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**Institutions, Aggregate Demand and Cross-Country Employment Performance:  
Alternative Theoretical Perspectives and the Evidence**

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## **Abstract**

In New Classical and New Keynesian thinking, the cross-country pattern of unemployment reflects prevailing equilibrium rates, which in turn are mainly explained by the protective labor market institutions that produce market rigidities. While this orthodox view has framed nearly all of the research that has addressed this issue, the evidence to date is not very compelling; recent work in the Keynesian tradition suggests that more attention should be paid to capital accumulation and monetary/fiscal policy. The central claim of this paper is that a still richer account requires embedding the Keynesian account in a comparative political economy framework to explain both levels of aggregate demand and the translation of demand to employment (and unemployment). Employment performance reflects the effectiveness of bundles of institutionalized practices related to firm strategies, labor relations, the welfare state, and macroeconomic policy. On this score the evidence is unequivocal: coherent institutional models grounded in high levels of social and political consensus can produce exceptionally low unemployment in labor markets characterized by low wage inequality and substantial income security.

## **1. Introduction**

During the postwar ‘golden-age’ of capitalism, the economies of the world’s richest nations produced jobs for nearly everyone who wanted one. In the early 1960s, unemployment rates for 19 OECD countries ranged from less than 1 per cent (West Germany, New Zealand, and The Netherlands) to around 5.5 per cent (the U.S., Canada and Ireland). Over the course of the next three 5-year periods, differences in unemployment rates across these countries remained small and the U.S. maintained its position as one of the OECD’s poorest performers. But the story changed dramatically in the decade after the mid-1980s: the median unemployment rate and cross-country differences in rates grew sharply and the U.S. became one of the top performers (Howell et al., 2007, Figure 1).<sup>2</sup>

This striking reversal in relative U.S. performance coincided with a revolution in macroeconomic thinking. In the postwar American Keynesianism of Samuelson, Solow and Tobin, government was called upon to play a central role in limiting unemployment through the manipulation of aggregate demand. But with the productivity collapse and stagflation of the 1970s, ‘New Classical’ theory came to dominate American macroeconomics and unemployment was now explained by labour market rigidities generated by

institutional and policy interventions. Any effort to reduce unemployment below its equilibrium (set by rigidities) would only produce accelerating inflation.<sup>3</sup>

A middle position has been occupied by 'New Keynesians', who acknowledge that labour markets are imperfect in important ways, so constructive roles can in principle be played by labour market institutions and public policy. But the equilibrium (or "natural") rate of unemployment rules here as well. As Mankiw explains, the source of persistent high unemployment reflects a high natural rate: "There are things that have been done to the labour market that either increase or decrease the natural rate, things like the minimum wage, unemployment insurance laws, labour training policies" (Mankiw, 2005, p. 441, see also Nickell et al., 2005). Whether New Classical or New Keynesian, belief that labor market flexibility is the answer to the unemployment problem is the 'overwhelmingly dominant perspective in the economics discipline' and that, as a result, 'there is a single optimal way of organizing economies' (Carlin and Soskice, 2009, p. 2). Keynes' critique applies today as it did in the early 1930s: '...(the heretics) reject the idea that the existing economic system is, in any significant sense, self-adjusting... *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, pp. 488-9; italics added).

While the recent empirical literature on cross-country patterns of unemployment has been almost exclusively framed by the orthodox rigidity view, a small recent literature has used Keynes' and Kalecki's emphasis on aggregate demand and distributional conflict as the point of departure. This 'Keynesian' literature can be roughly organized into two research programs, one on the effects of capital accumulation and the other on monetary and fiscal policy.<sup>4</sup>

This chapter argues that the empirical evidence to date offers much less compelling support for the orthodox rigidities explanation than is widely believed. At the same time, while recent Keynesian empirical work strongly suggests that more attention should be paid to the role of aggregate demand in determining persistent unemployment rate differences across countries, the focus on this literature on

capital accumulation and monetary/fiscal policy does not appear sufficient for an adequate account for cross-country differences in employment and unemployment rates. In short, measures like GDP per capita do not closely fit the pattern of cross-country patterns in unemployment, whether measured in levels or changes over time.<sup>5</sup>

This chapter suggests that a comparative political economy (CPE) framework can complement the Keynesian perspective to produce a far more compelling account of cross-country economic and employment performance. The key to the CPE perspective is the central role of institutional and policy 'bundles' for economic and employment performance. Following Hall (2007), political economy institutions must be designed to effectively address three closely interrelated problems: *the wage problem* – the challenge of keeping wages moderate enough to maintain price stability, trade competitiveness, and profitability (for investment), but high enough to maintain aggregate demand and social and political stability; *the employment problem* – the challenge of “securing levels of employment high enough to ensure national prosperity, while providing levels of compensation to those without work high enough to secure social peace” (p. 42); and *the productivity problem* – the challenge of economic efficiency, which requires that there are adequate levels and types of capital and labor and that each is deployed effectively, which in turn “depends on how well firms coordinate with other actors to secure skills, technology, finance, and the engagement of their employees” (p. 42-3).

These challenges are met in each country with a more or less unique bundle of institutions, including the labour relations system (how collective, coordinated and centralized?), dominant firm strategies (how coordinated or market-based?), welfare state programs (design and generosity?), public employment (size and purpose?), macroeconomic policy regimes (how discretionary?), and regulatory policy for labour, product and financial markets (how strict and for what ends?). If complementary, these institutional components of a nation's political economy form specific models, or 'varieties of capitalism' (Hall and Soskice, 2001; Hall, 2007; Amable, 2003, 2009). Social and political consensus helps

promote coherent institutional models, and more coherent models promote better employment performance. Like the narrower Keynesian aggregate demand perspective, bringing political economy institutions into the study of comparative employment performance has its roots in Keynes and Kalecki, who viewed the achievement of full employment as a political and institutional matter.<sup>6</sup>

The chapter is organized as follows. Since a great deal of research on cross-country employment performance in recent years has relied on regression tests to confirm either orthodox or Keynesian theoretical predictions, the next section raises some concerns about the standard indicators. Measures of labor market institutions are generally pretty poor, but even official OECD (or BLS) “harmonized” unemployment rates are not entirely comparable across countries. With this caution in mind, Section 3 considers what ‘common observation’ suggests about the orthodox predictions for employment performance and protective labour market institutions. Section 4 then offers a very brief assessment of the evidence for the mainstream labour market rigidities account. Section 5 provides a brief overview of the Left Keynesian case for the importance of aggregate demand via capital accumulation and macroeconomic policy. Section 6 suggests that recent work in comparative political economy should be seen as supplementing the Keynesian aggregate demand framework to tell a more compelling story about patterns of employment performance across countries. Section 7 concludes.

## **2. The Data: How Comparable are Harmonized Unemployment Rates?**

Research aimed at describing and explaining differences in employment performance across countries requires indicators that allow for meaningful comparisons. National statistical agencies conventionally group the working age population into three distinct, non-overlapping categories: the unemployed, the employed, and the inactive (or “out-of-the-labor-force.” The unemployed are “persons over a certain specified age who are without work, available for work and actively seeking work” (Sorrentino, 2000, p. 4), and the standard unemployment rate is measured as the unemployed share of

the labor force, in turn defined as the employed and the unemployed. The “employed” are those who work for pay for at least an hour in the reference week, and the employment rate is calculated as the employed share of the working age population. Working age individuals neither unemployed nor employed are allocated to the “out-of-the-labor-force” category.

Since the 1960s, OECD countries have adopted international standards that establish the criteria for who is “unemployed” based on household surveys. As data collection, processing methods, and criteria for “employment” and “unemployment” have converged across countries, both the OECD and the U.S. Bureau of Labor Statistics have produced “harmonized” (or “standardized”) series specifically designed to be broadly comparable across countries (Sorrentino, 2000). This is a big advance, but it should be noted that these consistent series go back to the 1960s and 1970s for only a handful of countries (see Howell et al., 2007).

Even when the series is fully “harmonized”, cross-country comparability can be complicated by a number of factors. Three such complications are briefly described to underscore the need for caution in taking differences in harmonized rates too literally as an indication of the ‘real’ unemployment problem.

The first concerns what is meant by employment. Since any kind of paid employment puts a person in the employment column, even if it is for just an hour a week, the same employment rate can mean very different magnitudes of “real” job opportunities. This affects the comparability of national harmonized unemployment rates since what passes for real paid employment may vary – even in response to identical questions - with social norms about work, the nature and extent of self-employment, unpaid family member ‘employment’, the informal labor market, social and family safety nets, and the quality and diligence of the interviewers.

The difficulty of comparing unemployment rates across vastly different economies and social systems is suggested by a comparison of three OECD countries: Mexico, the U.S., and Spain. Even as the Mexican economy collapsed in the 1980s and unprecedented numbers of workers crossed the border in

search of work in the U.S., the Mexican unemployment rate ranged from just 2.6 to 4.4%, lower than the 5.3 to 7.5% range for the United States (Fleck and Sorrentino (1994, Table 5). Under U.S. concepts, the Mexican rate would have been about 50-70 percent higher, but they point out that this would still leave Mexican unemployment at a relatively low level – and *below* U.S. rates (1994, Table 6). The explanation for such low rates goes to the heart of the inadequacy of the unemployment rate as an indicator of labor market performance: “Mexico’s low unemployment rates mask a large number of persons in unstable, marginal jobs. Thus, the rates reflect the need for persons to subsist through any work at all, rather than a situation of full employment.... Part-time work, marginal self-employment, and non-remunerated work in family businesses are frequently the only options for many workers in Mexico” (1994: pp. 3-4; see also Martin, 2000).

Spain’s (harmonized) unemployment rate, which was over 20 percent as recently as the mid-1990s probably did not reflect a level of labor demand for regular formal employment that was 4-5 times worse than Mexico’s in the mid 1990s. It is instructive that young people (ages 16-24) account for fully one-third of Spain’s unemployed, and nearly all of them live at home with their parents (Munoz de Bustillo, 2005). The lesson is that differences in levels of development, the role of the informal sector, the strength and nature of safety nets, and social norms are likely to result in substantial differences in both the meaning of “employment” (and hence “unemployment”).

A second problem concerns the construction of the unemployment rate, which has employment in the denominator. That the unemployment rate can depend on the incidence of (tabulated) employment rather than the magnitude of unemployment is simply a function of the fact that employment is in the denominator ( $U/U+E$ ): even if the number of unemployed is identical in a population of the same size, relatively more employment in one country than another will produce, by definition, a lower unemployment rate since the denominator (the labor force) will be larger.

For an example, consider the nearly universal view that French youth unemployment has been catastrophically high for decades and that is a striking example of the superiority of U.S. labor market performance. But hardly any French students ages 15-19 are employed while enrolled in school, and this has been the case independently of the tightness of the labor market – French teens did not work while in school during the full employment years of the 1960s. Under these conditions, an unemployment-to-population rate is more appropriate. For example, in 2004 French and U.S. male youth unemployment-to-population rates were nearly identical, 8.6 and 8.3 percent (see Howell and Okatenko, 2010). The lesson is that differences in unemployment rates may reflect differences in employment, not unemployment.

A third problem concerns how those not employed are counted – either as inactive or as unemployed. For example, the difference between French and U.S. labor markets for prime age workers is not to be found in the employment rates but in the *labor force status of those not employed* – a higher share of the non-employed in France report themselves as unemployed, while U.S. nonemployed prime-age workers do not participate in the labor force. This is important both because it directly challenges the conventional wisdom that the source of high French unemployment is the shortage of job opportunities. Schmitt and Wadsworth (2005) attribute much of the drop in U.K. unemployment in the 1990s to the rise in inactivity.

These considerations have obvious implications for the meaningfulness of the macroeconomic tests, which are entirely dependent on the reliability of small differences in the variables. The remainder of the chapter makes use of standard unemployment and employment indicators on the conventional assumption that they are sufficiently comparable for meaningful analysis, but the relative standing of countries should be viewed with caution, and skepticism should increase with the gap in economic development between countries, social norms regarding employment, and differences in family and social safety nets.

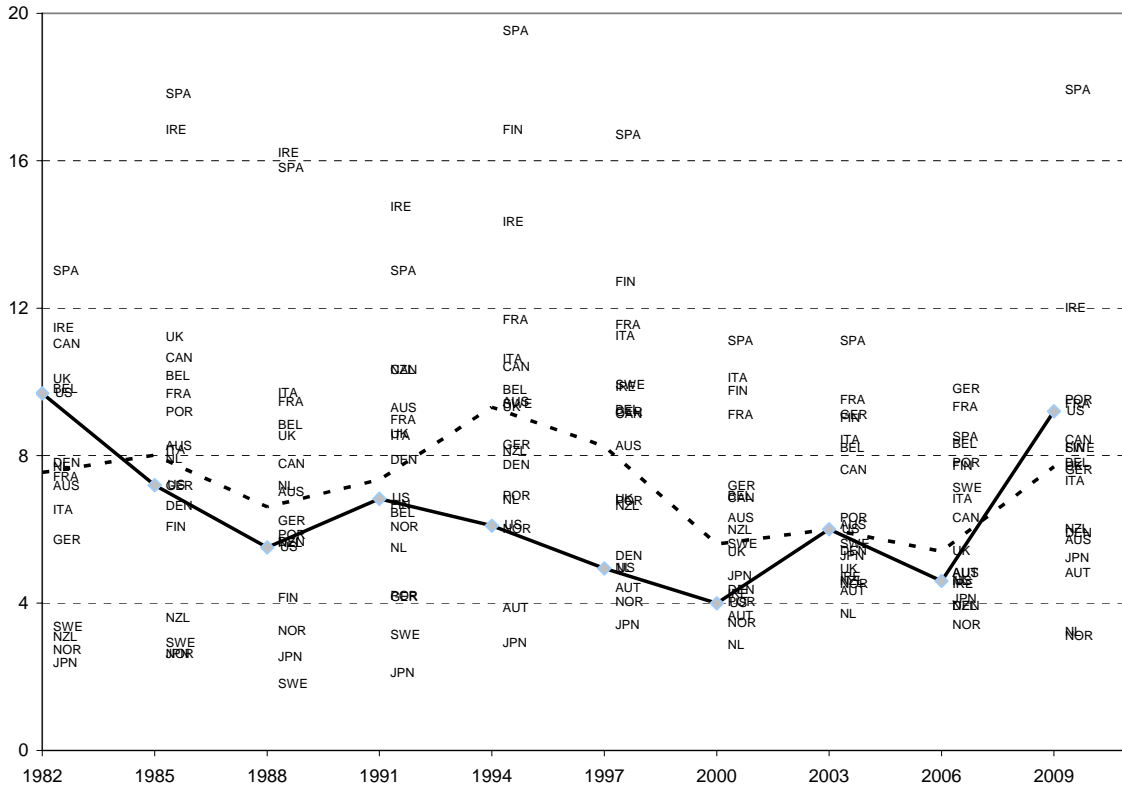
### **3. What does 'common observation' show?**

Among the 20 or so most developed OECD countries, it was not until the late-1980s that the U.S. began to show better than average employment performance. Figure 1 shows that between 1982 and 1991 the U.S. unemployment rate was only slightly below the median. This is quite unlike the early to mid 1990s, which saw rapidly declining U.S. rates and a sharp divergence with the European median. But convergence can be observed in the late 1990s and Figure 1 indicates that by 2003 the U.S. and the OECD median were identical and that they have tracked each other closely since. In contrast to the conventional view that U.S. price and wage flexibility should limit quantity adjustments in recessions compared to more regulated economies, Figure 1 shows just the reverse: U.S. rates have reached levels well above the OECD median in the two years since the start of the most recent crisis.

Figure 2 shows a divergence in employment rates between the U.S. and the OECD median beginning in the early 1980s, but it also clearly indicates that the gap was driven by rising rates for the U.S., not by a falling OECD median. In contrast, the 2000s show strong convergence, due both to a declining U.S. rate and a rising OECD median.

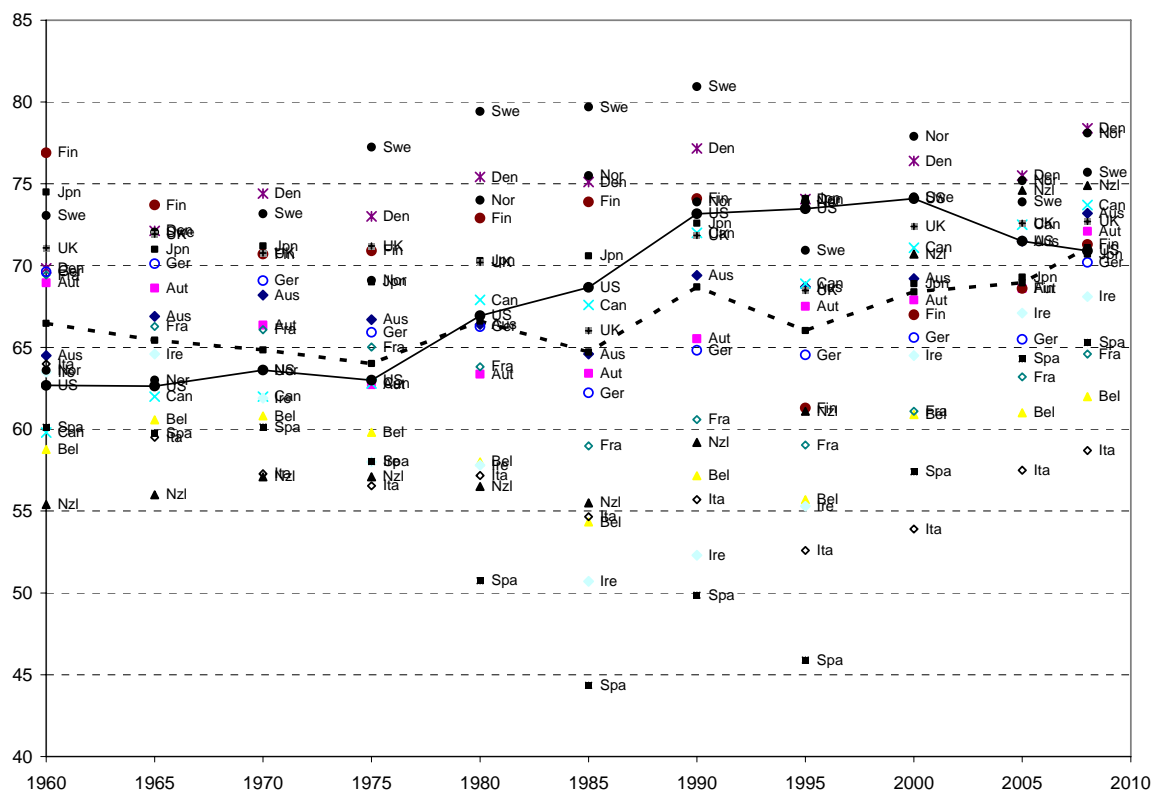
**Figure 1: Harmonized Unemployment Rates for 19 OECD Countries, 1982-2009**

(3-year intervals; solid line: U.S.; dotted line: the median)



Source: Standardized Unemployment Rates, downloaded from the OECD.

**Figure 2: Employment-Population Ratios for 19 OECD Countries, 1960-2008**  
(5-year intervals; solid line: U.S.; dotted line: the median)



Source: employment rates, downloaded from the OECD.

Does employment performance within Europe show an obvious relationship to differences in labour market regulation and benefit generosity? Table 1 organizes countries into three groups of six: liberal, high unemployment Europe and low unemployment Europe. The Table indicates that while both of the European groups have much greater levels of social protection and regulation (rows 4-8) and much higher tax revenue shares (row 10), only the conservative/corporatist economies of 'high-unemployment Europe' report worse employment performance than the liberal economies. Indeed, on both unemployment and employment rates, the low unemployment European welfare states show, on average, superior labour market performance to the liberal ones (rows 1-3), and they do so with much lower wage inequality (row 9).

**Table 1: Employment and Institutional Patterns across country groups**

	Six Liberal Economies	Six High Unemployment Euro Countries	Six Low Unemployment Euro Countries
1. Unemployment Rate 2004 (%)	5.2	9.1	5.0
2. Employment Rate 2004 (%)	70.8	62.6	73.7
3. Employment Rate: <HS (%) (% <High School Educ. in pop)	59.4 (27)	56.0 (38)	63.9 (23)
4. Employment Protection Legislation 2003 (Index)	1.2	2.6	2.2
5. Unemployment Benefits – Net Replacement Ratio 2002 (%)	52	72	77
6. Trade Union Membership 2000 (% employees)	26	36	47
7. Collective Bargaining Coverage 2000 (% of employees)	36	83	76
8. Co-ordination of Bargaining 2000 (index)	1.7	3.8	3.9
9. Wage Differentials: ratio of median wages to 10 <sup>th</sup> decile 2000	1.9	1.6	1.5
10. Tax Revenue as % GDP 2004	32	41	43
11. Active Labour Market Policies 2004 (% of GDP)	0.5	1.0	1.2

Source: See Howell et al. (2007). Data are mean values for country groups. Liberal economies: Australia, Canada, Ireland, New Zealand, UK, USA; High unemployment Europe: Belgium, Finland, France, Germany, Italy, Spain; Low unemployment Europe: Austria, Denmark, Netherlands, Norway, Switzerland, Sweden.

Sources: Rows 1-3: *OECD Employment Outlook 2005* (Tables A, B, D).

Rows 4: *OECD Employment Outlook 2004* (Table 2 A2).

A sharply different perspective on what ‘common observation’ shows is offered by Nickell’s ‘ticks and crosses’ analysis (Nickell, 2003, 2006; Layard et al., 2005, Introduction).<sup>7</sup> He contends that changes in unemployment across countries are nicely explained by changes in some key employment-unfriendly labour market institutions. Nickell notes that it is an extremely simple, “back of the envelope” exercise, but it has been remarkably influential. Indeed, it takes up much of the new introduction to the 2<sup>nd</sup> edition of Layard et al’s important text (2005), and is the only empirical evidence cited in St. Paul’s *Journal of Economic Perspectives* article to support the strong conclusion that the pattern of unemployment across Europe is wholly explained by labour market rigidities (St. Paul, 2004, p. 53).

Nickell makes the important point that the problem of European unemployment has for some time been concentrated in 'the big four': France, Germany, Italy and Spain. His method is to identify 'good' and 'bad' institutional changes for nine measures and 20 countries over the 1980s and 1990s. The objective of the scorecard exercise is 'to see how these institutional variables have changed over time and what these changes can tell us about why the European Big Four countries have performed less well than most other countries on the unemployment front in the 1990s'. He interprets the results to lend strong support for the orthodox view: 'We may reasonably conclude that the countries which had very high unemployment in the early 1980s and still have high unemployment today simply have too few ticks and/or too many crosses'.

If this is so, one might suppose that the big high unemployment countries should be located at the far negative end of the Nickell rigidity spectrum. But it turns out that only France fits the prediction, and according to Nickell's scorecard, both Austria and Switzerland – two consistently low unemployment countries – should have shown the same dismal performance as France. The three other high unemployment countries (Germany, Spain and Italy) get the same scores in the middle of the distribution (0 to 1) as Norway and the U.S. If Nickell's assessment of institutional changes is correct, the Big Four unemployment countries are not identified, and it does *not* seem reasonable to conclude that the European unemployment problem has simply been too few ticks (good changes) and too many crosses (bad changes).

#### **4. The Orthodox View: the problem is labor market rigidities**

##### *Theory and predictions*

Keynes replaced the classical focus on labour market flexibility with the adequacy of aggregate demand – in a monetary economy characterized by profound uncertainty, consumers and capitalists could effectively go on strike, not spending enough to keep offices, factories running and workers employed. In a Keynesian

world of unemployment-inflation tradeoffs, policy makers had some room for maneuver. In contrast, in the more rigid vision of New Classical and New Keynesian thinking, long run levels of unemployment gravitate around the equilibrium rate, which is set by the rigidities imposed by labor market institutions and policy interventions designed to protect workers from competitive outcomes (e.g., see Nickell, 2006, p. 24). As opposed to the 'Nairu theory', which is consistent with the Keynesian vision, Stockhammer (this volume) calls this rigidity account the 'Nairu story.'

Three protective labour market institutions are believed to stand in the way of efficient job matching and wage flexibility: unemployment benefit generosity, employment protection, and collective-bargaining (union density and coverage). Two broad empirical predictions directly follow. First, we should observe persistent high unemployment in countries with high real wages and a highly compressed wage structure. Second, since these wage outcomes are produced by protective labour market institutions that prevent the labour market from functioning in the textbook competitive fashion and quickly pricing workers back into jobs, cross-country macroeconometric tests should produce compelling evidence of the employment-unfriendly effects of these key institutions.

#### *Wage compression and inequality-unemployment tradeoffs*

At the heart of the orthodox story is wage rigidity – workers are not able, or have little incentive, to price themselves into employment due to protective labour market institutions. As Horst Siebert (1997, p. 45) explains, '[a] lower degree of wage differentiation indicates that the wage rates do not completely fulfill their function of bringing about the necessary adjustments to a new equilibrium with more employment; then, as the alternative to adjusting the price of labour, adjustments take place via changes in the quantity of employment'. Given how poorly measured even the much improved OECD institutional measures are (see Howell et al., 2007), it is surprising how little attention has been paid to tests that would directly estimate, first, the effects of institutions on labour costs, and second, the effects of labour costs on

employment and unemployment. According to James Heckman (2007, p. 2), 'The only valid index of the effect of institutions on the labour market is the cost of labour... it would be more constructive to quantify the effects of the *entire edifice* of labour market institutions on demand and supply of labour through their effects on a single measure – the labour cost schedule' (italics in the original).

Apart from some provisional work that appeared in the OECD's *Jobs Study* (for an assessment, see Howell et al., 2007), there has been hardly any attention paid to direct labour costs. But the orthodox prediction is both straightforward and testable. If unemployment is due mainly to wage compression generated not by the skill distribution but by labour market institutions, there should be compelling evidence of tradeoffs between various measures of employment performance and earnings inequality.<sup>8</sup>

There is, in fact, little direct evidence of employment-earnings tradeoffs. Howell and Huebler (2005) examined 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 found no evidence of these predicted tradeoffs in any of these exercises.

If wage rigidity is a major source of the unemployment problem, the underlying reason must be that the absence of downwardly flexible wage rates has undermined employment growth. Comparing employment rates by skill across different OECD countries using different methodologies, Nickell and Bell (1995) and Card et al. (1999) find no support for the tradeoff prediction. In their study of the U.S., Canada, and France, Card et al. conclude that '[t]aking 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'. Similar failure of the evidence to support the tradeoff view can be found in Glyn (2001) and Krueger and Pischke (1997). In a case study of the U.S. and the U.K., Schmitt and

Wadsworth (2005) find that the labour 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.

#### *The econometric evidence on institutions and unemployment*

An increasingly sophisticated literature has developed that has attempted to confirm the orthodox position that the equilibrium unemployment rate will vary across countries in accordance with the relative rigidity of the labour market as measured by various protective labor market institutions. The most influential early econometric work was produced by Layard et al. (1991), followed by several studies by OECD researchers (Scarpetta, 1996; Elmeskov et al., 1998). The mainstream consensus is not just that the levels of these indicators (generosity of benefit, strictness of employment protection, extent of collective bargaining) matter (Nickell, 1997), or that the interplay between levels economic ‘shocks’ matters (Blanchard and Wolfers, 2000), but that changes in ‘employment unfriendly’ institutions can explain the evolution cross-country unemployment rates, and would do better but for the crude nature of the institutional indicators (Nickell et al., 2005; Nickell, 2006; Blanchard, 2006).

Early on, Bean (1994) voiced doubts about the ability of cross country regression tests to provide meaningful measures of the effects of individual labour market institutions on employment performance, given the small number of observations (countries), the inherent difficulty of measuring the relevant institutions, the likely interdependence between all these institutions, and the likelihood that there will be many missing variables (see section 6 below). It can be argued that Bean’s prediction has stood the test of time. In his *Comment* on Nickell et al. (2003), Fitoussi (2003, p. 434) expressed strong skepticism about the performance of this literature: despite the explosion of published evidence, ‘Until now, there has been no convincing evidence that labour market institutions are responsible for the high level of unemployment in Continental Europe...’ (see also Freeman, 2000; 2005). Baker et al. (2005) called

attention to the evidently unrobust nature of the findings, a conclusion implicitly supported by the OECD's own survey (OECD, 2006, chapter 3) which found quite mixed results for many of the standard institutional measures. Nearly all published studies found strong support for the orthodox prediction, but each one did so with different results, despite reliance on much the same data, both within and across studies.

Responding to this state of the literature, the OECD commissioned an internal study that would rely on the most recently developed OECD institutional measures and pay special attention to issues of robustness (Bassanini and Duval, 2006). It is notable that the Bassanini-Duval study failed to confirm the orthodox predictions for any protective labour market institution (PMLI) other than unemployment benefit generosity (the tax wedge and a measure of product market regulation were also found to be significant in the expected direction).

Since the orthodox literature has placed particular emphasis on the destructive employment effects of unemployment benefit generosity, it is worth focusing on this institution. The OECD's (2006, chapter 3) survey covered 17 studies and concluded that '[t]he evidence from cross-country panel regression studies substantiates concerns that generous benefits tend to raise the equilibrium level of unemployment... In a majority of these studies, the impact of benefits on unemployment is highly significant across all alternative specifications...' (p. 59). Howell and Rehm (2009) evaluate the plausibility of this claim and argue that there are good reasons to be quite skeptical. First, the generosity indicator used in nearly every test, the OECD's gross replacement rate (GRR) is widely acknowledged to be a particularly poor measure. Howell and Rehm show that the GRR shows little or no correlation with the OECD's recently developed and far superior measures of net benefit rates (NRRs). Further, there is little or no simple correlation between a variety of measures of employment performance and either the GRR (for 1981-2005) or any one of a number of NRRs (for 2001-6, the only years for which they are available). Howell and Rehm's figures of GRR and unemployment trends by country show that for nearly every country

there is either no association, or the causation is reversed (a rising GRR follows rising unemployment). The lack of association is particularly striking for three of the Big Four unemployment countries (the exception is France, but here the causation appears reversed, running from high unemployment to higher benefits).

### **5. The Keynesian view: the problem is aggregate demand**

A Keynesian perspective on the general rise OECD unemployment would stress deficient aggregate demand and distributional conflict. The story goes something like this: growing worker bargaining power in the 1960s due to tight labour markets, stronger social safety nets, and rising labour militancy combined with oil price and productivity shocks in the 1970s to generate wage increases that were unwarranted by productivity increases; as profit rates fell, so did prospective profits ('animal spirits' collapsed), leading to declining investment and lower capital accumulation; with rising unemployment and rising inflation, and in response, deflationary monetary policies and declining real wages further reduced aggregate demand and increased unemployment. Carlin and Soskice's (2009) case study of Germany highlights many of these elements. Two essential elements of the deficient aggregate demand story are inadequate capital accumulation and deflationary monetary and fiscal policy.

#### *Capital accumulation and unemployment*

Among the channels through which accumulation can be expected to matter is through increased capacity, which can increase output and reduce price pressure (and so maintain real wages and reduce distributional conflict) and increase labour productivity. Both channels can 'help relieve inflationary pressure and allow the economy to operate with lower unemployment' (Rowthorn, 1995, p. 31).

This contrasts sharply with the orthodox story that focuses entirely on labour market rigidities, and it is notable that orthodox empirical work almost never includes measures of capital accumulation. How can capital accumulation not matter? Rowthorn (1995, 1999) has shown that in the most prominent

rendition of New Keynesian microfoundations (Layard et al., 1991), the role of capital accumulation and technical advances for employment performance are ruled out by assumption. Layard et al. (1991) assume an economy that operates on the basis of a Cobb-Douglas production function, with the critical restriction that the elasticity of substitution between employment and capital stock is unity. Under these conditions, 'unemployment in the long run is independent of capital accumulation and technical progress' (Layard et al., 1991, p. 107). This means that productivity gains from investment are absorbed entirely by real wage gains, and not by employment gains. But Rowthorn (1995, 1999) shows that nearly all published estimates directly challenge this unitary elasticity assumption, and if this is so '....none of their major conclusions with regard to unemployment is valid.... The policy implication is that measures to stimulate investment may have an important role to play in reducing unemployment' (p. 414).

Following Rowthorn (1995) and Glyn (1998), recent empirical work has provided some evidence for a capital accumulation effect on unemployment (Alexiou and Pitelis, 2003; Stockhammer, 2004; and Arestis et al., 2007). These studies are limited by their failure to pay attention to the possible confounding effects of labour market institutions. Stockhammer and Klar's (2008) study adds measures of capital accumulation to tests similar to the orthodox tests described above. They find strong effects for alternative measures of capital accumulation using two different data sets and three time periods. The results are impressively robust to alternative measures (capital stock growth and investment), data sets, and specifications.

But like the orthodox literature using the same techniques and data, the results suggest a high degree of sensitivity to specification, both within and between the two data sets they employ (Bassanini-Duval and Baker et al.). In the mainstream literature the unemployment benefit generosity indicator (the gross replacement rate) is among the strongest performers, and in the Bassanini-Duval study it is the only protective labour market indicator that shows economic and statistical significance. But using the same data, Stockhammer and Klar find no effects in five of the six specifications and offer no explanation for

these contradictory results. They note that although the tax wedge was ‘the single most influential institutional variable in the regressions of Bassanini and Duval (2006) – (it) is only occasionally significant with the expected sign, and apparently sensitive to the specification’ (2008, p. 15). Similarly, Bassanini and Duval found very strong orthodox results for product market regulation, but Stockhammer and Klar find it insignificant in every specification. No explanation is offered for these inconsistencies.

At the same time, the Stockhammer-Klar results on the effects of capital accumulation are lent considerable support by the strong findings from a new research programme led by Marika Karanassou and Dennis Snower. This research consists of country case studies framed by the ‘chain reaction theory’ of unemployment. The key shocks that affect the lagged adjustment processes most important for noncyclical movements in unemployment are expected to be technological progress, capital accumulation, and population growth (Karanassou and Snower, 1998, p. 834). This approach calls for a different empirical estimation strategy: ‘It is only in a multi-equation labour market system that we can observe employment, real wages, and the labour force all drifting upwards while unemployment remains stationary, and thus it is only in this context that the influence of lags on the long-run equilibrium unemployment rate becomes visible’ (p. 835). Using such a multiple equation approach, Karanassou et al. (2008) find that capital stock growth has a ‘major’ effect on the unemployment experiences of Denmark, Sweden and Finland since the mid 1970s. Similarly strong results using this framework are found for the UK (Henry et al., 2000) and Spain (Bande and Karanassou, 2007).

#### *Employment friendly monetary and fiscal policy*

In the orthodox view, assumptions regarding inflation expectations and the absence of any money illusion rule out the ability of expansionary monetary or fiscal policy to reduce unemployment below the equilibrium level set by the structural features of the labour market. The ability of workers and employers to predict and correctly act in anticipation of price and wage increases is ultimately an empirical question.

Increasingly, the rigid orthodox commitment to extremely low inflation targets on the grounds that this has no persistent effects on unemployment has been challenged. 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' (see also Akerlof, 2002, p. 416). In sum, 'high equilibrium unemployment may just reflect deflationary macro policies' (Soskice, 2000, p. 39).

The evidence for a substantial effect of deflationary macro policy is compelling, particularly in continental Europe and Canada. According to Lawrence Ball (1999, p. 191), '[i]n 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.... labour market policies are not important causes of the unemployment successes and failures since 1985'. 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 (for updated evidence, see also Stockhammer and Sturm, 2008). The impact of persistent deflationary macro policy by Germany, the Bundesbank, and the European Central Bank is well documented (Iverson, 2000; Hein and Truger, 2005a, 2005b; Carlin and Soskice, 2009; Schettkat and Sun, 2009).

The cross-country statistical evidence for this aggregate demand story is admittedly limited. As Fitoussi (2003, p. 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 per cent in a period (1991-1995) in which the rate of growth was about 1 per cent?' (Fitoussi, 2003, p. 438). On the other hand, a number of macroeconomic tests have produced

significant (negative) effects for the interest rate (e.g., Fitoussi et al., 2000; Blanchard and Wolfers, 2000; Bassanini and Duval, 2006).

## **6. A comparative political economy perspective on employment performance**

The argument so far has been that explanations for cross-country patterns of employment performance have focused narrowly either on labour market flexibility (the orthodox view) or the adequacy of aggregate demand (the Keynesian view). The empirical work framed by these two perspectives proceeds as if employment performance can be understood as the outcome of a linear combination of a small number of independent factors. This section argues that a richer vision is one that sees employment performance as an integral part of a complex institutional system.

In this view, employment performance reflects the set of institutional bundles that address the essential problems of wage-setting, securing adequate employment opportunities, and ensuring high productivity (see above, p. ). These bundles may take the form of a liberal market economy, with a minimal welfare state and with markets doing the main job of determining and coordinating wages, skill acquisition, employment, investment and finance; or a coordinated market economy, in which strong welfare states provide the security required for the development of specific skills and strong institutions and organizational networks allow strategic coordination to play a much larger role in the economy. In this 'varieties of capitalism' (VoC) perspective, most prominently advanced by Hall and Soskice (2001), liberal market economies operate according to rules and incentives quite different from coordinated market economies; among the latter, the Nordic 'regime' with its universalistic welfare state should, for certain purposes, be distinguished from the continental corporatist one (e.g., Germany, Austria and The Netherlands). The same might be said for 'Mediterranean' and 'Asian' models of capitalism (see Amable, 2003, 2009).

For example, countries with institutions that reduce wage inequality and promote literacy among the least advantaged are also likely to have well-developed institutions that promote cooperation and on-the-job training. Estevez-Abe et al. (2000) contend that higher levels of social protection – particularly employment protection, unemployment protection, and wage protection – provide workers with the insurance they need to invest in firm and industry specific skills. Similarly, Amable (2009, p. 19) points out that ‘In the case of wage bargaining, for instance, the outcome depends on each party’s outside options. These outside options are, in turn, dependent on the institutions affecting other areas than the labour market.... What is to be considered is, therefore, how institutional forms in different areas complement each other.’ For workers, these institution-dependent outside options areas range from opportunities for skill acquisition (the education and training system) to opportunities for work (commitments to use macro policy and public sector hiring to maintain full employment); for firms, outside options in wage bargaining will reflect the constellation of labour and product market regulations, the opportunities available to outsource production, and access to funds in the financial market for investments.

How effective institutions are bundled can affect economic efficiency and levels of GDP (Hall and Gingerich, 2004), but a central claim of this chapter is that it can also affect the translation of GDP into employment (and unemployment). From a comparative political economy perspective, the orthodox fixation on labor market rigidities amounts to a special case in which institutions have not been designed or managed appropriately for the given VoC regime. The adequacy of aggregate demand – the Keynesian focus - is one critically important outcome of the bundle of institutionalized practices that define a VoC. More specifically, what Soskice calls ‘aggregate demand management regimes,’ can be expected to vary across institutional regimes, both in terms of goals (inflation vs. unemployment) and practices (how discretionary and interventionist in response to shocks and cyclical changes).

The importance of taking a broad comparative political economy approach to cross-country employment performance can be illustrated by reference to the experiences of individual countries. For reasons of space, I briefly consider Germany and then a recent case study that compares Austria, Belgium and the Netherlands.

Until unification, German (West) unemployment rates were consistently superior to those of the United States. The rapid rise of German unemployment rates in the 1990s can be traced to the pressure of unification and various mistaken and uncoordinated policy responses. 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, labor taxes rose, which raised unit labor costs. 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, p. 288).

A good part of the German employment problem can be located in weak domestic effective demand, 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, 2005b, Table 4; see also Carlin and Soskice, 2009 and Schettkat and Sun, 2009). Not only was aggregate demand undermined by persistent and pronounced deflationary monetary and fiscal policy, but the implementation of OECD 'reforms' also contributed. As wages stagnated in the core (export-led) economy and declined in the peripheral economy, worker savings actually increased, reflecting what Carlin and Soskice (2009) argue was rising insecurity as threats of job loss rose and the strength of social safety nets eroded. This is particularly threatening to middle age workers in an employment system that is not friendly towards older workers in need of a job.

A case study of Austria, the Netherlands, and Belgium powerfully illustrates the importance of the complementarities of political economy institutions and social and political consensus (Hemerijck et al., 2000). These are three small continental European countries in close physical proximity with strong welfare states and highly regulated labour markets. As the authors point out, '[t]he 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 labour costs is around the average of all OECD countries' (p. 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.

Hemerijck et al. argue that the key to these differences in employment performance 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, p. 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 major problem: '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' (p. 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 severe 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.

While institutional and policy coherence grounded in political and social consensus can help explain the adequacy of effective demand and its translation into employment, it should be noted that some high unemployment countries have had to confront special structural challenges, ranging from rapid changes in the age distribution of the population to dramatic changes in the productive basis of the economy from rural to industrial to services (Spain) and profound regional inequalities (Italy and Germany). A satisfactory explanation for the cross-country pattern of OECD unemployment would need to take account of these structural factors.

## **7. Conclusion**

Empirical explanations for cross-country patterns of unemployment require an indicator of unemployment that is fully comparable across countries. While the OECD's harmonized rates are far superior to national rates, there are reasons to be cautious – what counts as 'employment', differences in employment (not just unemployment), and how those not employed tend to be allocated to nonactive or unemployed, can have substantial effects on a country's unemployment rate ranking. There are many reasons to treat cross-country regression results with a great deal of skepticism, and this is one of them.

Taking the unemployment and institutional indicators at face value, the review of the evidence – both 'common observation' and regression results – challenges the orthodox view that rigidities, imposed by too much regulation and social protection, can provide a good account of the pattern of employment performance over the last several decades. 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 in unemployment and employment rates across the OECD since the early 2000s and especially in the current crisis (2008-10). At the same time, fairly

compelling results have been produced by recent research framed by the traditional Keynesian view that aggregate demand should be at the center of the story of post-1970s employment performance.

This chapter argues that neither labour market rigidities nor aggregate demand are sufficient for a good account of persistent differences in unemployment rates. As Keynes and Kalecki noted, a full employment economy requires appropriate institutions. A more comprehensive comparative political economy framework is required that underscores the importance of institutional and policy complementarities between labour relations systems, welfare state programs, firm strategies, macroeconomic policy, public employment and regulatory policy. If coherent, these interrelationships form models, or what has become known as varieties of capitalism. Coherent institutional models grounded in relatively high social and political consensus have produced exceptionally low unemployment with strong and generous welfare states. Examples include Austria and Norway, West Germany (before unification), Sweden (except the late 1980s and early 1990s), and the Netherlands and Denmark (since the late 1980s).

The deregulatory policies that follow from free market orthodoxy have long had immense intellectual and political appeal. 'The strength of the self-adjusting school depends on it having behind it almost the whole body of organized economic thinking of the last hundred years' (Keynes, 1973, p. 487). While considerably less elegant, the Keynesian aggregate demand model embedded in a comparative political economy perspective has the potential to offer a far more convincing explanation of cross-country patterns of employment performance. This perspective can also challenge the mainstream deregulation approach by explaining how political economy institutions can be organized to flexibly adjust to economic shocks while promoting full employment with decent wages.

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## Notes

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<sup>2</sup> These unemployment rates are those used in the Baker et al. study (2005), and are those most commonly used in the macroeconomic literature. They are intended to be as 'harmonized' as possible to make them comparable across countries. The reality, however, is that there are harmonized rates for only a small number of countries prior to the late 1970s (see Howell et al., 2007).

<sup>3</sup> Hence the term 'NAIRU': the non-accelerating inflation rate of unemployment.

<sup>4</sup> I do not label this literature as "Post-Keynesian" because this has come to represent a specific and fairly narrow school of thought, and many of the contributors to the broader literature would not characterize themselves as such (e.g., Solow, Akerlof, Ball and Stiglitz).

<sup>5</sup> According to a recent study, for nearly all countries over the last 20 years the elasticity of unemployment with respect to output – Okun's Law – is less than .6; for the big European countries and the U.S., it ranges around just .4; and the overall range is huge, from about zero (Norway) to over .8 (Spain) (IMF, 2010, figure 3.7).

<sup>6</sup> In 1943, Keynes noted that '[t]he task of keeping efficiency wages reasonably stable ... is a political rather than an economic problem' (quoted by Glyn, 1995, p. 37). In the 'Political Aspects of Full Employment' Kalecki pointed out that 'full employment may be secured by a government spending programme', this would raise worker bargaining power and 'reduce discipline in the factories'. Whether collective bargaining under conditions of full employment was sustainable without accelerating wage inflation 'would depend on the institutional arrangements of the regime of full employment... Full-employment capitalism will, of course, have to develop new social and political institutions which will reflect the increased power of the working class' (quoted by Glyn, 1995, p. 38).

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<sup>7</sup> For a more extensive discussion, see Glyn et al. (2006).

<sup>8</sup> See Freeman and Schettkat (2000), Devroye and Freeman (2001), and Howell and Huebler (2005).