With much of the developed world plagued by high levels of unemployment since the 1980s, it has become widely accepted that the answer is "structural reform" of the labor market. It is said that only with the lower labor costs and greater flexibility that follows from labor market deregulation and a smaller welfare state can there be hope of achieving anything close to full employment. Mainstream economists and leading policy and banking institutions like the OECD, the IMF, and the ECB\(^1\) have all strongly advocated such reforms, arguing that as firms are confronted by increasingly competitive, global markets, workers must adjust by accepting lower wages, stingier unemployment benefits, and less secure jobs. They have led the battle cry that policy makers must stand up to the insiders and special interests that ultimately undermine the employment-creating dynamism of free markets. Confronted by this conventional wisdom, policy makers have been caught between this "economic reality" and the popular and deeply embedded social norms that favor social regulation and the support of prevailing living standards, particularly concerning wages and job and income security.

This book takes a rather heretical view toward this orthodox free market prescription for good employment performance. The chapters that follow, authored by economists from seven European and North American countries, are unified by their focus on (and their answers to) several closely related questions: Does the available evidence really support the orthodox call for radical labor market deregulation? Is full employment really unattainable without American levels of wage inequality and job

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\(^1\) European Central Bank
insecurity? And more generally, is there really no viable alternative to wholesale deregulation?

What unites all sides of the unemployment debate is the seriousness of the problem: unemployment in OECD-Europe ranged from 9–11% throughout the 1990s (OECD 2002: Appendix Table A). At mid-decade, 2.5 million jobless British workers were able, willing, and actively looking for work. Over 2.9 million French workers and about 3.6 million German workers were in similar straits. Among OECD countries, only Austria, the Czech Republic, Luxembourg, Japan, and Switzerland reported unemployment rates below 5% in 1995. Even the United States stood at 5.6%. While unemployment in OECD–Europe fell to 8.3% in 2001, it began rising again in 2002–2003. Unemployment in the United States fell sharply in 1995. Even the United States stood at 6% in 2003.

Although all developed countries have substantial benefits systems in place to reduce the costs of unemployment on individuals, families, and communities, redistribution never fully compensates for the material, social, and psychological costs of involuntary job loss. At the aggregate level, persistent high unemployment represents massive social inefficiency. How could high unemployment possibly persist over long periods in such wealthy, highly educated societies at the end of the twentieth century? After all, there have been no major “shocks” to the system since the 1979 OPEC oil price hike, and raw materials prices have since collapsed, to the great advantage of the wealthiest countries (and to the disadvantage of developing countries). And most importantly, after the sharp slowdown in the 1970s, productivity growth has improved. Indeed, the material well-being of working people in North America and Western Europe stands at unprecedented levels, sharply contrasting with the subsistence living standards that prevail in much of the rest of the world.2

All this wealth underscores the dark side of the recent economic performance of the world’s richest nations—the dramatic rise in joblessness and economic insecurity since the late 1970s. While most workers can no longer expect a continuation of the 1950s–70s golden age of reliable growth in real wages and benefits, at the heart of the new insecurity is the fear of unemployment, which reached levels in the 1980–90s not seen since the great depression of the 1920s–30s. The affliction of high involuntary joblessness—which consists of the unemployed (who are still looking for work) and the discouraged (who have given up looking)—has been regularly referred to with terms like “crisis.” A recent European Commission report is typical, asserting in its opening sentence that “Unemployment is the current European nightmare” (Buti, Pench, and Sestito 1998: i).

It is not always the case that the appropriate policy response to a major social problem requires addressing its root cause, or even having a good understanding of it. But this is certainly not the case with conventional wisdom about unemployment. In this view the cause is held to be the rigidity that comes with benefits and regulations that shelter workers from competitive labor market outcomes, and the cure must, it is argued, be wage and employment flexibility in the form of lower wages and greater job insecurity. As labor market rigidities are pared back, workers will get “priced” back into jobs. That this free market orthodoxy has come to completely dominate the academic and policy discussion of the unemployment crisis reflects a striking ideological shift towards pro-market (or “neo-liberal”) policies that began to emerge in the late 1970s, a shift exemplified by the attack on the state and protective labor market institutions in the 1980s by the Thatcher (U.K.) and Reagan (U.S.) administrations. In economic thinking, there was a similar ideological shift toward theoretical and empirical work that presumed the superiority of reliance on individual incentives and free market forces, illustrated by the hegemony of the human capital revolution of the 1960s in labor economics and by the “new classical” thinking in macroeconomics since the 1970s.

In this increasingly market-friendly political and intellectual context, the major employment-related problems of the developed countries in the 1980s and 1990s—falling wages and rising earnings inequality in some labor markets and persistent high unemployment in others—has been explained with a “unified theory.” In this account, inequality and unemployment are two sides of the same coin: fundamental economic forces (price, productivity, technology, and globalization “shocks”) have produced a dramatic shift in demand against the least skilled, requiring either lower wages, as in the “flexible” labor markets of the United States, or higher unemployment, as in the more “rigid” welfare states of Europe. The solution to high joblessness is then quite straightforward: reduce the pay (and job security) of those already at the bottom of the pay distribution. The most recent and comprehensive case for the unified theory has been made by two leading liberal U.S. economists, Francine Blau and Lawrence Kahn (2002). As they put it,

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

Among mainstream economists, it has been widely accepted that the crisis of high unemployment, and its persistence over time, essentially reflects a policy choice. Too often, the argument goes, policy makers and their political supporters chose to maintain institutional arrangements that furthered the interests of “insiders,” harmed “outsiders,” and resulted in sclerotic labor markets. In the words of Gregg and Manning (1997: 395), this stance may reflect less a balanced assessment of the evidence than the
ideal in which everyone who wants a job can find one at a wage equal to "touching faith that many economists have in the view that the deregu-
academic economists," it has been relentlessly promoted in the policy
the value of their contribution to society."

While this "touching faith" has characterized the thinking of many academic economists, it has been relentlessly promoted in the policy sphere by several leading international economic and financial organizations, most notably the OECD, the International Monetary Fund (IMF), the German Bundesbank, and the European Central Bank. Undoubtedly the most influential advocate of the labor market flexibility solution has been the OECD, in large part through its massive jobs Study (OECD, 1994) and a series of follow-up implementation reports (OECD 1997, 1999) and country case studies. The International Monetary Fund (IMF) has followed the OECD's lead with several reports that have heralded the deregulation solution (IMF 1999, 2003). For this reason, "OECD-IMF orthodoxy" will be used in this volume as a shorthand label to describe the application of the orthodox free market view to the 1980-90s unemployment crisis. But it should be understood that this is only a term of convenience, since the view that deregulation is the only solution to the unemployment problem is widely accepted among economists and is, on the other hand, not necessarily shared by all individuals (or departments) within organizations like the IMF and OECD.

This book challenges this OECD-IMF orthodoxy. The unifying theme across the essays is that the free market case for blaming persistent high unemployment exclusively on the rigidities imposed by "employment unfriendly" labor market institutions cannot be sustained on the basis of the available evidence. This question has enormous policy significance. Since the individual, economic, and social costs of unemployment are so high, we need to fight unemployment as effectively as possible. At the same time, it is often forgotten (particularly by well-paid tenured economists—speaking of protective labor market institutions!) that eviscerating regulations and rolling back the welfare state can have high individual, economic, and social costs as well.

The chapters include both cross-country analyses (chapters 2 and 3) and individual country case studies (chapters 4-9). In different ways, each chapter calls into question the dominant policy prescription of recent years—that improving employment performance requires the adoption of the "American model" of deregulated and decentralized labor markets. The larger message is that very different labor market models, ranging from the relatively free market approach of the United States to the much more regulated and "universalistic" Scandinavian model, are capable of delivering low levels of involuntary joblessness. At the same time, these chapters suggest that these alternative models can have substantially different implications for the distribution of income and the economic well-being of the less advantaged. In short, the essays in this volume suggest that while protective labor market interventions can quite effectively reduce the incidence of low pay, income inequality, and poverty, they do not necessarily produce harmful employment effects. This may seem hopelessly naive, given what we hear over and over about the need for "tough choices" and the inevitability of tradeoffs. But the evidence is strongly suggestive—not a few strong welfare states have consistently outperformed even the United States.

A key implication of this critical assessment of the OECD-IMF orthodoxy is that its dominance has had the quite unfortunate effect of diverting the attention of researchers, policy makers, and the business media from other, better explanations of the unemployment crisis. While this volume does not attempt to provide the definitive alternative explanation (much less a solution) for persistent high unemployment, likely non-labor-market-related factors are considered in a number of the case study chapters, and I refer to them briefly in the final chapter of the book. It will be enough if this volume contributes to steering research and public opinion away from simplminded free market prescriptions.

1.1 UNEMPLOYMENT AND THE WELFARE STATE

The developed countries have been hit with levels of unemployment not seen since the Great Depression. The policy response in the earlier episode was the creation, or vast expansion, of the welfare state. With the transformation from primarily agricultural and small-town economies, in which most families were at least partially self-sufficient, to urban industrial and service economies in which nearly all families are entirely dependent on wages, the state became the insurer of last resort. The growth of the welfare state has been a twentieth-century phenomenon, and its expansion has occurred in sudden spurts: after each of the two world wars, in response to the Great Depression, and during the unprecedented affluence of the 1960s and 1970s.

With high unemployment after World War I, the United Kingdom extended unemployment benefits in 1920, and by the mid-1930s both unemployment insurance and assistance programs were in place. As Nicholas Barr (1998: 28) writes, "Sixteen years after the end of the first World War, the UK had a system of unemployment relief which worked reasonably smoothly. . . . The main lesson for the future was that laissez-faire capitalism could not solve the problem of unemployment—in this area, too, state intervention was necessary." U.K. policy makers chose the more conservative path of unemployment insurance and assistance, not taking Keynes's advice that more aggressive state action to promote employment was necessary (Garraty 1979: 207).

In sharp contrast, the United States was among the last of the industrialized nations to establish a system of support for the unemployed and had no federal scheme until the 1935 Social Security Act. As an insurance scheme begun in the midst of the Depression, social security did not pay benefits to those unemployed at the time, and few had contributed enough
to receive benefits before the end of the 1940s. With a negligible unemployment benefit fund and facing up to 16 million unemployed, the Roosevelt administration allocated $3.3 billion for public works in 1933–1934 and put 4 million people to work (Barr 1998: 30). The Swedish government followed the same public works route in 1933. But the most aggressive by far was the German (Nazi) government, whose public (military) spending had dramatically reduced unemployment by the mid-1930s (Garraty 1979: 206). The French, on the other hand, remained committed to laissez-faire policies, refusing to intervene in a substantial way either through public employment (the U.S. response) or unemployment relief (the U.K. response), preferring policies that attempted to discourage mechanization and diminish the pool of workers competing for jobs (e.g., through the repatriation of foreign-born workers) (Garraty 1979: 210–211).

With the postwar boom, institutions, regulations, and policies designed to promote worker (and consumer) well-being became entrenched in one way or another in all the developed countries, even those—like the United States—most committed to a free market regime. This public commitment to the maintenance of a socially acceptable standard of living was clearly a reaction to the trauma of the Great Depression and World War II, but it also reflected shifting social norms as economic growth made the nations of North America and Europe dramatically richer over the course of a single generation. From the perspective of the entire world, this was a development limited to the rich Western nations. As Esping-Andersen (1994: 713) writes, “Even the poorest Third World nation has some form of social policy, but if by the welfare state we mean citizens' rights across a comprehensive array of human needs, the concept can hardly be stretched beyond the eighteen to twenty rich capitalist countries in the Organization for Economic Cooperation and Development area.”

Notably, the case for the welfare state has been made on efficiency as well as equity grounds. The Great Depression helped teach the lesson that too much poverty, inequality, economic insecurity, and lack of access by large parts of the population to basic needs—food, health and safety, housing, and education—can cripple economic efficiency. The case for a healthy, safe, decently housed, and adequately educated workforce can be traced back to Alfred Marshall’s Principles of Economics (1890) and even further back to Adam Smith’s Wealth of Nations (1776). With the early postwar period, the efficiency implications of the argument were extended (see, for example, Gregg and Manning 1997; Agell 1999). The right to join a union and bargain collectively can increase worker voice, encourage stability in industrial relations, promote on-the-job training, and reduce the pressure on taxpayers to maintain acceptable standards of living by placing the responsibility for decent income and benefits on the firm (and consumer). The provision of unemployment insurance and assistance would not only help workers in time of need but would facilitate job search, and thereby potentially improve matches between jobs and worker skills and interests.

But, like the diversity in approaches to the unemployment problem in the interwar period noted earlier, developed countries have chosen sharply different welfare state models. In the late 1950s, Titmuss distinguished “residual” from “institutional” welfare states. The former, exemplified by the United States, is “distinct in its minimalist approach to welfare guarantees, its active encouragement of private welfare in the market, and its adherence to the traditional liberal view that social protections should be targeted to only those groups demonstrably incapable of working” (Esping-Andersen 1994: 715). The institutional model, exemplified by the Scandinavian countries, commits the state to a “system of social guarantees that, unconditionally, assures adequate living standards to all citizens” (Esping-Andersen 1994: 714).

In perhaps the most influential of such groupings, Esping-Andersen (1990) identifies Liberal (U.S., U.K.), Social-Democratic (Denmark, Sweden), and Conservative (France, Germany) models (see Hicks and Kenworthy [2003] for a recent critical assessment of the Esping-Andersen framework). In another typology, Visser focuses on industrial relations systems and identifies four categories (Auer 1999: 40). Visser’s “Anglo-Saxon Pluralism” and “Northern Corporatism” groups overlap with Esping-Andersen’s “Liberal” and “Social-Democratic” categories (and Titmuss’s “Residual” and “Institutional” groups). But in the Visser scheme, “Central Social Partnership” countries (Austria, Germany, the Netherlands) are distinguished from “Latin Confrontation” countries (France, Italy, Spain). In the latter, bargaining is less well-coordinated between employers and unions; as a result, industrial relations tend to be more unstable and contested, with a greater role played by the state in the bargaining. Hall and Soskice (2001) simply distinguish “liberal market” from “coordinated market” economies.

1.2 THE NEW UNEMPLOYMENT CRISIS

While welfare state and industrial relations models differ significantly across the developed countries, rising unemployment in the 1980s and critically high unemployment rates in the 1990s struck almost all of them. Figure 1.1 shows the levels and spread of unemployment rates for 19 OECD member countries for each five-year period between 1960 and 1999 and adds figures for 2000 and the second quarter of 2002. As a reference, the line that runs from left to right marks the U.S. rate.

This figure highlights some key facts that are at the center of the unemployment policy debate. First, there was a general trend of increasing unemployment rates through the 1980s, and the median rate (half above, half below) peaked at 8.8% in 1990–1994. Second, the dispersion of rates moves with the median. The range of unemployment rates was extremely compressed in the four 1960–1979 periods (standard deviations range from 1.22 to 2.2). These rates became quite dispersed in the 1980s and 1990s (3.35 to 4.47) and then dropped sharply in 2000–2002 back to late-1970s
levels (2.24 in the second quarter of 2002). Third, the employment performance of the United States was among the very worst throughout the first two decades (1960–1979). Indeed, the U.S. unemployment rate did not drop below the median until the second half of the 1980s. And, fourth, while the United States performed strikingly well in the late 1990s, even in the 1995–1999 period three nations with a substantial commitment to social protection spending and regulation (Austria, Norway, and the Netherlands) performed as well or better using the unemployment yardstick. By the second quarter of 2002, fully 10 of the other 18 countries shown in figure 1.1 had unemployment rates below that of the United States. The latest data indicate that only five major OECD countries report substantially higher unemployment rates than the United States: Germany, Italy, France, Finland, and Spain.

An understanding of the unemployment crisis requires recognition of the variation across countries in unemployment by age and gender. Figures 1.2 (male) and 1.3 (female) show OECD standardized unemployment rates for two age groups, 15–24 and 25–54, for nine representative European and North American countries for 2001 (the most recent year available), organized roughly from the strongest welfare state on the left (Sweden and the Netherlands) to the most laissez-faire countries on the right (the United Kingdom and the United States), with the southern countries states in the middle (Spain and Italy). Germany and France are placed to the left of Spain and Italy, while Canada appears slightly to the right.

Figure 1.2 makes clear that for prime-age men, the Swedish and Dutch welfare states performed about as well (Sweden) or better (the Netherlands) than the U.S. and U.K. economies in 2001. On the other hand, Germany, France, Spain, Italy, and Canada all had prime-age male...
unemployment rates between 5.7% and 7.3%, compared to the U.S.–U.K. range of 3.7%–4.1%. Male youth unemployment rates were particularly high in 2001 for France, Spain, Italy, and Canada. The results for women, shown in figure 1.3, were broadly similar. France, Spain, and Italy had by far the highest female unemployment rates for both youth and prime-age workers.

As a measure of labor market performance or worker well-being, the unemployment rate is well known to have drawbacks rarely considered in popular discussions. Statistical agencies have become quite skilled at improving comparability across countries, in the sense that similar surveys are used to calculate rates that are defined in similar ways. But it is difficult to account for the different ways people in different countries respond to the surveys and how they understand “employment.” Young Mexican workers may think of any kind of low-paid informal employment as “working for pay last week.” On the other hand, many young Spanish and southern Italian workers live at home (see chapter 7) with paid part-time, temporary, “under-the-table” jobs. If they believe that only “good” formal-sector jobs count as real “employment,” they may respond that they are in fact “unemployed”—that they are not really working and that they are able, willing, and actively searching for a (real) job. The level of development and the nature of the social safety net will affect who can afford to drop out of the labor force altogether, again with potential implications for who is counted as unemployed. Schmitt and Wadsworth (see chapter 5) argue that this, rather than the 1980s–1990s neoliberal reforms, is the main reason for the decline in unemployment in the United Kingdom. A related problem is that the design and generosity of the unemployment benefit system can encourage workers to make sure they qualify to be counted as unemployed. As Gregg and Manning (1997: 407) put it, “The problem is that whether someone is classed as ‘unemployed’ on this definition is not likely to be invariant to the system of unemployment insurance.” Given the differences in benefits systems, Spanish workers may have an incentive to meet the official criteria, unlike Mexican workers. Whatever the explanation, certainly the magnitude of unemployment rate differences between Spain and Mexico suggests that more than job availability (or labor market rigidities) is at work: standardized Mexican unemployment comes in below the U.S. rate, while Spanish unemployment has been three to four times higher, particularly for young women (see figure 1.3).

To avoid such measurement issues, another standard way to assess employment performance is to refer to the employed share of the working-age population—the employment rate. Figures 1.4 and 1.5 present this rate by age and gender for the same countries and year (2001) as the previous figures. Figure 1.4 shows that the employment rate for prime-age men is remarkably similar across these nine countries. With the exception of Italy (81.7%) and the Netherlands (92.7%), they range from 85.4% (Canada) to 88.1% (France). The U.S. prime-age male employment rate (87.9%) is nearly identical to that of France, Sweden, and Germany. Male youth employment rates show much more variation, from the Netherlands at the top (71.5%) to France and Italy (27.8% and 32.6%) at the bottom.

Female employment rates for prime-age workers (figure 1.5) show much greater variation across countries. But again, the United States does not stand out. While Sweden’s prime-age female employment rate was 82.5%, far higher than the U.S. rate of 73.5%, which was in turn nearly identical to that of the Netherlands (72.6%), Germany (72.2%), Canada (74.3%), and the United Kingdom (73.6%). France’s rate was slightly lower, at 70.8%, while the Spanish and Italian rates were far lower (52.8% and 49.5%). For female youth, figure 1.5 shows that the Netherlands had by far the highest rate (69.2%). The United States is in the next tier with Canada and the United Kingdom (52.2%–56.2%), followed by Sweden and Germany (48.5% and 43.9%). Far below are Spain (29.7%), Italy (22.1%), and France (20.7%).

These data (figures 1.2–1.5) suggest that much of the employment problem in the developed countries can be found in the high unemployment and low employment rates for youth in France, Spain, and Italy. But how big a problem is a high unemployment rate or a low employment
rate for young workers? To take an extreme example, assume that 90% of French persons ages 15-24 are in school and that the remaining 10% are either employed or unemployed. This 10% (employed and unemployed) is what would be tabulated as the "labor force" of 15- to 24-year-olds. If half of this labor force (5%) is unemployed, we get a huge 50% unemployment rate (5/10), and a very low 5% employment rate (5/100). These rates make the situation look catastrophic. But the incidence of unemployment in the youth population would actually be quite low; only 5% of the youth population in the example is unemployed.

Figures 1.6 and 1.7 contrast the standard unemployment rate with the much less commonly employed unemployment-population rate for 2001 for the same set of nine countries. Whereas male youth unemployment rates for the United States were lower than six of the other eight countries in the figure (the exceptions were Germany and the Netherlands), only three countries show higher unemployment to population rates: Spain, Italy, and Canada. Equally significant, the difference between the unemployment-population rates for these high youth-unemployment countries and the United States and the United Kingdom are surprisingly small (from .8 to 2.1 percentage points). Indeed, the incidence of male youth unemployment in 2001 was substantially higher in the United States (7.7%) than in France (5.3%), Germany (5.1%), and the Netherlands (3.2%). The results for female youth are similar, with only Spain, Italy, and Canada showing notably higher unemployment incidence. While France's unemployment rate for female youth was more than twice as high as the U.S. rate, the incidence of unemployment in the French female youth population was nearly identical (5.8% for France and 5.7% for the United States). In sum, figure 1.1 showed that, as measured by the standard unemployment measure, the decline in employment performance in much of the OECD relative to the United States took place in the 1990s, but by 2001-2002 national unemployment rates had substantially converged. As the more detailed data for 2001 show, much of the problem for the high unemployment countries (France, Spain, and Italy) can be found in high unemployment and low employment rates for youth (figures 1.2 and 1.3). The exception is Germany, whose unemployment rates were similar across age and gender groups. Employment rates produce broadly similar results: male prime-age employment rates are similar across countries, as are female prime-age rates except for Spain and Italy, but France, Spain, and Italy all show very low male and female youth employment rates (figures 1.4 and
1.5). However, when the incidence of unemployment in the youth population is considered, there is far less divergence across countries, and the United States does not stand out as particularly impressive (figures 1.6 and 1.7). This is an important alternative, if rarely used, measure for understanding the severity of youth unemployment (how many actually experience it), since schooling rates and social norms governing the appropriate age for entering the formal workforce vary widely across the OECD.

1.3 THE OECD-IMF ORTHODOXY

Despite the remarkable convergence in unemployment rates shown in figure 1.1, the largest countries on the European continent—France, Germany, Spain, and Italy—have continued to report much higher rates than the United States and the United Kingdom, and, in the conventional wisdom, sclerotic labor markets are the leading culprit (see for example Blau and Kahn 2002; Nickel et al. 2001; Heckman 2003). Leading policy and banking institutions like the OECD and the IMF have strongly advocated “structural reforms” in national labor markets. According to a recent IMF survey paper, “the dominant view” holds that major structural labor market reforms are required for many OECD member countries and that particular attention should be focused on “the wage bargaining framework, the severity of various types of labor market regulations (job protection legislation, the flexibility of work arrangements), and the generosity of income replacement in unemployment benefit or welfare schemes” (IMF 1999).

The OECD-IMF orthodoxy has its roots in the basic supply-and-demand framework that assumes perfectly competitive markets (Gregg and Manning 1997). High minimum wages and widespread collective bargaining must raise wages and compress the wage structure, pricing less-skilled workers out of the labor market. The stakes are raised with demand shocks, such as productivity slowdowns, oil price hikes, significant technological changes, and intensifying trade competition, which may require downward wage flexibility, particularly for the less skilled. On the supply side, social spending that supports family income tends to reduce the incentive for family members to take available jobs. In sum, welfare state interventions raise both the wage floor (the lowest wages that
can be paid) and the reservation wage (the lowest wage at which workers will be willing to work), necessarily reducing the demand for labor.

At the height of the mid-1990s European unemployment crisis, the OECD released *The Jobs Study* (OECD 1994), an ambitious and highly influential study of employment performance in the member countries. The recommendations of this report, known as “The Jobs Strategy,” provide a “broad programme of action designed to improve labour-market performance in Member countries” (OECD 1997: 51). The *Jobs Study* (1994: 30) concluded that the source of OECD labor market problems could be found in the response on both sides of the Atlantic to the collapse in demand for less-skilled workers. Specifically, the problem was “the failure to adapt satisfactorily to change. In the U.S., workers have not upgraded their skills fast enough. In Europe . . . , by contrast, such low-wage jobs were, by and large, disallowed by society, whether through state-imposed or union-negotiated wage floors and employment protection.” This reflected the views of most economists across the ideological spectrum.6

Table 1.1 presents what has become known as the Strategy’s “Ten Commandments,” whose theme is a call for less social protection spending and regulation and an increased reliance on competitive market forces. Our concern in this book is mainly with the fifth, sixth, seventh, and ninth recommendations: wages should be downwardly flexible, reflecting the demand for and supply of skill in local labor markets; employment protection legislation should be limited or eliminated altogether; and, similarly, social protection spending and regulations (“passive labor market policies”) should be scaled back or eliminated. The only possible exception to a free market approach would be the promotion of job search and worker training (“active labor market policies”). Responding to an international unemployment experience that varied widely across OECD-Europe and the United States for less than a decade (see figure 1.1), the Jobs Strategy nevertheless called on member countries to radically transform their labor market institutions along the laissez-faire lines of the American model.

If the OECD-IMF orthodoxy is correct, the extent to which flexibility-enhancing structural reforms have been implemented over the course of the past decade should go a long way toward explaining changes in the employment performance of OECD member countries in the 1990s. Indeed, this is precisely the contention of the OECD’s *Member Countries’ Experience* (OECD 1997), a follow-up report to the influential *OECD Jobs Study* (OECD 1994). According to the report, “Developments in structural unemployment over the 1990s to a large extent reflect the progress made in implementing the OECD Jobs Strategy.” Again, in a 1999 assessment, the OECD confirmed the correctness of the Jobs Strategy path: countries “that have been most successful in curbing structural unemployment and improving overall labour market conditions . . . have been amongst the most determined in implementing the Jobs Strategy” (OECD 1999: 54).

<table>
<thead>
<tr>
<th>Area</th>
<th>Recommendations</th>
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<tr>
<td>1. Macroeconomic policy</td>
<td>“Set macroeconomic policy such that it will both encourage growth and, in conjunction with good structural policies, make it sustainable, i.e., non-inflationary.”</td>
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<tr>
<td>2. Technology</td>
<td>“Enhance the creation and diffusion of technological know-how by improving frameworks for its development.”</td>
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<tr>
<td>3. Working time</td>
<td>“Increase flexibility of working time (both short-term and lifetime) voluntarily sought by workers and employers.”</td>
</tr>
<tr>
<td>4. Entrepreneurship</td>
<td>“Nurture an entrepreneurial climate by eliminating impediments to, and restrictions on, the creation and expansion of enterprises.”</td>
</tr>
<tr>
<td>5. Wages and labor costs</td>
<td>“Make wage and labor costs more flexible by removing restrictions that prevent wages from reflecting local conditions and individual skill levels, in particular of younger workers.”</td>
</tr>
<tr>
<td>6. Employment protection legislation (EPL)</td>
<td>“Reform employment security provisions that inhibit the expansion of employment in the private sector.”</td>
</tr>
<tr>
<td>7. Active labor market policies</td>
<td>“Strengthen the emphasis on active labor market policies and reinforce their effectiveness.”</td>
</tr>
<tr>
<td>8. Labor-force skills</td>
<td>“Improve labor force skills and competences through wide-ranging changes in education and training systems.”</td>
</tr>
<tr>
<td>9. Social security benefits</td>
<td>“Reform unemployment and related benefit systems—and their interaction with the tax system—such that societies’ fundamental equity goals are achieved in ways that impinge far less on the efficient functioning of labor markets.”</td>
</tr>
<tr>
<td>10. Competition</td>
<td>“Enhance product market competition so as to reduce monopolistic tendencies and weaken insider-outsider mechanisms while also contributing to a more innovative and dynamic economy.”</td>
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Despite this assessment by OECD experts, many countries have resisted the free market model. This hesitation is dismissed by the orthodoxy as a reflection of the power of self-interested “insiders” in maintaining the status quo. As leading OECD economists have put it, “the medicine prescribed under the OECD recommendations is bitter and hard for many countries to swallow, especially insofar as it appears to raise concerns about equity and

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6. Employment protection legislation (EPL)
appears to threaten some of the rents and privileges of insiders" (Elmeskov, Martin, and Scarpetta 1998: 30). The fact that the United States outperformed most European countries only for a relatively brief period, roughly the mid-1980s through the late 1990s and that this decade and a half coincided with unprecedented monetary and fiscal constraint in Europe (but not in the United States) has been largely ignored.

1.4 UNEMPLOYMENT, FLEXIBILITY, AND LABOR MARKET INSTITUTIONS

In the debate over job creation, nearly everyone agrees that flexibility is a good thing. It is certainly hard to argue with flexibility if the alternative is rigidity. But in the economist's lexicon, "flexibility" has a particular meaning: a market is flexible if short-run adjustments of prices and quantities (wages and employment) produce a match between demand and supply. In labor markets, this means that, with full information and negligible cost, workers should move quickly and smoothly from one job and employer to another to land the best job, while employers should hire and fire workers—again with full information and negligible cost—to maximize profits. But, as Schettkat points out in chapter 8, once it is recognized that the textbook assumptions of perfect competition do not (and could not) characterize developed world labor markets, the case for the efficiency of full wage and employment "flexibility" is substantially weakened, and labor market institutions (e.g., collective bargaining, unemployment benefits, and employment protection laws) may be preferred on both efficiency and equity grounds (Agell 1999). And, as Stanford points out (see chapter 4), for the purposes of achieving competitive advantage in real-world dynamic labor markets, a broader and perhaps more relevant understanding of flexibility is the ability to quickly and effectively respond to change. This kind of flexibility may require the kinds of skills and knowledge that come only with extensive organizational experience (Estevez-Abe, Iversen, and Soskice 2001). Successful, flexible organizations, in turn, may require longer-term planning, the antithesis of atomistic market flexibility.

Different labor market institutions, and different combinations of them, produce various kinds of rigidities and flexibility. To lay the groundwork for the chapters that follow, table 1.2 highlights some of the key indicators of institutions that have been most frequently singled out as the sources of the unemployment crisis. Alternative measures of the generosity of social protection spending are shown in columns 1-2. Cash transfers to the nonelderly population in the early 1990s ranged from 12%-15% in the Netherlands, Denmark, Sweden, and Finland, to just 3.7% in the United States and 1.9% in Japan. Such spending reduces the dependency of families on the paycheck and may therefore raise the reservation wages of the less-skilled, reducing their incentive to search for and take jobs (violating the ninth commandment of the OECD Jobs Strategy; see table 1.1). But this spending may also facilitate education, training, and job search and

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promote both worker morale (and productivity) and the legitimacy of reliance on competitive market forces.

Collective bargaining (column 3) is often blamed not only for raising wages but for compressing the wage distribution and reducing employment flexibility (over time and across plants, firms, occupations, and industries), violating the fifth jobs strategy commandment. But unions can also increase worker voice, raise productivity (by helping to manage the workplace and reduce employer-worker conflict), and provide a vehicle to facilitate wage moderation. In the mid-1990s, the share of workers whose pay was determined collectively (but who may not be labor union members) ranged from 98% in Austria and 95% in France to 47% in the United Kingdom and 18% in the United States.

It is not just the breadth of coverage that matters for the way labor markets function, but the structure of bargaining. The industrial relations literature has focused on two dimensions of institutional structure—centralization (whether bargaining takes place at the national, industry sector, or firm level) and coordination (the extent to which individual employers and unions bargain as part of larger associations). Although the country scores on these two dimensions tend to be closely associated—highly centralized bargaining tends to be highly coordinated, and vice versa—this is not so in every case. For instance, Japan’s strict pattern bargaining at the firm level gets a centralization score of 1 (most decentralized) and a coordination score of 3 (most coordinated). The fourth column of table 1.2 shows that the United States (2), New Zealand (2), and the United Kingdom (2.5) had the most “atomistic” bargaining arrangements, while Austria (5.25), Germany (5), and Norway (4.75) had the most coordinated industrial relations systems. It should be noted that, with the exception of postunification Germany, these coordinated market economies have consistently shown lower unemployment rates than their atomistic (free market) counterparts.

The unemployment benefit system can reduce the incentive to work, but it can also promote job training and search among workers (since they don’t have to take an inappropriate job immediately) and can facilitate productivity improvements through enhanced employment flexibility, since employers in solidaristic societies will be more likely to fire workers (and workers will be more likely to accept working under this threat) if there is a substantial safety net, as in the Danish model (see chapter 9). Table 1.2 shows a wide range in benefit generosity across countries. The replacement rate (columns 4–5) measures the relative generosity of unemployment benefits in the first year. Table 1.2 shows that in the early 1980s, the most generous countries were Spain (77%), Denmark (69%), Sweden (68%), and the Netherlands (66.5%), while the United States, the United Kingdom, New Zealand, and Australia were least generous (22%–33%). As column 5 shows, these countries maintained their positions at the top and bottom of the generosity ranking throughout the 1980s and 1990s. France’s replacement rate has been relatively high, dropping from 62% to 58% between the early 1980s and the late 1990s, while Germany’s has been relatively low, declining from 39% to 36%. Both the United States and the United Kingdom substantially reduced their already low replacement rates.

The other key dimension of the unemployment benefit system is the duration of benefits. Columns 6–7 of table 1.2 report the OECD’s unemployment-benefit duration index, measured as the weighted average of the benefits paid to unemployed workers from the second to the fifth year as a share of the first-year benefit level. The larger the number, the more generous the benefits in years 2–5 relative to those in the first year; a zero means that no benefits are paid after the first year. Interestingly, there is often an inverse relationship between the generosity of replacement rates and the duration of benefits. For example, the United Kingdom (7.73), Australia (1.02), and New Zealand (1.04) appear at the top of the duration ranking but are among those with the lowest replacement rates. Sweden, on the other hand, provides generous replacement rates (.04–.05), but only for a relatively short time. Notably, several countries with very different unemployment records increased their duration of benefits quite substantially: France, with already high unemployment (from .32 to .6); Denmark, with declining unemployment (from .62 to 1.0), and Ireland, also with sharply declining unemployment (from .38 to .75). Again, the United States (15.1) ranks at the bottom of the generosity ranking.

The last two columns report the OECD’s employment protection law strictness index for the early 1980s and late 1990s. Strict regulations reduce the freedom to fire workers but also reduce the incentive to hire them. It should also be noted that there are longer-term effects—employers may make better hires in the first place if the freedom to fire is limited. Among the most strict are Italy (2.0 and 1.8), Spain (1.91 and 1.62), and Portugal (1.93 and 1.91). France and Germany are a notch below (1.3 and 1.5; 1.65 and 1.41). At the very bottom of the strictness ranking are the United Kingdom (.35) and the United States (.1).

In the world of the OECD-IMF orthodoxy, these vast differences in institutional frameworks largely explain the pattern of unemployment across the developed world and its change since the late 1970s. Chapters 2–10 critically assess this claim.

1.5 AN OVERVIEW OF THE CHAPTERS

The case for the OECD-IMF orthodoxy has been made most powerfully by reference to cross-country comparisons. The United States, with its minimalist welfare state, weak labor market institutions, and high and rising inequality, showed good employment performance in the 1990s, in sharp contrast to most European countries, which tend to do much more labor market regulation and redistribution. Chapters 2 and 3 take a look at the evidence.

Chapter 2 addresses the heart of the orthodox view—the belief that there is an ineluctable choice that must be made between employment
and equality. Choosing equality, Europe has had to cope with high unemployment, whereas the high job growth of the United States reflects its willingness to accept high levels of earnings inequality. Howell and Huebler explore 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. In contrast to unified theory (and the OECD-IMF orthodoxy), they find little evidence for these predicted tradeoffs.

The tradeoff prediction follows directly from the simple competitive (supply/demand) model—constrain downward wage adjustments and employers will respond with fewer jobs. But, in fact, this model can also accommodate the evidence of little or no unemployment-inequality tradeoff. If OECD labor markets are fairly competitive in the textbook sense, differences in inequality across OECD member countries should reflect mainly differences in skill distributions. According to the "skill dispersion" view, institutions are not as responsible for high unemployment as the conventional wage rigidity view suggests, since the compressed wage distributions simply reflect compressed skill distributions. For example, it is Sweden's skill distribution, not necessarily the rigidities imposed by its welfare state, that accounts for the equality of its wage distribution. In the skill dispersion view, institutions may contribute to the unemployment problem by limiting incentives to hire (employment protection laws) and supply labor (generous unemployment benefits), but not because wages are too compressed. While there is some evidence for this skill dispersion effect, Howell and Huebler's results support other recent research that has found that differences in institutions, not skill distributions, are the main source of cross-country differences in the distribution of earnings. They conclude that the failure of the data to show the predicted unemployment-inequality tradeoffs occurs not because competitive labor markets have ensured that wage distributions reflect productivity-related skill distributions but because the institutions that do in fact compress wages do not have a direct and necessary adverse effect on employment performance.

Still, even if wage compression per se is not the main source of the unemployment problem, "employment-unfriendly" institutions may be the main culprit, because they limit the necessary wage and employment adjustments to external shocks (Blanchard and Wolfers 2000), and perhaps because they have become increasingly restrictive in the face of the price and productivity shocks of the 1970s and 1980s. As Nickell et al. (2002: 19) put it, "broad movements in unemployment across the OECD can be explained by shifts in labor market institutions." Chapter 3 takes up the question of the robustness of the cross-country evidence for this claim. It is distinctive in a number of respects. Unlike much of the rest of this literature, Baker et al. begin from a skeptical stance, challenging the literature and the data to convincingly demonstrate the harmful effects of labor market institutions on employment performance across OECD member countries. Second, they offer the most comprehensive survey of the cross-country literature currently available. And third, they assemble a state-of-the-art data set (both from the generosity of other researchers whose papers they review and from the OECD) and employ these data in relatively simple, transparent regression tests of the institutions—unemployment relationship.

Baker et al. present simple scatter plots of unemployment against 6 standard measures of labor market institutions for five-year periods between 1980 and 1999. Only the unemployment replacement rate shows the predicted positive relationship, but even this is statistically insignificant and, it turns out, entirely driven by the outlying observations for Spain. The authors show that there is no relationship between the OECD's index of labor market deregulation and changes in the inflation-neutral unemployment rate (the NAIRU, as defined by the OECD) over the 1990s. In their multivariate tests, Baker et al. find weak and even perverse effects of the standard institutional variables and conclude that "the empirical case has not been made that could justify the sweeping and unconditional prescriptions for labor market deregulation which pervade much of the policy discussion."

Chapters 4–9 consist of country case studies and in almost every case (Spain is the exception) contrast the experiences of two countries. Like most of Europe, Canada experienced high levels of unemployment from the early 1980s through the late 1990s and responded by introducing significant labor market reforms aimed at implementing OECD-style flexibility. In chapter 4, Jim Stanford points out that, on the basis of labor force participation and employment rates, Canada's employment performance was even worse, particularly relative to the United States, than the unemployment data suggest. Was this a function of too little labor market flexibility? Stanford carefully distinguishes our common-sense understanding of flexibility as the "ability to change and respond to change" from its narrower meaning in conventional economic theory—as price and quantity adjustments to shifts in supply and demand.

Using standard indicators of this broader understanding of flexibility, Stanford shows that Canada actually scores quite highly. Shifts of employment across sectors and the responsiveness of employment (hiring and firing) and labor compensation to demand conditions have been higher in Canada than the United States. Similarly, the prevalence of both part-time employment and self-employment were higher in Canada in the 1990s. Among the most widely accepted measures of labor market rigidity is the lack of worker geographic mobility, and, according to Stanford, Canadians "have demonstrated themselves at least as able and willing to relocate in response to economic circumstances (positive or negative) as
Americans.” Stanford also notes that unemployment remained high in the 1990s after major reforms in the unemployment benefit system were implemented at the beginning of the decade. Measured by flux and turbulence, the Canadian labor market has been as flexible as any.

This chapter suggests that the real objective of Canadian reforms has not been greater labor market flexibility per se but greater labor market discipline. When the labor market is deregulated, power shifts to employers as collective action is replaced by private contracting and as job insecurity increases. This promotes downward wage flexibility (and rising inequality), but other forms of flexibility are reduced, such as mobility between employers (a key, for example, to the success of the Dutch and Danish models). Stanford develops an index of regulation and finds, like Baker et al. (see chapter 3), that there is no statistical relationship between it and employment performance across OECD member countries. He finds that it is aggregate demand conditions, not labor market institutions, that best accounts for labor market performance between Canada and the United States and concludes that "Canada experienced the 'worst of both worlds' during the 1990s: weak macroeconomic conditions combined with a movement away from interventionist labor and social policies. This combination produced both falling employment and rising inequality."

In chapter 5, John Schmitt and Jonathan Wadsworth investigate the extent to which the logic of flexibility that underpinned the OECD’s Job Study can explain the labor-market performance of the United States and the United Kingdom. They focus on a central prediction of the OECD’s theoretical model: that greater labor-market flexibility should be associated with relatively lower unemployment and higher employment of less-skilled workers, particularly young workers and those with lower levels of formal education. The reasoning is straightforward—downward wage and employment flexibility lowers the relative costs of hiring less-skilled workers, which is supposed to price them back into jobs.

Their principal findings call into question the orthodoxy’s flexibility thesis. The international data for the end of the 1990s, as well as the data for Britain in the 1980s and 1990s, consistently demonstrate that labor market outcomes of both young and less-skilled workers in the flexible United States and United Kingdom are no better, and are frequently far worse, than those of their counterparts in most of the rest of the OECD. Regarding the United Kingdom, Schmitt and Wadsworth conclude that “the serious restructuring of the country’s labor market since the early 1980s appears to have produced no noticeable improvement in the labor market prospects facing less-skilled workers in the 1990s relative to the 1980s.” Indeed, they find that all of the improvement in U.K. unemployment rates is accounted for not by workers being priced into the labor market but by workers dropping out of the labor market, a result that “appears to contradict directly the logic behind much of the Jobs Study focus on flexibility.”

Chapter 6 turns to Ireland and New Zealand, two island nations on opposite sides of the globe, which have been acclaimed as 1990s success stories (OECD 1999; IMF 1999). Ireland’s performance has been truly spectacular, with unemployment falling steadily from 15.6% in 1993 to 3.8% in 2001 (OECD 2002: table A). Andrew Glyn shows that Ireland achieved this extraordinary improvement in labor market performance without adopting the OECD’s neoliberal labor market policy prescription. Employment took off, and unemployment collapsed, without an increase in wage inequality at the bottom (the d5/d1 ratio remained stable); without significant changes in employment protection regulations; and without major changes in the unemployment benefit system. Indeed, as Glyn puts it, “The precipitate fall in total and long-term unemployment during the 1990s, without major reform of the benefit system, makes wholly implausible the OECD’s earlier claim that the benefit system was a major factor behind the extreme levels of joblessness in Ireland.”

Glyn attributes Ireland’s success not to increased decentralization and the freeing of the labor market but to cooperative and regulated wage bargaining. Responding in part to a large supply of relatively low-cost but well-educated workers, foreign direct investment poured into the country, which in turn spurred productivity growth. “Social-Partnership” agreements between trade unions and employers kept wage growth moderate, but take-home pay for workers increased because, as part of the bargaining, the state reduced the tax burden on workers. Glyn concludes that labor market deregulation “played no role in the employment boom of the 1990s.”

Entirely unlike Ireland, New Zealand policy makers were early and enthusiastic converts to the OECD’s labor market deregulation prescription, and the effects were substantial. As Glyn puts it, “The impact on trade unions was traumatic; union density and the share of workers covered by collective bargaining halved, the biggest fall in any OECD country.” Not surprisingly, earnings inequality accelerated from already relatively high levels (see Howell and Huebler, chapter 2, figure 2.3). The OECD noted approvingly that New Zealand had substantially cut unemployment-related benefits and significantly tightened eligibility. At the same time, New Zealand followed the OECD’s recommendation of balanced budgets and extremely tight monetary policy. But it turns out that New Zealand’s unemployment performance has been quite mediocre, fluctuating between 7.8% and 10.3% between 1990 and 1994 and from 6.3% and 7.5% between 1995 and 1999, before falling to 5.3% in 2001 (OECD 2002: table A). The lesson Glyn draws from this Ireland–New Zealand comparison is that “extensive labor market deregulation is neither a necessary nor a sufficient condition for a radical improvement in employment.”

Like Ireland, Spain experienced extremely high unemployment in the 1980 and 1990s and showed a sharp decline at the end of the 1990s. From a stunning 23.9% in 1994, Spain’s unemployment rate fell to 13% in 2001 (OECD 2002: table A). In chapter 7, Rafael Bustillo challenges the conventional view that the main culprits were generous unemployment
benefits, excessive wage rigidity, and strict employment protection legislation.

Bustillo argues that analysis of the benefit levels shows that they are not nearly as generous as many observers believe—about 30% of the average wage, one of the lowest in the European Union. He points out that "it is difficult to consider unemployment protection the culprit behind the high rate of unemployment in Spain when more than half of the unemployed workers are not eligible for UB, and when out of those who are eligible, more than half are eligible only for the much less generous (and means tested) unemployment assistance." As for wages, Bustillo demonstrates that Spain, while enduring high unemployment, has been characterized by wage moderation, relatively low labor costs, and relatively high earnings inequality. There is, in fact, little support for the wage rigidity story here. Nor are employment protection laws particularly onerous, despite the complaints of Spanish employers. The relatively high level of job security had its origins in the Franco period as a way to legitimate a system of low wages and an absence of the labor rights that had become standard throughout the OECD. Nevertheless, by the mid-1980s, dismissal rates were comparable to those of other leading OECD countries.

While Bustillo does not aim to provide a full explanation for the massive official unemployment levels reported since the early 1980s, he points to some prime suspects. The transformation from a highly agricultural to a service economy in a matter of a few decades in a period of political upheaval was probably important, as was the rapidly growing labor force and the persistence of extremely tight monetary policy. Bustillo also points to low R&D investment, a fairly ineffective system of active labor market policies (job training and placement), and limited geographic mobility, largely a result of high housing prices and high unemployment in all regions, which made it risky for workers to relocate.

Whereas Spain, with its high unemployment, is characterized by low levels of public social expenditure and relatively high wage inequality, the Netherlands and Germany are widely recognized as "corporatist" welfare states that rely on bargaining among employers, unions, and the state to ensure socially acceptable levels of employment and income. While the Netherlands experienced high unemployment in the late 1980s, it outperformed the United States in the early 1990s and again since 1997. Germany's high unemployment is entirely a postunification phenomenon—it was not until 1993 that Germany's unemployment rate was higher than that of the United States. Inchapter 8, Ronald Schettkat assesses the employment performance of Holland and Germany in light of the OECD-IMF flexibility prescription.

The employment experience of the Dutch and the German economies contrasted sharply throughout the 1990s. This is often claimed to have been the result of deregulation in the Netherlands and overregulation in Germany (see, for example, OECD 1997). However, Schettkat argues that, despite Dutch reforms, by the late 1990s, their regulations still tended to be stronger, and their social protection spending more generous, than Germany's. For example, concerning employment protection regulations, "the Netherlands has the strictest regulations for regular employment, stricter than in Germany and far above the U.S. value." Nor can the answer be found in wage inequality. "If a compressed wage structure was the cause for high Dutch unemployment . . . one would expect that its rapidly improving employment performance would have tied to rising wage dispersion. This, however, is not observed." Wage and skill dispersion are, in fact, quite similar in the two countries. And neither the tax nor the unemployment benefit systems can explain the higher unemployment rate in Germany.

According to Schettkat, the answer lies elsewhere. The Netherlands has been distinguished by high levels of part-time employment, particularly among women, which, in turn, facilitated a much more rapid growth in service-sector employment than in Germany. The Netherlands experienced substantially slower wage growth (at least partially compensated for by tax cuts), which contributed to an export boom. The key to the Dutch employment miracle has been a consistent mix of monetary, fiscal, and wage policies, in sharp contrast to Germany, whose policies since unification have been contradictory. The politics of the unification process (and of European integration) produced both huge public debts as funds flowed to the East and substantial growth in real wages. The response was fiscal austerity, tight monetary policy, and a rise in social security payments levied on both employers and employees, which may have hindered the growth of low-productivity service jobs (Manow and Seils 2000; Bibow 2001). The chapter concludes that the economic and political discussion has greatly overemphasized supply-side work incentives (regulations and benefits) and neglected the role of consistent wage bargaining practice and macroeconomic policy.

Chapter 9 considers Denmark and Sweden, two countries that exemplify the universalistic welfare state. If strong labor market regulation and high social protection spending necessarily produce high unemployment, the employment performance of these two countries should have been among the OECD's worst. As figure 1.1 shows, this has clearly not been the case. Denmark's five-year average unemployment rate was identical to that of the United States in the 1980s, rose above the U.S. rate in the 1990s, but by 2002 was again significantly below it; Sweden's five-year unemployment rates were far below those of the United States until the early 1990s, and, although unemployment shot up to almost 10% in 1997, by 2002 Sweden was again outperforming the United States (see figure 1.1). This vastly improved employment performance in both Denmark and Sweden has been achieved without changing the fundamentals of the Scandinavian model: high tax rates, a comprehensive social security system, a universal unemployment insurance benefit system, and among the lowest levels of wage and income inequality in the developed world.

In their chapter, Peter Ploughmann and Per Kongshøj Madsen argue that an important part of the explanation can be found in a strong
commitment of both countries to active labor market policies—most important, job placement and work-related education and training programs. With the Netherlands and Ireland, Denmark and Sweden spend the most among OECD member countries in these areas, about 1.5% of GDP, which is three to four times greater than in the United Kingdom or the United States (see their figure 9.5). When linked to participation in effective job placement and training programs, relatively generous unemployment benefits (but of limited duration) can facilitate good matches of workers to jobs. The authors make the case that these government interventions actually facilitate labor market flexibility, as well as the transition to the “new economy” of services and high technology.

This reshaping of the Scandinavian welfare state to promote a flexible and innovative “high-road” economy appears to have been effective in both countries, even though in some respects they are quite different; Denmark is characterized by small firms, very low levels of employment protection, and high job turnover, while Sweden’s economy is far more linked to the performance of multinational corporations, and its employment protection laws are much stronger. But, as the authors note, “The strong emphasis on life-long learning, new forms of work organizations, and the increasing use of e-learning are already key components of both the Danish and Swedish ALMP.” The chapter concludes that the experience of these two countries shows that it is not necessary to embrace the American model of unregulated labor markets. While they face tough challenges, particularly the aging of the population and the growing presence of immigrant workers, Denmark and Sweden (and the Netherlands) show that impressive employment performance is possible without abandoning the universalistic welfare state.

Chapter 10 concludes the book with an overall assessment of the OECD-IMF orthodoxy. A consistent message of the chapters is that there is no simple explanation for high unemployment in the OECD area. Chapter 10 provides additional evidence that challenges the orthodox view, in part by focusing attention on the experiences of several important countries that were not the subject of our case studies—Austria, Belgium, France, and Italy. It notes that one of the consequences of the dominance of the free market orthodoxy is that other explanations have been given short shrift in the research and policy-related literature. Although an entirely convincing account of the high unemployment crisis of the past 25 years has yet to be written, this concluding chapter pulls together several elements of what such an account will likely have to include, all of which appear in one way or another in chapters 2-9.

The OECD-IMF orthodoxy is mistaken. The unemployment problem cannot be blamed on labor market rigidities imposed by the welfare state. The evidence simply does not support the free market view that convergence with the American model—reduced wages, increased inequality, and greater economic insecurity—is the only path to good employment performance. Markets are essential to the effective functioning of all modern economies, but they cannot function well without sensible regulation and strong social safety nets. The nature of these institutional constraints and supports varies widely across countries, reflecting different cultural values and institutional histories. Many of these “varieties of capitalism” can produce good employment performance, as the universalistic welfare states in northern Europe and Scandinavia have demonstrated. This book aims to help free the conventional wisdom from free market orthodoxy.

Notes

1. The Organization for Economic Cooperation and Development, the International Monetary Fund, and the European Central Bank.

2. National income per employed worker in 12 major Western European countries nearly doubled between 1973 and 1998, increasing from $28,100 to $43,100 (in 1990 dollars). This figure reached $55,600 for the United States. For purposes of comparison, this measure of national well-being was just $20,800 for Mexico, $14,500 for Brazil, $6,200 for China, and $4,500 for India (Maddison 2001: Table E-5 and E-6). In absolute terms, the level of worldwide inequality—explained mostly by cross-country inequality—has never been greater (Sutcliffe, 2003).

3. Gary Becker, perhaps the most prominent living economist, aptly summed up the orthodox view and the frustration of mainstream economists with European policy makers: “I argued in previous columns that rigid labor markets and high social security and other taxes on employed workers explain Europe’s excessive unemployment. Yet, Helmut Kohl and the Christian Democrats took only modest actions to reduce labor taxes and give companies more flexibility over employees” (Becker, 1998).

4. According to Garrity (1979: 212), “The French state also devoted enormous energy to checking up on those who did qualify for aid—aid that amounted to only a few francs a day—to make sure that no undeserving person was feeding at the public trough. In 1935 some 323,000 francs were extracted from people found to have obtained relief improperly.”

5. It might be argued that the similarity of the French and U.S. unemployment population rates in 2001 partly reflects the slowdown in the U.S. economy that year. In 1998, the male youth unemployment incidence was 6.7%, compared to the U.S. rate of 7.6%; the female youth rate was 7.4% for France and 6.5% for the United States.

6. On the right, the German economist Horst Siebert (1997) unhappily placed the entire blame for high unemployment in Europe on labor market rigidities. Gary Becker spread the same message through his Business Week commentaries, pronouncing in one, for example, that “rigid labor markets and high social security taxes on employed workers explain Europe’s excessive unemployment.” Similarly, Robert Haveman (1997: 3), a prominent liberal economist who has specialized in the study of poverty, wrote that “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 [and] slow employment growth.”

7. See Bjorklund and Freeman (1997); Freeman and Schettkat (2000); Devroye and Freeman (2000); and Lucifora (2000).
References


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It is the orthodox view that the persistence of high unemployment is explained by the rigidities imposed by labor market institutions such as centralized collective bargaining, legal minimum wages, employment protection laws, and unemployment benefit programs. Job creation is made less attractive for employers, whereas joblessness becomes more attractive for workers. These disincentives for employment growth may take place as direct effects of protective labor market institutions or indirectly through their effects on the wage structure—by raising wages at the bottom of the skill distribution, protective regulations and institutions price the less-skilled out of jobs. The policy response must be comprehensive labor market deregulation (OECD 1997; OECD 1999; IMF 1999; IMF 2003). This should be of particular importance in the aftermath of 1970s–80s productivity, energy price, technology, and trade shocks that are argued to have dramatically shifted the demand for labor away from the less-skilled. Because of the strong advocacy for this diagnosis and policy prescription by the Organization for Economic Cooperation and Development (OECD) and the International Monetary Fund (IMF), we refer to this widely accepted view as the "OECD-IMF orthodoxy."

This orthodox explanation for persistent high unemployment has two distinct variants. In the first, institutions may increase unemployment by blocking downward wage flexibility (the wage compression variant). In the second, institutions can undermine employment opportunities not through their direct effects on the wage structure but through non-wage-labor costs and work incentives, since competitive forces ensure that the skill distribution will determine the wage structure (the skill dispersion variant).