree that these contributed to the high unemployment of the early 1980s. Relying on a vision of a textbook competitive economy, the standard story is that these shocks temporarily raised the 'natural' rate of unemployment (or NAIRU – the non-accelerating inflation rate of unemployment), which would have returned to its pre-shock levels but for adverse labor market institutions. As Ball puts it, 'the conventional wisdom holds that the NAIRU is unaffected by aggregate demand, and thus that demand does not influence long-run unemployment trends' (Ball, 1999, p. 189). Ball argues to the contrary, that the aggregate demand matters for both short- and long-run movements in the unemployment rate:

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.*, pp.190–91)

It is increasingly recognized that, in sharp contrast to US policy, under the leadership of the German Bundesbank and then the European Central Bank an increasingly integrated Europe was saddled with contractionary fiscal and monetary policy for much of the last two decades. Studies by Ball (1999) and Baker and Schmitt (1999) find empirical support for substantial aggregate demand effects on the cross-national pattern of unemployment. While the conventional account relies on adverse labor market institutions to explain the persistence of unemployment since the early 1980s, a more convincing

explanation might point to these policy-induced differences in aggregate demand, supplemented by the adverse timing of employment restructuring across sectors and demographic shifts, and country-specific idiosyncratic factors.

After the productivity and energy price shocks of the 1970s, the developed world experienced de-industrialization in the 1980s, but regions with large shares of agricultural employment (e.g., Spain, Portugal, Ireland, Italy, and France) were also faced with de-ruralization (Esping-Andersen, 1999, p. 102–3). At the same time, they experienced a late demographic bulge from the baby boom. The regression results summarized in Table 7.1 show that a high agricultural share of employment was significantly associated with high unemployment in every test – five of the 20 countries had far higher agricultural shares than the rest: Spain, Portugal, Ireland, Finland, and Italy.

While the demographic variable in these tests – the ratio of the 20–24-year-old population to the 25–59 population – approached statistical significance only for 1989–94 long-term unemployment, it consistently had the right sign (the higher the young adult population share, the higher the unemployment). Part of the reason for its weakness in these tests may be that there is a notable overlap between countries with a high agricultural share of employment and those with a high youth share of the population. In addition, countries with high agricultural shares show relatively small declines in the youth share over this decade: while the ratio of 15–19 to 25–59-year-olds dropped dramatically in the US from 21.2 per cent to 14.6 per cent between 1980 and 1990, Ireland saw a decline from 25.4 per cent (1980) to just 23.4 per cent (1990), Spain's teen ratio fell from 20 per cent to 19.3 per cent, Italy's from 17.8 per cent to 16 per cent, and France's from 17.9 per cent to 16.4 per cent.⁷

In a simple regression for unemployment in 1997 (not shown), three demographic and demand variables accounted for over half (54 per cent) of the unemployment variation across 20 countries: the 1990 young adult share of the population (positive and significant), the 1990–97 real interest rate (positive and significant), and the 1990–97 change in investment spending (negative and significant).⁸ No combination of labor market institution variables came close to this explanatory power for the 1997 unemployment rate. An adequate accounting of unemployment levels and changes over time would also have to include country-specific events, such as the economic and political restructuring of Spain after Franco's death, German unification, the Swedish fiscal crisis, and the effects of the Soviet collapse on Finland.

In sum, the empirical evidence surveyed above, coupled with the fact that there has recently been a dramatic decline in unemployment rates across Europe to levels approaching or even below that of the US (Figure 7.2), points to the need to move beyond the simple labor market rigidity story. Of

course, labor market institutions may have had adverse employment impacts, but the available evidence offers little support for the conventional wisdom among economists and many policy makers that high unemployment in the OECD countries can be explained by labor market rigidities.

NOTES

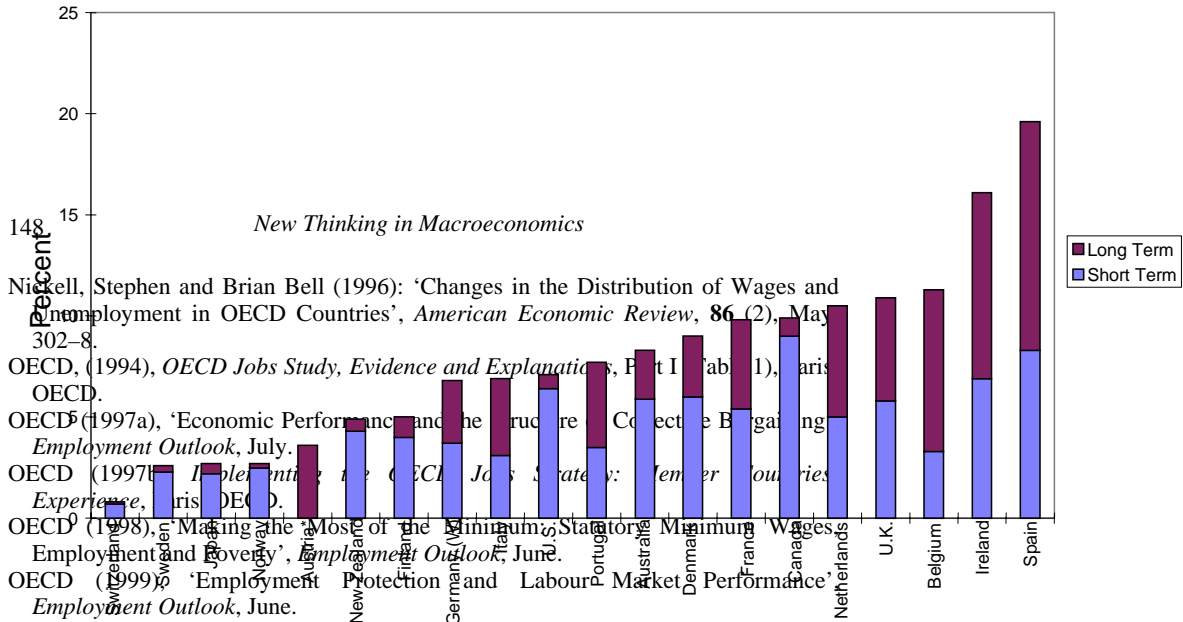
1. This is a revised version of parts of 'Increasing Earnings Inequality and Unemployment in Developed Countries: Markets, Institutions and the 'Unified Theory', (Howell, 2002). I thank Friedrich Huebler for his outstanding research assistance.
2. Figure 7.3a uses unemployment data by skill for males from Stephen Nickell and Brian Bell, who define skill categories differently for different countries (e.g., across educational attainment categories in some cases, across high and low skill occupations in others). In contrast, Figure 7.3b covers all workers and uses skill categories defined consistently across countries by educational attainment from the OECD.
3. Since the problem is held to lie in the labor market as a result of skill-biased demand shifts and institutional rigidities that work against the least skilled, we should not see rising unemployment rates for skilled workers. Indeed, a queuing story (see Thurow, 1997; ILO, 1997) is perfectly consistent with a rising ratio of low- to high-skilled unemployment even if a downward demand shift afflicts some group of high skilled jobs. If displaced high-skill workers get preferential treatment in competition for lower skilled jobs, 'bumped' lower-skill workers may be left to bear the brunt of the unemployment. Consequently, unambiguous empirical support for the demand-shift story requires not just evidence of a secular rise in the ratio of low to high skill unemployment rates, but a rise generated from rising low-skill rates in the presence of stable or declining high skill unemployment.
4. See Glyn (2001). In addition, it is likely that part of the high employment rate gap in many European countries stems from a generous pension system that encourages retirement before age 60. If this generosity has a greater impact on the employment rates of the less skilled, as I would suspect, limiting the data to those under 60 would tend to reduce the employment rate gap in the strong welfare state countries, leading to some convergence towards US levels.
5. These data come from various OECD documents and appear in Tables 1 and 2 of Howell et al., 1998.
6. As Blanchard and Wolfers (2000, C13) note, 'employment protection both decreases flows of workers through the labour market, and increases the duration of unemployment . . . the effect of lower flows and higher duration on the equilibrium rate itself is ambiguous'. According to an OECD study employment protection legislation 'has little or no effect on overall unemployment, but may affect its demographic composition' (OECD 1999, p. 50). As for taxation, we again cite Blanchard and Wolfers (2000, C13): 'Taxes which by their nature apply equally on the unemployed and the employed, such as consumption or income taxes, are likely to be roughly neutral. And if the unemployment insurance system tries to achieve a stable relation of unemployment benefits to after-tax wages – a reasonable assumption – even payroll taxes may not matter very much.'

7. Calculated by the author from the UN's Women in Statistics database, generously provided by John Schmitt.
8. The investment and interest rate data come from table 8 of Stanford, 'Canadian Labour Market Developments in International Context: Flexibility, Regulation, and Demand,' manuscript, CSLS Conference, Ottawa Canada (April 1999).

REFERENCES

- Atkinson, Anthony (1998), 'The Distribution of Income in Industrialized Countries', paper presented at the symposium 'Income Inequality: Issues and Policy Options,' the Federal Reserve Bank of Kansas City, Jackson Hole, Wyoming, 27–29 August.
- Baker, Dean and John Schmitt (1999), 'The Macroeconomic Roots of High European Unemployment: The Impact of Foreign Growth', Washington DC: Economics Policy Institute.
- Baker, Dean, Andrew Glyn, David Howell and John Schmitt (2003), 'Labor Market Institutions and Unemployment: A Critical Assessment of the Cross-Country Evidence', in David R. Howell (ed.) *Unemployment and the Welfare State: International Perspectives on the Limits of Labor Market Deregulation*, New York: Oxford University Press; available at www.newschool.edu/cepa
- Ball, Laurence (1999), 'Aggregate Demand and Long-Run Unemployment', *Brookings Papers on Economic Activity*, **1**.
- Blanchard, Olivier and Justin Wolfers (2000), 'The Role of Shocks and Institutions in the Rise of European Unemployment: The Aggregate Evidence', *Economic Journal*, **110**, March: C1–C33.
- Blank, Rebecca (1977), 'No Easy Answers: Comparative Labor Market Problems in the United States Versus Europe', Northwestern University/University of Chicago Joint Center for Poverty Research Working Paper No. 188.
- Bound, John and George Johnson (1992), 'Changes in the Structure of Wages in the 1980s: An Evaluation of Alternative Perspectives,' *American Economic Review*, **82** (3), June: 201–32.

- Bustillo, Munoz de (2001), 'Spain and the Neoliberal Paradigm', Manuscript, Center for Economic Policy Analysis, New School University.
- Card, David, Francis Kramarz and Thomas Lemieux, (1995), 'Changes in the Structure of Wages and Employment: A Comparison of the United States, Canada, and France', Industrial Relations Section, Princeton University Working Paper #355. 3.
- Edin, Per-anders, Anders Harkman and Bertil Holmlund, (1996), 'Unemployment and Wage Inequality in Sweden', mimeo, Uppsala University.
- Esping-Andersen, Gosta (1999), *Social Foundations of Postindustrial Economics*, Oxford: Oxford University Press.
- Fitoussi, Jean-Paul, D. Jestaz, E. Phelps and G. Zoega (2000), 'Roots of the Recent Recoveries: Labor Reforms or Private Sector Forces?', *Brookings Papers on Economic Activity*, **1**.
- Glyn, Andrew (2001), 'Inequalities of Employment and Wages in OECD Countries', manuscript, Department of Economics, Oxford University.
- Glyn, Andrew and Wiemer Salverda (1999), 'Employment Inequalities', unpublished paper presented at the Levy Economics Institute, May.
- Haveman, Robert H. (1997), 'Equity with Employment', *Boston Review*, Summer.
- Howell, David R. (2002), 'Increasing Earnings Inequality and Unemployment in Developed Countries: Markets, Institutions and the "Unified Theory"', *Politics & Society*, **30** (3), June: 193–244.
- Howell, David R. and Friedrich Huebler (2003), 'Unemployment and Earnings Inequality in OECD Countries: Demand Shifts, Labor Market Institutions and the Unified Theory', in David R. Howell (ed.) *Unemployment and the Welfare State: International Perspectives on the Limits of Labor Market Deregulation*, New York: Oxford University Press, available at www.newschool.edu/cepa
- Howell, David R, Margaret Duncan and Ben Harrison (1998), 'Low Wages in the US and High Unemployment in Europe: A Critical Assessment of the Conventional Wisdom', Center for Economic Policy Analysis Working Paper No. 5, New School for Social Research (February).
- International Labor Organization (ILO) (1997), 'Chapter 3: Industrial Countries: Reversing the Drift From Full Employment', *World Employment 1996/97*, Geneva: ILO.
- Krueger, Alan B. (1993), 'How Computers Have Changed the Wage Structure: Evidence From Micro Data', *Quarterly Journal of Economics*, February: 33–60.
- Krueger, Alan, and Jörn-Steffen Pischke (1997), 'Observations and Conjectures on the U.S. Employment Miracle', NBER Working Paper No.6146, Cambridge, Massachusetts.
- Krugman, Paul (1994), 'Past and Prospective Causes of High Unemployment', in *Reducing Unemployment: Current Issues and Policy Options*, Kansas City, KS: The Federal Reserve Bank of Kansas.
- Layard, Richard, Stephen Nickell and Richard Jackman (1994), *The Unemployment Crisis*, New York: Oxford University Press.
- Lungqvist, Lars and Thomas J. Sargent (1998), 'The European Unemployment Dilemma', *Journal of Political Economy*, **106** (3), 514–50.
- Nickell, Stephen (1997), 'Unemployment and Labor Market Rigidities: Europe versus North America', *Journal of Economic Perspectives*, **11** (3), 55-74.
- Nickell, Stephen and Brian Bell (1995), 'The Collapse in Demand for the Unskilled and Unemployment Across the OECD', *Oxford Review of Economic Policy*, **11** (1), 40–62.



Nickell, Stephen and Brian Bell (1996): 'Changes in the Distribution of Wages and Unemployment in OECD Countries', *American Economic Review*, **86** (2), May 302-8.

OECD, (1994), *OECD Jobs Study, Evidence and Explanations*, Part I, Table 1), Paris: OECD.

OECD (1997a), 'Economic Performance and the Structure of Collective Bargaining', *Employment Outlook*, July.

OECD (1997b), 'Implementing the OECD Jobs Strategy: Lessons from Four Countries', *Employment Outlook*, Dec.

OECD (1998), 'Making the Most of the Minimum: Statutory Minimum Wages, Employment and Poverty', *Employment Outlook*, June.

OECD (1999), 'Employment Protection and Labour Market Performance', *Employment Outlook*, June.

Siebert, Horst (1997) 'Labor Market Rigidities: At the Root of Unemployment in Europe', *Journal of Economic Perspectives* **11** (3), Summer: 37-54.

Thurow, Lester (1997), *Generating Inequality*, New York: Basic Books.

Figure 1a
Unemployment in the OECD, 1983-1988

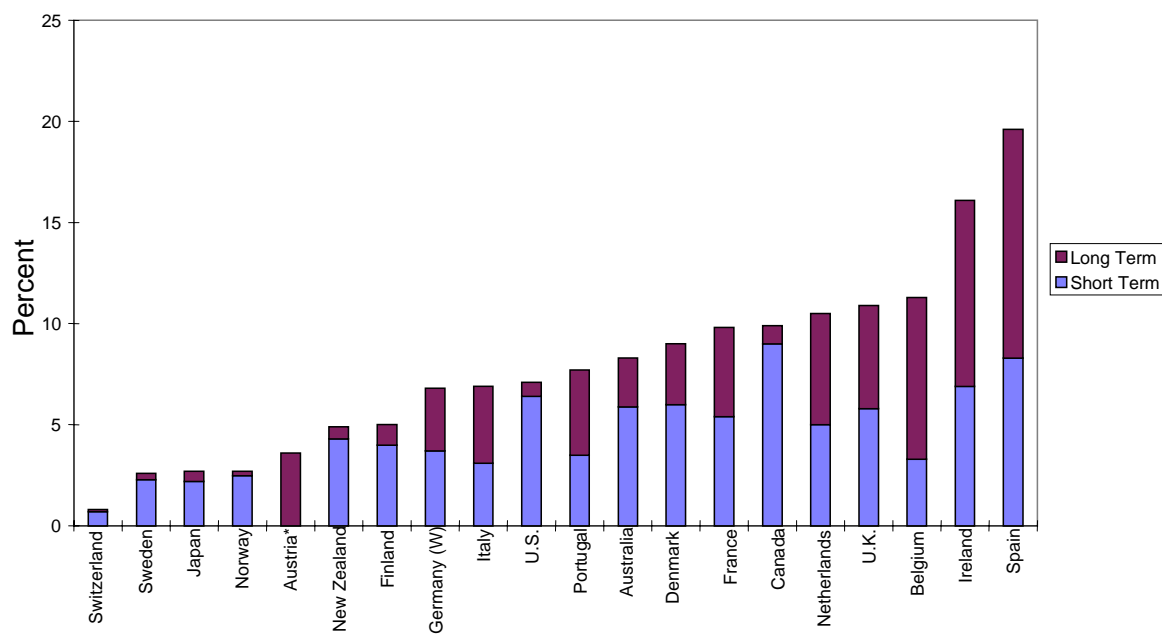


Figure 1a
Unemployment in the OECD, 1983-1988

Source: Nickell (1997)

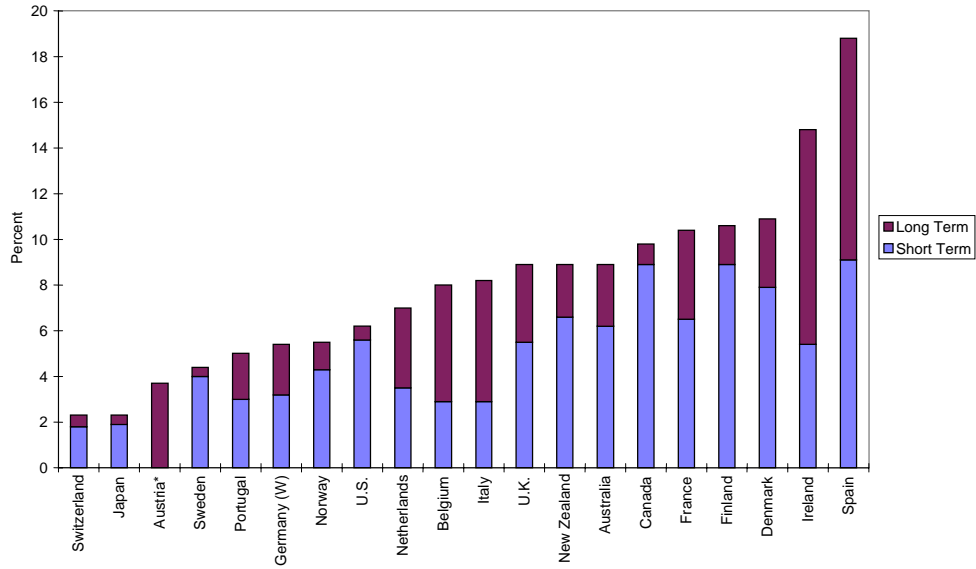


Figure 1b
Unemployment in the OECD, 1989-1994

Source: Nickell, 1997

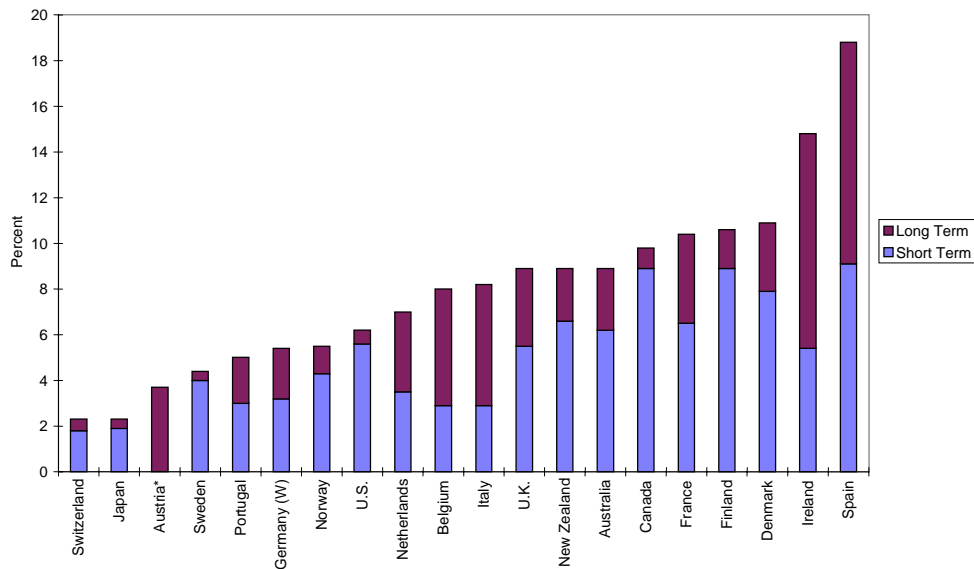
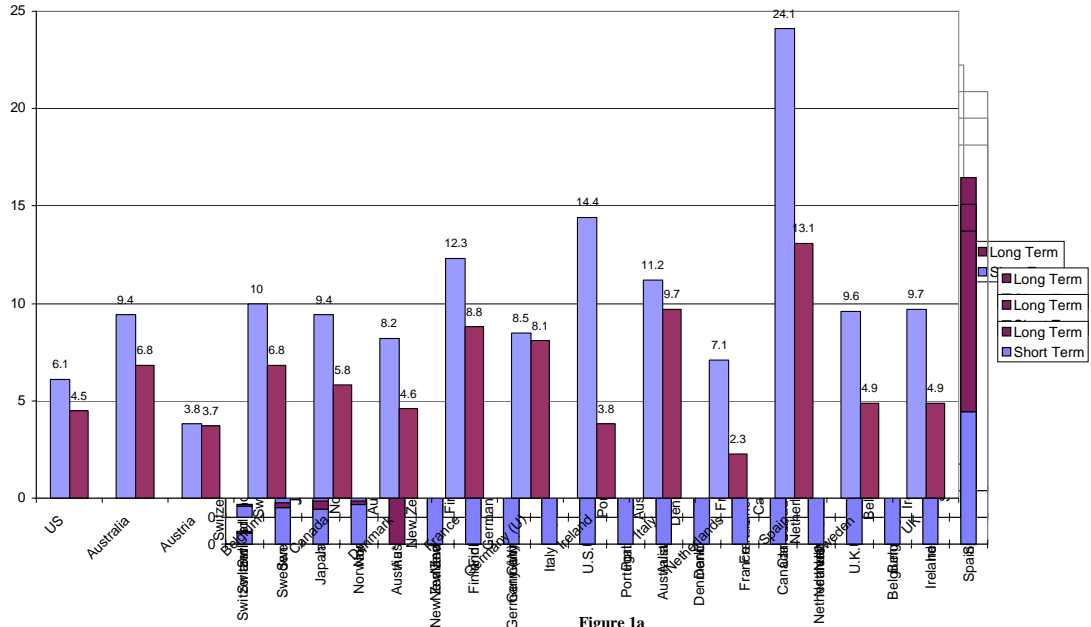


Figure 1b
Unemployment in the OECD, 1989-1994

Source: Nickell, 1997

Figure 2: Standardized Unemployment Rates, 1994 and 2001 (April)



Source: U.S. Bureau of Labor Statistics

Figure 1a
 Unemployment in the OECD, 1983-1988
 Unemployment in the OECD, 1983-1988
 Unemployment in the OECD, 1983-1988
 Unemployment in the OECD, 1983-1988

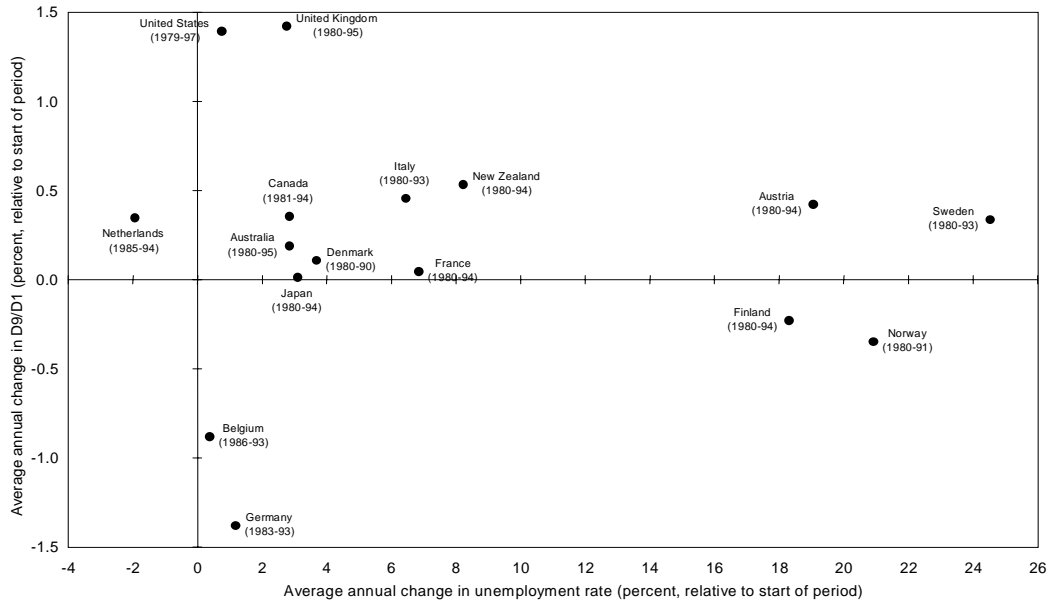
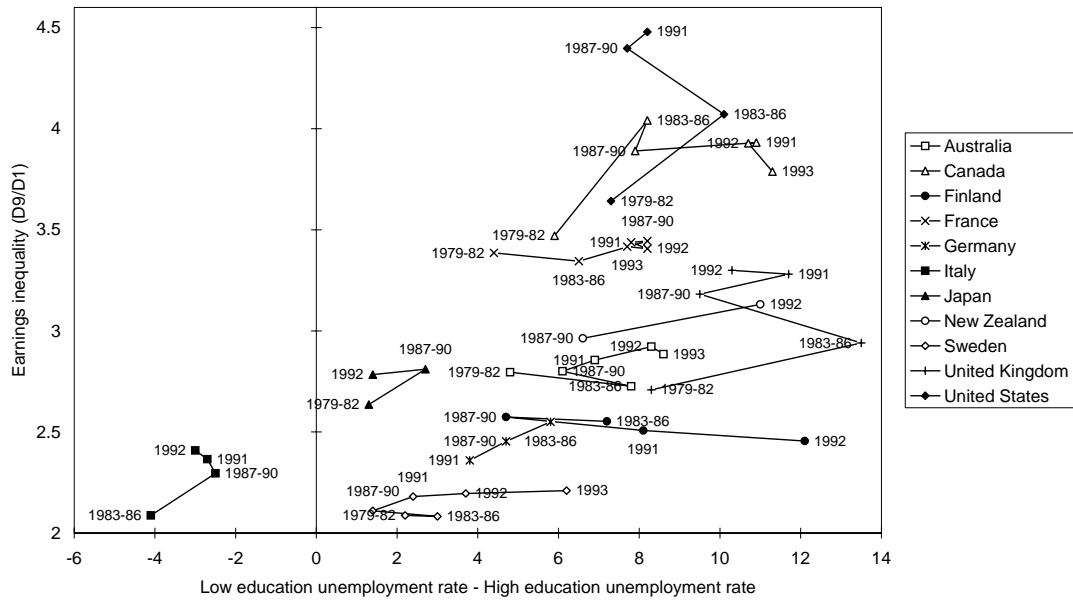


Figure 3: Unemployment Rate and Earnings Inequality
Average Annual Change (Relative), 1979-1997

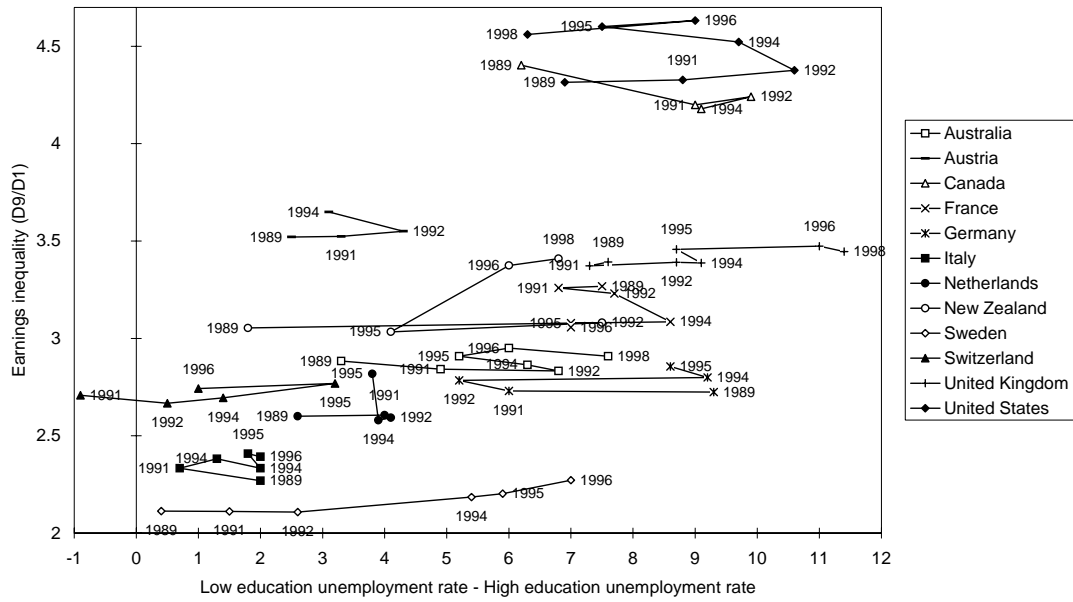
Sources: D9/D1: OECD Employment Outlook (1996). D9/D1 for United States: L. Mishel, J. Bernstein, J. Schmitt, The State of Working in America, 1998-99 (1999); D9/D1 for United States. Unemployment rate: OECD Economic Outlook No. 64 (1998).

Figure 4: Earnings Inequality and Relative Unemployment Rates by Education Level, Male Workers, 1979-1993



Data sources: see Howell and Huebler, 2003.

Figure 5: Earnings Inequality and Relative Unemployment Rates by Education Level, All Workers, 1989-1998



Data sources: see Howell and Huebler, 2003.

Table 1: Regression Results for Alternative Measures of Unemployment, 1989-2001

(t statistics in parentheses)

Panel A

	unemployment 1989-94			Long-term Unemployment 1989-94		
	(1)	(2)	(3)	(4)	(5)	(6)
union density, 1988-94 (%)	.029 (.73)	.022 (.46)	.035 (.72)	-.025 (.91)	-.033 (1.0)	-.021 (.69)
union/employer coord (2-6)	-1.03 (1.7)	-1.14 (1.67)	-1.19 (1.76)	-.045 (.09)	-.154 (.29)	-.077 (.16)
active labor mkt 1991 (%GDP)	-.078 (1.2)	-.08 (1.1)	-.079 (1.1)	-.015 (.34)	-.014 (.29)	-.019 (.4)
UB duration (years)	1.53 (3.3)			1.14 (3.66)		
UB duration Spain=1.5		1.36 (2.41)	1.16 (1.98)		1.1 (2.9)	.89 (2.4)
UB repl. Rate (%)	.09 (2.0)	.104 (2.0)	.11 (2.17)	.016 (.48)	.029 (.81)	.029 (.85)
high agric share (dummy)	5.13 (3.7)	5.7 (3.5)	5.0 (2.9)	3.84 (4.0)	4.36 (4.0)	3.6 (3.2)
20-24 pop. share, 1990 (%)			.7 (1.15)			.683 (1.73)
adj R2	.586	.47	.483	.579	.477	.552
N	20	20	20	19	19	19

Panel B

	unemployment 1995		young female unemployment 1995		unemployment 2001	
union density, 1988-94 (%)	-.031 (.61)	-.036 (.62)	-.197 (1.3)	-.194 (1.2)	-.056 (1.4)	-.056 (1.3)
union/employer coord (2-6)	-.53 (.7)	-.66 (.8)	1.03 (.47)	.76 (.34)	.42 (.72)	.34 (.55)
active labor mkt 1991 (%GDP)	.054 (.68)	.051 (.58)	-.08 (.34)	.073 (.3)	.04 (.63)	.038 (.57)
UB duration (years)	1.44 (2.54)		2.02 (1.2)		.74 (1.65)	
UB duration Spain=1.5		1.18 (1.7)		1.29 (.69)		.54 (1.0)
UB repl rate (%)	.076 (1.4)	.088 (1.4)	.026 (.16)	.035 (.2)	-.011 (.26)	-.006 (.1)
high agric share (dummy)	7.64 (4.5)	8.1 (4.1)	17.9 (3.6)	18.2 (3.4)	3.1 (2.3)	3.31 (2.2)
adj R2 N	.518 20	.41 20	.316 20	.265 20	.122 20	.02 20

Sources: Unemployment: unemployment 1989-94 and long-term unemployment 1989-94 (Nickell and Layard, 1997, Table 13); unemployment, 1995 (OECD Employment Outlook, 1998, Table A, p. 190); female youth (15-24) unemployment, 1995 (OECD Employment Outlook, 1998, Table C, p. 200-2); unemployment 2001 (bls.gov/pub/special.requests/foreignlabor).

Explanatory variables:

Union density and union/employer coordination (Nickell and Layard, 1997, Table 3);
 UIB duration and replacement, and active labor market policies (Nickell and Layard, 1997, Table 6);
 20-24/25-59 population share, 1990 (Women in Statistics Database, Version 4: United Nations Department of Economic and Social Affairs, Statistics Division);
 High agricultural share, 1980 (ILO, Key Indicators of the Labor Market, 1999).