

Determinants of Unemployment in Western Europe and possible Policy Responses

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Introduction

There can be no doubt that the experience of persistent mass unemployment in much of Western Europe (and in some countries outside Europe) since the mid-1970s has been the most conspicuous and costly failure of macroeconomic management in the post war era. The failure has been at root a failure of economic theory, in that the problem was not foreseen and could not be solved by the policies suggested by the then prevailing (neo-Keynesian) orthodoxy. Subsequently that amount of economic analysis of this problem has been absolutely enormous, in part because of the linked need to re-orientate macroeconomic policy, so that for much of the period policies were introduced in something of a theoretical vacuum. More recently, though, more of a consensus has developed around the idea that sustainable low unemployment can be achieved only through a well-functioning labour market, though this of course leaves room for debate over the types of policy which might work best.

The paper first summarises the key facts, both of unemployment in Western Europe relative to the rest of the developed world, and the different experiences of different European countries. It then outlines the main explanations which have been offered, and attempts, with the benefit of hindsight, an evaluation of their relative importance. It then proceeds to an examination of the various policies attempted by governments, and of the literature evaluating their impact and efficacy. Of course, the literature on all these subjects is vast and this account is necessarily selective. Rather than attempt to cover everything, the paper endeavours to look at some key issues and offer some new interpretations in particular of the relationship between unemployment and labour market participation. The paper concludes by attempting to link together these various strands, in an attempt to link the major causes of persistent unemployment with policy recommendations.

1. Background: the data

1.1 The measurement of unemployment

International comparisons of unemployment experience were for a long time bedevilled by problems of the comparability of data collected in different countries. Most early measures of unemployment were compiled from statistics of those in receipt of unemployment benefits or of other social assistance by reason of being unemployed. Obviously this ‘claimant’ measure is affected by the rules and regulations affecting benefit eligibility, and differences across countries in this measure may reflect differences in the availability of benefits rather than differences in the number of people out of work. Matters have in this respect improved enormously in recent years with acceptance amongst governments, international institutions and academic economists that unemployment is best measured by the ILO definition, according to which unemployment is measured as the number of people out of work, looking for work and available for work as a proportion of the total labour force. The ILO and OECD have at the same time encouraged the introduction of labour force surveys, which measure unemployment on this basis in a manner which is consistent across countries.

It should be stressed that the ILO measure represents a labour force state, but says nothing about the reasons why people may be in that state. In particular it does not distinguish ‘voluntary’ from ‘involuntary’ unemployment, and further it distinguishes the state of unemployment from that of being ‘out of the labour force’ by the criterion of having searched for work in the past four weeks, a criterion which may itself be both subjective and sensitive to economic conditions.

The alternative ‘claimant’ measure, the number of people in receipt of unemployment benefit, is of course of continuing relevance to governments on account of its direct budgetary significance. Further some aspects of the ‘conditionality’ attached to the payment of benefit may be linked to filtering out those who are ‘voluntarily’ unemployed (for example benefit entitlement may be withdrawn if people leave their jobs voluntarily, refuse to look for work or will not take up suitable offers). The criteria for payment of benefit are in any case objective and applied fairly uniformly.

The difference between these measures raises a more fundamental question of what it is one is trying to measure, or why unemployment should be regarded as an issue of particular significance. People may be in employment or they may not, and only relatively few of those not working are classed as unemployed. The reason unemployment is of greater concern than non-participation is that unemployment is seen as involuntary and reflects a failure of the labour market. By contrast, non-participation is seen as voluntary, and results from a deliberate choice on the part of particular individuals to devote their time to their families, to study or to take early retirement. Unfortunately, however, the distinction between unemployment and non-participation is far from clear-cut in practice, and neither the ILO nor the claimant count definition are fully satisfactory in distinguishing the two.

1.2 Unemployment in Europe

While it now tends to be taken for granted that the United States has lower unemployment than Europe, this is in fact quite a recent development. Figure 1 compares European and American unemployment over the past 40 years. The unemployment rate in Europe was consistently lower than that of the United States until the late 1970s and has been significantly higher only during the second half of the period, since about 1984. Like Europe, the US suffered a very sharp rise in unemployment at the beginning of the 1980s, but, unlike Europe, the unemployment rate then quite quickly fell back to its post war average of around 6 per cent. By contrast European unemployment averaged around 3 per cent in the 1960s and early 1970s, but more like 10 per cent in the 1980s and 1990s.

The economic history of the period provides some insight into the causes of these developments and of the differences between European labour markets and those of the United States. The sharp rise in unemployment in the early 1970s followed the first OPEC oil price shock, and its deflationary impact on aggregate demand. However, attempts by governments during the 1970s to stimulate demand and bring down unemployment appeared simply to lead to a resurgence of inflation towards the end of the 1970s. Following the second oil price shock in 1979, it was generally accepted that macroeconomic policy had to concern itself primarily if not exclusively with the control of inflation. From the early 1980s, the stance of macroeconomic policy in most countries was deflationary, and the impact on unemployment depended on the capacity of the labour market to adjust to this new regime. The clear picture is that the American labour market recovered fairly quickly, whereas in Europe unemployment not only remained at a much higher level than before, but even showed some tendency until very recently to rise further rather than to fall back to its level of the 1960s. Unemployment in the United States reached exceptionally low levels in the 1990s, and since the mid 1990s there has also been a clear downward trend in European unemployment.

The evolution of European unemployment is obviously something of a puzzle for those who believe that for example institutional rigidities or more generous welfare policies account for

the recent European experience. For these policies and rigidities characterised the earlier part of the period as much as the later. We need to understand not only why unemployment was so high in the 1990s but also why, relatively speaking, it was so low in the 1960s.

It is at the same time essential to recognise that differences in unemployment rates across European countries are large both in absolute terms and relative to the difference between Europe and the US. Thus, in 2000, the range of unemployment rates across European countries stretched from only 2.7 per cent in the Netherlands or Switzerland to over 14 per cent in Spain (Table 1). Europe cannot therefore in this context be regarded as a homogeneous block: differences between European countries in measured unemployment can be larger than the difference between the European average and that of the United States. While not remarkable in itself, this observation counsels against any simplistic association of US policies with labour market success. By 2001, no less than 7 European countries had unemployment rates below 5 per cent, which might be taken as approximating full employment. Not only that, but it may be noted that some of these are Nordic countries whose labour market policies are very different from those of the United States. Even so, it can be seen from Table 1 that no major economy outside Europe recorded an unemployment rate in excess of 7.0 per cent, whereas six Western European economies have higher rates than this, including four of the largest, namely France, Germany, Italy and Spain.

Further the ranking of European countries by unemployment rate has not been stable over time. Some of the countries with the worst unemployment records in the 1980s are amongst the success stories of recent years (the Netherlands and Ireland in particular, but also the UK and Denmark). On the other hand some of those which coped best in the early period like Germany and Sweden have fallen on harder times (Figures 2 and 3). These variations over time again do not seem to correspond in any very obvious way to changes in labour market institutions.

We have already noted however that unemployment is not necessarily the most instructive measure of conditions in the labour market. On other measures, such as the proportion of the working-age population in employment, or the participation rate, the differences between Europe and America are even more stark. In 2000, just over 74 per cent of working age Americans were in employment, as against an average of just under 66 per cent in Europe. More people are in work in America both because the participation rate is higher (more of the working age population are in the labour force) and because the unemployment rate is lower. But differences in participation account for a larger part of the difference in employment.

However, as with the unemployment rate, it is notable that employment-population ratios vary substantially across European countries. The ratio is particularly low in Italy (53.4 per cent), in Greece (55.9 per cent) and in Spain (56.1 per cent), while being exceptionally high in countries like Norway (77.8 per cent) and Switzerland (79.6 per cent).

It is notable that countries with high unemployment rates also typically have low employment-population ratios, and the variation in the employment-population ratio appears in most cases large as compared to the variation in unemployment rates. By definition, the employment-population ratio (E/P) is the product of the employment rate (E/L) and the participation (or activity) rate (L/P), where E is employment of working age people, L the labour force and P the population of working age. The employment rate (E/L) is of course equal to one minus the unemployment rate (U/L) since employment and unemployment sum to the labour force. Table 1 suggests that countries with high unemployment rates typically

also have low participation rates, so that variations in employment are greater than would be implied by the unemployment rate differentials on their own. In fact the variations in participation rates are generally greater than the variations in unemployment rates. For example, comparing the employment-population ratio for Europe with that for the United States, of the 8.4 percentage point gap, three-quarters is accounted for by differences in the participation rate, and only one quarter by the lower unemployment rate.

Figure 4 contrasts the unemployment rate and the participation rate across OECD economies. It is clear that participation rates are strongly and negatively correlated with unemployment rates. It may also be noted that the countries which have been most successful in reducing their unemployment rates have also experienced higher labour force participation rates (Figure 5). To the extent therefore that one is concerned with overall employment, the key explanatory variable is the participation rate, and we consider this further in section 2.2 below.

2. Explanation

2.1 A Brief Review of Models

i) simple Keynesian models

The theoretical framework of Keynesian models supposes that in the short run economic activity is driven by the state of aggregate demand, and this in turn determines the unemployment rate. However excessively high demand feeds into inflation, and it is the trade-off between unemployment and inflation which determines the sustainable unemployment rate. The key relationship is the Phillips Curve, which in expectations augmented form can be written:

$$P = P^e + f(z,u) \quad \dots \quad (1)$$

In equilibrium ($P=P^e$), the rate of unemployment consistent with any expected rate of inflation, usually taken as stable or non-accelerating inflation, the NAIRU, is then given by $u_N=g(z)$, that is to say that unemployment takes whatever level is required to offset the impact of wage pressure or wage push on inflation. Trade unions are generally seen to have a key role in this process and wage pressure variables are those which measure the power of unions in the wage bargain. The type of factors seen to be critical include the proportion of the workforce unionised (or covered by collective bargaining), and the extent to which union power is supported by social security measures such as unemployment benefits or by legal or institutional measures such as employment protection legislation.

ii) simple structural models

These take their inspiration from Milton Friedman's (1968)¹ notion of the 'natural' rate of unemployment, which is explicitly grounded in labour market institutions, and in particular the various imperfections and rigidities held to characterise the labour market. The starting point is therefore the natural rate, but in the absence of perfect information demand shocks create cyclical movements of familiar form. From this framework one may derive a Phillips

¹ Friedman, M. (1968) 'The Role of Monetary Policy' *American Economic Review*, 58 pp. 1-17.

Curve relationship (though it is price shocks which lead to fluctuations in unemployment rather than unemployment influencing wage demands) which takes the form:

$$P = P^e - h(u - u^*) \quad \dots \quad (2)$$

Where u^* is the natural rate of unemployment and $h' > 0$. The imperfections and rigidities which determine the natural rate of unemployment include such factors as the role of trade unions, labour market legislation and taxes and benefits, that is much the same variables as are held to be responsible for 'wage pressure' in Keynesian models. Thus, in terms of equations if we write $u^* = u(z)$, and the z variables in these models are much the same as those of the Keynesian models, the two models are essentially equivalent in terms of their empirical implications. Both imply equilibrium unemployment rates determined purely by institutional or structural factors, with fluctuations about the equilibrium being determined by fluctuations in aggregate demand or other macroeconomic shocks.

Models of this type appear consistent with the behaviour of the aggregate unemployment rate in the United States, but not with European experience. In the United States, the institutions of the labour market have remained fairly static over the years, and the unemployment rate itself has fluctuated around a relatively stable average of around 5.5 – 6.0 per cent. In Europe, by contrast, there has been a sharp upward trend in the underlying rate of unemployment over the past 40 years, which appears to have come to an end only quite recently. While in their detail labour market institutions in Europe have been changing all the time, it is hard to argue that these changes have been large relative to differences between Europe and the United States. Many of the changes may in any event have been in the direction of reduced rather than increased rigidities which might be associated with lower rather than higher unemployment.

Structural models at first sight appear to do better in explaining the differences between countries than the evolution of aggregate unemployment over time. Starting with the innovative work of Calmfors and Driffill (1988)² and Layard *et al.* (1991)³, a number of studies (notably Elmeskov, 1993,⁴ Bean, 1994,⁵ Heylen *et al.*, 1996⁶ and Jackman *et al.*, 1996⁷) have found fairly systematic links between aggregate unemployment (usually over say a 5 year period) and structural factors. These studies have identified factors such as trade union membership, the degree of centralisation of bargaining and the level and duration of unemployment benefits as having a fairly systematic impact, while evidence on the effects of employment protection measures and of spending on active labour market seems more mixed.

These studies may none the less be criticised on the grounds that the number of countries under consideration is quite small (typically between 15 and 20) and the number of potential explanatory variables is enormous. It is further the case that some variables such the degree of

² Calmfors, L. and Driffill, J. (1986) 'Centralisation of Wage Bargaining and Macroeconomic Performance' *Economic Policy*, 6, pp. 13-61.

³ Layard R., Nickell, S. and Jackman, R. (1991) *Unemployment: Macroeconomic Performance and the Labour Market*, Oxford University Press, Oxford.

⁴ Elmeskov, J. (1993) 'High and Persistent Unemployment' Assessment of the Problem and its Causes' OECD economics Department Working Paper no. 132, OECD, Paris.

⁵ Bean, C. (1994) 'European Unemployment: A Survey' *Journal of Economic Literature*, 32(2) pp.573-619.

⁶ Heylen, F., Goubert, L., and Omey, E. (1996) 'Unemployment in Europe: a Problem of Relative or Aggregate Demand for Labour?' *International Labour Review*, 135(1) pp.17-36.

⁷ Heylen, F., Goubert, L., and Omey, E. (1996) 'Unemployment in Europe: a Problem of Relative or Aggregate Demand for Labour?' *International Labour Review*, 135(1) pp.17-36.

co-ordination in wage bargaining are somewhat subjectively measured, since the objective is to measure the 'effectiveness' of co-ordination rather than a particular institutional structure.

The credibility of these studies is also undermined by the sharp changes in the unemployment rates of the countries relative to one another over the period while institutional arrangements have by and large not changed. To some extent these international cross-section studies are 'children of their time' in the sense that they describe and summarise empirical regularities that characterise a particular period rather than identifying the fundamental determinants of the unemployment rate.

These simple models are therefore substantially inconsistent with the broad facts of post-war European experience. The sustained very low rates of unemployment in the 1950s and 1960s, followed by the extremely high and persistent unemployment rates of the 1980s and early 1990s cannot be explained by demand shocks. They persist for too long for any normal model of the business cycle and do not accord with the behaviour of other labour market or macroeconomic indicators. Nor can the sudden shift from very low to very high unemployment be explained by labour market or institutional variables, as these hardly changed in many countries over the relevant time period.

We proceed therefore to models developed to explain these broad facts:

iii) hysteresis

Hysteresis is the idea that a system can be changed for a long time, perhaps even permanently, by the experience of a shock. By way of graphic illustration, Keynes (in the *Tract on Monetary Reform*, 1920⁸) gives the example of a storm at sea. In the example, a ship is destroyed and sunk in the storm and its destruction, and the deaths of the sailors, are permanent even though the storm itself is temporary. When the storm is over, the sea will be calm again but the ship will not return to surface nor will its sailors be brought back to life. The disruptive effects of a shock can in this case cause permanent damage, even though the determinants of the long run equilibrium are unchanged. In the economic sphere, events like bankruptcies, in which a previously viable firm closes down and its capital, workers and managers are dispersed, could be cited as a parallel.

The notion that the labour market might be subject to hysteresis was prompted by the persistence of very high rates of unemployment in many Western economies in the 1980s. The idea is that the structure and institutions of labour markets do not of themselves cause high unemployment, but rather lock in high rates of unemployment caused by macroeconomic downturns, such as those caused by the OPEC shocks. This has led to a whole class of models in which the capacity of labour market institutions to enable the economy to adjust to shocks plays a critical role. Most, but not all, models of this category assume that hysteresis is partial, so that the effects of a shock may be prolonged but are not permanent.

The concept of hysteresis may be grafted onto either the simple Keynesian or the simple structural framework. In the structural case for example, there will still exist a long run equilibrium natural rate, but in the short run the equilibrium rate will be given by:

⁸ Heylen, F., Goubert, L., and Omey, E. (1996) 'Unemployment in Europe: a Problem of Relative or Aggregate Demand for Labour?' *International Labour Review*, 135(1) pp.17-36.

$$U_{SR} = \lambda u^* + (1-\lambda)u_{-1} \quad \dots \quad (3)$$

where u_{-1} is the unemployment rate in the previous period. Likewise in the Keynesian model we would have previous period unemployment amongst the wage pressure variables:

$$P = P^e + f(u, u_{-1}, z) \quad \dots \quad (1')$$

With $\partial f/\partial u_{-1} > 0$, so that the higher is past unemployment the higher current unemployment needs to be to achieve any given effect on wage pressure.

In either case, should there be a sharp rise in unemployment following some shock, the equilibrium, or non-inflationary, rate of unemployment will rise and thereafter decline slowly back to its long-run equilibrium. The rate of decline is described by the parameter λ (in equation (3)), or on the value of f_2/f_1 (in equation (1')).

Thus formalised, hysteresis models have the property that a sharp increase in unemployment, such as that which followed the oil market shocks and the monetary deflation of the 1970s and early 1980s, would persist for some years thereafter. How many years would depend on the factors characterising the speed of adjustment, and these factors in turn are held to depend on various labour market or other institutions. The structural variables affect not the equilibrium rate of unemployment but rather the speed with which the economy adjusts to shocks, and any cross-section correlation between unemployment and these structural variables would represent a snapshot at a particular stage in the adjustment process, rather than a long run equilibrium.

Clearly hysteresis models which explain unemployment in terms of the interaction of shocks and labour market institutions are attractive in a number of respects. In particular, i) they allow movements in aggregate unemployment over time to be explained largely by shocks which themselves have high variance rather than by structural factors which tend to be relatively static, ii) they are consistent with explanations of the cross-section variation across countries at a point in time which rest largely on structural factors, and iii) they imply that such cross-section relationships will not be stable over time.

Hysteresis models need first to identify a mechanism generating slow adjustment. A number of studies in the early 1980s were concerned with the causes of cross-country variation in various nominal rigidities (e.g. Bruno and Sachs, 1985,⁹ or Grubb *et al.*, 1983¹⁰). Economists at this time were particularly struck by the observation that unemployment rates in the Scandinavian countries had remained remarkably low throughout the 1970s and early 1980s. The explanation offered was that the institution of centralised wage bargaining enabled wages to be set in awareness of the economic consequences of the oil price increase, whilst in other countries with decentralised bargaining wages were still set by reference to targets for real wage growth. Such targets were no longer attainable, but the attempt to achieve them imparted an inflationary bias to wage demands, which in turn had to be offset by higher unemployment. But the experience of the 1980s suggested that persistently high rates of unemployment coexisted with stable inflation, and the term hysteresis came then to be

⁹ Bruno, M. and Sachs, J. (1985) *Economics of Worldwide Stagflation*, Basil Blackwell, Oxford.

¹⁰ Grubb, D., Jackman, R., and Layard, R. (1983) 'Wage Rigidity and Unemployment in OECD Countries' *European Economic Review*, 21, pp. 11-39.

associated with real rather than nominal rigidities. Though various ideas were explored two main themes came to dominate.

The first was that in economies where wages were set by trade unions, only the interests of current employed union members would be taken into account in wage determination. Thus if an adverse shock led to reduced employment, those who lost their jobs would also lose their vote and wages would be set to maximise the welfare of those in work and not with regard to the job prospects of those currently unemployed. In an early model of this type, Blanchard and Summers (1986)¹¹ demonstrated that employment would then follow a random walk with no reference to the unemployment rate. The basic idea was however developed extensively by Lindbeck and Snower (1988)¹², under the name of the ‘insider-outsider’ model.

We will argue below that, while the ‘insider-outsider’ insight is important, the particular manifestation in terms of wage-setting was unconvincing. The objection to the model in the context of wage-setting is that by and large it appears that unions take no interest in employment in the wage bargain; their concern is to maximise their members’ wages and they do not look further than that.

The second main theme came to prominence with the work of Layard and Nickell on the UK economy during the 1980s and focussed on long-term unemployment (Layard and Nickell, 1986¹³). The basic notion was that, as unemployment rose, there would be an increase in the number of people experiencing a long duration of unemployment, and that long spells of unemployment could discourage job search, weaken motivation and be associated with a depreciation of skills. Employers might then be reluctant to hire long-term unemployed people, so people with long unemployment spells would to some extent fade out of the labour force.

Long-term unemployment causes hysteresis to the extent that people are scarred by the experience, and conclusive evidence on this has been hard to pin down. It is well-known that outflow rates from unemployment decline with duration, but difficult to establish whether this result derives from heterogeneity or from a direct causal impact of the length of an unemployment spell on the chance of finding a job. However, more recent work using longitudinal data finds significant evidence of long-term scarring (Gregg, 2001)¹⁴.

While the rise in unemployment following the OPEC shocks of the 1970s was evidently the sharpest disruption faced by the economies of Western Europe in the post-war period, it is by no means the only shock to have occurred. Other major shocks include the downturn in productivity growth, also from the 1970s (Grubb *et al.*, 1982)¹⁵, and the sharp rise in real interest rates throughout the world in the 1980s (Phelps, 1994)¹⁶. As a general framework to

¹¹ Blanchard O. and Summers L. (1986) ‘Hysteresis and the European Unemployment Problem’, in S. Fischer (ed.) *NBER Macroeconomics Annual*, MIT Press, Cambridge, MA, pp.15-77.

¹² Lindbeck A. and Snower, D. (1988) *The Insider-Outsider Theory of Employment and Unemployment*, MIT Press, Cambridge, MA.

¹³ Layard R. and Nickell, S. (1986) ‘Unemployment in Britain’ *Economica*, 53, pp. S121-169.

¹⁴ Gregg, P. (2001) ‘The Impact of Youth Unemployment on Adult Unemployment in the NCDS’ *Economic Journal*, 111, pp. F626-653.

¹⁵ Grubb, D., Jackman, R., and Layard, R. (1982) ‘Causes of the Current Stagflation’ *Review of Economic Studies*, 49, pp. 707-730.

¹⁶ Phelps, E. (1994) *Structural Slumps. The Modern Equilibrium Theory of Unemployment, Interest and Assets* Harvard University Press, Cambridge, MA

allow for the effects of any such shocks, Blanchard and Wolfers (2000)¹⁷ estimate a fixed effects model in which the structural variables interact with the aggregate level of unemployment. In their formulation when unemployment is high in aggregate structural variables have a big impact in explaining the differences in unemployment across countries, while when aggregate unemployment is low the impact of such factors is much less.

The results in the Blanchard-Wolfers (2000) paper are much in line with previous studies and may be taken as representative. They find first that both the unemployment benefit replacement rate and the duration of unemployment benefits prolong adjustment. These variables are associated with a tendency to long-term unemployment. They also find employment protection measures slow down adjustment, as do high taxes, while active labour market policies speed it up. Finally, they find that union membership slows down adjustment, while co-ordinated wage bargaining speeds it up. These variables link up with the role of long-term unemployment or that of insiders in wage bargaining. Blanchard and Wolfers also investigate whether the country fixed effects in their estimation can be explained by the same set of structural variables but are unable to identify any statistically significant results. They suggest that this implies that such structural variables matter only because they affect adjustment speeds, and not the long run equilibrium, though this is an issue which will need further research.

iv) interactive models

These models are static in character, but assume that the economy is hit by some permanent shock the impact of which depends on the economic structure. The best-known of these is the technology shift hypothesis, which argues that the impact of recent technological advances particularly in the spheres of computers and information technology has been to raise the demand for skilled at the expense of unskilled labour. This hypothesis was originally advanced to explain the increase in wage dispersion in the United States economy. This idea was then extended to argue that in economies where greater wage inequality was obstructed by financial provisions such as unemployment benefits, or legal measures such as minimum wage laws, or institutions like egalitarian trade unions, the reduced demand for unskilled labour would create unemployment. Thus, for example, in a vivid presentation of this thesis, Krugman (1994)¹⁸ who suggested that ‘growing US inequality and growing European unemployment are different sides of the same coin’. Krugman argues that the shift in demand towards more highly skilled labour has created persistent unemployment in countries where relative wages have not been able to adjust. To put matters another way, a set of institutions and policies which function effectively in one economic environment may be dysfunctional in another and in fact lead to high equilibrium unemployment.

While to some extent plausible, the technology explanation has run up against the difficulty that there is no evidence that higher levels of unemployment in Europe are concentrated amongst the unskilled. Of course, it is always the case that the unemployment rates of unskilled workers are higher, but both aggregate analysis (Heylen *et al.*, 1996,¹⁹ Jackman *et*

¹⁷ Blanchard O. and Wolfers J. (2000) ‘The Role of Shocks and Institutions in the Rise of European Unemployment: the Aggregate Evidence’ *Economic Journal*, Conference Papers, March, pp. C1-33.

¹⁸ Krugman, P. (1994) ‘Past and Prospective Causes of High Unemployment’ in *Reducing Unemployment: Current Issues and Policy Options*, Federal Reserve Bank of Kansas City, Missouri, pp. 49-80.

¹⁹ Heylen, F., Goubert, L., and Omey, E. (1996) ‘Unemployment in Europe: a Problem of Relative or Aggregate Demand for Labour?’ *International Labour Review*, 135(1) pp.17-36.

al., 1997)²⁰ and microeconomic studies such as Krueger and Pischke (1997)²¹ fail to detect any differential shift in excess demand. One explanation may be that many European countries gave high priority to improvements in secondary and post compulsory education, so that the increased demand for more skilled workers was matched by an increased supply. This would in turn imply that the observed stability of the wage distribution reflected not so much institutional resistance to any change in relative wages as an absence of market pressure for change in the first place.

Of course, there have been many changes in the labour markets of the European countries over the past 40 years, and in some respects demographic changes have been even more dramatic than technological advances. Labour force participation rates have risen strongly in most countries and there is much evidence (see below) that participation can affect unemployment. The main underlying cause of increased labour force participation has been the huge increase in female participation, and, as hinted in the introduction, this change perhaps has dominated labour market developments in many countries.

A second demographic change of immense importance has been the reduction in the mortality rate. In the early years of this century, improvements in living standards and in public health greatly reduced infant mortality rates. This together with the associated reduction in the birth rate, led to a substantial improvement in women's health and after a time to an increase in female labour force participation. However, in recent years, improvements in health care have primarily reduced mortality of older people. This has led to a sharp growth in the proportion of retired people in the population with obvious adverse implications for the dependency ratio. An increase in the proportion of old people in most European countries has severe fiscal implications, and in general necessitates an increased tax burden on those in work.

The argument of this paper will be that these demographic changes as much as advances in technology are critical to understanding labour market developments of the post-war period.

2.2 The participation rate and the employment to population ratio.

Figure 6 shows the major developments in the participation rate, both in the United States and in Europe. There is a pronounced upward trend in the female participation rate both cases. By contrast the male participation rate shows some tendency to decline. For both men and women participation is much higher in the United States than in Europe. Causes of differences in participation rates across countries have not been as intensively investigated as with unemployment, though some cross-section econometrics can be found in Layard and Nickell (1999)²² and Nicoletti and Scarpetta (2001)²³. Table 1 gives participation rates for individual countries both in aggregate and separately for men and women.

As already noted in relation to the comparison between Europe and the United States, the main cause of the differences in the employment-population ratio across countries is the

²⁰ Jackman, R., Layard, R., Manacorda, M., and Petrongolo, B. (1997) 'European versus US Unemployment: Different Responses to Increased Demand for Skill?' Centre for economic Performance Discussion Paper No. 349, and printed in R. Layard *Tackling Unemployment* (1999), Macmillan, London.

²¹ Krueger, A. and Pischke, J. (1997) 'Observations and Conjectures on the US Employment Miracle' NBER Working Paper No. 6146.

²² Nickell, S. and Layard, R. (1999) 'Labour Market Institutions and Economic Performance' in Ashenfelter, O. and Card D. *Handbook on Labour Economics*, volume 3C.

²³ Nicoletti, G. and Scarpetta, S. (2001) 'Interactions between Product and Labour Market Regulations: do they affect Employment? Evidence from OECD Countries' OECD Economics Department Working Paper.

variation in participation rates. There is a clear tendency in the data for countries with lower participation rates to have higher unemployment rates (though there is no necessary reason why this should be so, and we return to this below). As already noted in Figure 4, a plot of unemployment rates against participation rates displays a clear negative correlation. The slope coefficient suggests that an increase in unemployment of one percentage point tends to be associated with a three percentage point reduction in participation. This means that roughly speaking three-quarters of the variation in the employment-population ratio can be explained in terms of variation in the participation rate and only one-quarter as a result of variation in unemployment.

It is clear that the immediate cause of these differences lies in the participation of women. Male participation rates cluster in the 75 to 85 per cent range across the OECD, with the European average (at 78.9 per cent) only around 5 percentage points lower than the figure for the United States (83.9 per cent). By contrast female participation rates range from only around 50 per cent in Spain and Greece to more than 75 per cent in Denmark, Norway and Sweden. The female participation rate in the United States is 10 percentage points higher than in Europe (70.8 per cent as against 59.8 per cent). The gap between male and female participation rates ranges from a low of less than 5 per cent in Finland and Sweden to close on 30 per cent in Greece, Italy and Spain. It is natural therefore to think that these differences reflect differences in social traditions and social structures and simply embody the different preferences over the 'household allocation of time' that result from them. Two pieces of evidence suggest however that the reality is more complex.

First, if one disaggregates participation rates by age, the evidence for different age groups is quite different. In Table 2, the employment-population ratios, unemployment rates and participation rates of 'prime-age' adult workers (age 25-54) for men and women. There is a remarkable closeness in the employment-population ratios of prime age men in all countries, notwithstanding the very considerable differences in other labour market indicators. Participation rates are also very similar for this group across all countries and the variation in unemployment rates is quite limited. In all these measures, the variation across countries is much greater for women than for men. In particular, in the low unemployment countries the unemployment rates of adult men and women are much the same, but where unemployment is high, such as Spain, Greece or Italy, the unemployment rate of women is very much higher than of men. Indeed, it is sometimes argued that the European unemployment problem is less severe than appears at first sight, because the unemployment rates of primary workers (identified as prime age men) is lower than the aggregate unemployment rate.

There are by contrast remarkably large disparities across countries in the employment-population ratios for young people age 15-24 (Table 3). In France, only 23 per cent of people aged 15-24 have a job as against 68 per cent in Netherlands or 67 per cent in Denmark. These differences across neighbouring economies seem extraordinarily large. Of course a high proportion of young people are not in work because they are in school or college, but the figures for educational enrolment given in column 4 of Table 3 suggest the variation in this factor across countries is not enormous nor able to account for any part of the difference in employment. For example, Denmark and the Netherlands both have higher educational enrolment rates than does France. (In some countries, the employment-population ratio and the education enrolment rate add up to more than one, presumably because young people may both work and attend a school or college within a given period, and can be counted in both categories.)

One may further note that though in nearly all countries the employment-population ratios of young women are lower than for young men, the differences are generally not great and do not play an important part in explaining the differences across countries in youth employment. It is also the case that educational enrolment rates for men and women are now fairly similar in most OECD countries. Differences in employment-population ratios for young people cannot be explained in terms of traditional social structures affecting the role of women in the labour market. This is to some extent confirmed by evidence on birth rates (column 5) which shows that birth rates tend to be lower in countries where the employment rates of young women are low.

The large differences across countries in the proportion of young people employed may more plausibly be explained by factors on the demand side. Young people typically are less skilled and experienced and earn lower wages than adult workers, and the profitability of employing them is therefore more sensitive to non-wage labour costs as well as to institutional rigidities like say minimum wage requirements. Such factors would affect both men and women and are known to be particularly prevalent in countries like France and Italy where the youth employment proportion is particularly low.

Finally, the proportion of older workers in employment also varies very markedly across countries (Table 4). The labour force participation of older people and in particular of older men has declined quite significantly in recent years, but the variation across countries seems extraordinarily large, from 70 per cent in Switzerland to only 25 per cent in Belgium. While there is a gap between the employment proportions of men and women, as with young people, the more remarkable observation is the differences across countries which cannot be accounted for by this factor. Further variations in countries in the health of older people cannot explain any part of these differences. As shown in columns (4) and (5), life expectancy as a summary measure is very similar in all OECD countries. As with young people, it seems a more plausible explanation may be found on the demand side. In particular, the extent to which countries resorted to early retirement schemes during the years of high unemployment, and such schemes continue to influence retirement behaviour seems the biggest influence on the continuing employment of older people.

Second, as already noted there is a clear relationship between the participation rate and the unemployment rate. While there are various possible explanations for this, the leading one must be some form of 'discouraged worker' effect, according to which it is in part a lack of job opportunities which leads to workers leaving the labour force. Figures 7, 8 and 9 plot the relationship across countries of unemployment with the female participation rate, with the youth employment proportion and with the employment of older people. In each case there is a clear negative correlation, again suggesting that an important factor accounting for the low employment of these groups is a lack of job opportunities.

A lack of job opportunities does not of course equate to a deficiency of aggregate demand. As with the theories of unemployment the more likely medium term explanations concern structural impediments to job creation. To take a very obvious example, minimum wage laws may discourage employers from creating low productivity jobs for unskilled workers. Trade unions may resist changes in production technologies which might replace production by service jobs. High taxes may price some types of jobs out of existence, or heavy overhead costs may discourage the creation of part-time work. These factors may therefore explain low participation as much as higher unemployment, which in turn suggests that their economic costs go beyond their effects on measured unemployment.

2.3 Some aspects of demographic change.

i) The female participation rate

A broadbrush comparison of European and US labour markets cannot escape the most remarkable change over the period, namely the extraordinary increase in the female participation rate. In 1960, the labour force participation rates in the US were twice as high for men as for women (84 per cent as against 37.7 per cent), while by 1997 the gap had narrowed to only 15 percentage points (75 per cent to 59.8 per cent). In Europe between 1973 and 1991, the participation rate of men fell from 88.7 per cent to 78.3 per cent, while for women it rose from 44.7 per cent to 54 per cent.

As with unemployment, it is important also to recognise that the experiences of European countries have been far from uniform. Thirty years ago, as shown in figure 10, the participation rate varied from 60 per cent in Sweden, to only around 30 per cent in the Netherlands. Since then, while there has been a tendency for the rate to rise in most countries, the increase has been very sharp in the Netherlands and in Ireland, and much slower in France and Germany.

The increase in the number of women in the labour force in most European countries clearly reflects a very fundamental change in society, and it is important to recognise the main factors behind this change. There are both supply side and demand side influences at work (Costa, 2000). On the supply side, the most important exogenous factors have been the reduction in the birth rate, the introduction of various labour saving devices which have reduced the time needed for housework and changes in working conditions in paid employment which have made employment more attractive to women. There have also been changes in social attitudes concerning women at work, but it is not clear whether these have constituted an independent factor or have simply taken the form of an adjustment to a changing situation.

Insofar as these supply side changes are exogenous, and to the extent that men and women are not perfect substitutes as employees, it might be expected that an increase in the relative supply of women workers would lead to a reduction in the relative wage of women. This has not happened; there has if anything been a tendency for women's wages to increase relative to those of men (Blau and Kahn, 2000)²⁴. The simultaneous increase in relative employment and relative wage can be explained by several factors. There has been a shift in the composition of the demand for labour to activities such as service and public sector work where women are at an advantage. There has been a marked improvement in the access of women to education resulting in a significant improvement in the education levels and other qualifications of women. There has also in some countries been a breakdown of various customs according to which particular types of jobs were assumed reserved for men.

Thus it could be claimed that, as a result of economic changes over the last 50 years or so, there has been both an increase in the supply of women wanting to work and an increase in the demand for their services as employees. Insofar as these economic changes have been exogenous, the factors responsible for them have been largely common or shared across countries, rather than being specific to individual countries. But this then raises the question why, if the exogenous changes have been common, the impact on female participation has been so different.

²⁴ Blau, F. and Kahn, L. (2000) 'Gender Differences in Pay' *Journal of Economic Perspectives*, 14(4) pp. 75-99.

The likely reason for this may again be found in the differences in labour market institutions. The rise in female participation in the Netherlands for example may be traced back to the deliberate decision in the early 1980s as part of the Wassenaar agreement (see below) to remove impediments to part-time work, and to encourage employers to provide part-time work (Nickell and van Ours, 2000)²⁵. This decision and the response to it indicate that in the Netherlands the reason for low female participation was a structure of institutions preventing the labour market from functioning to provide women with the type of work they wanted. There seems no reason to think that the Netherlands is unique in this respect.

There is perhaps a critical divergence between labour market policies whose emphasis has been on the protection of existing jobs and the standards of living of the workers holding them, and policies attempting to stimulate new job creation. The first type of policy may well be consistent with low unemployment in a static environment. The protection of existing jobs and the improvements in working conditions will lead to stable employment relationships. There is perhaps a critical divergence between labour market policies whose emphasis has been on the protection of existing jobs and the standards of living of the workers holding them, and policies attempting to stimulate new job creation. The first type of policy may well be consistent with low unemployment in a static environment. The protection of existing jobs and the improvements in working conditions will lead to stable employment relationships.

ii) The increase in life expectancy

Life expectancy has been rising steadily in developed countries over the last 200 years, but until recently much of the increase took the form of reduced infant and child mortality and an increase in the proportion of the population reaching retirement age. Such developments lead to increased survival in all age groups and hence do not significantly alter the balance between the proportion of the population of working age and the proportion of dependants (children and the elderly). In the last twenty years, though, the increase in life expectancy has largely taken the form of an increase in the life expectancy of those reaching retirement age. This means that the proportion of old people in the population has been increasing, is projected to increase, and in some countries is projected to increase very sharply, over the next 30-50 years.

The impact of the increase in the number of elderly people on the labour market arises from the impact on public expenditure. For many Western European countries, pensions are the largest and most rapidly growing element of public expenditure and there is sometimes talk of a pensions 'timebomb' in public expenditure projections. Further, it is well known that health care expenditure per head on elderly people is about three times as high as for adults of working age. It seems inevitable that at least in the medium term the bulk of such costs will have to be borne by from public expenditure in the form of taxation of those in work. Evidently the tax burden of supporting the elderly can to some extent be lightened by increasing the number of people in work, and thus the tax base. This may include increasing the proportion of people approaching or past retirement age who remain in work. These considerations suggest that labour market policies will need to aim to increase labour force participation, rather than be concerned only with reducing unemployment.

²⁵ Nickell, S and van Ours, J. (2000) 'The Netherlands and the UK: a European Employment Miracle?' *Economic Policy*, 30, pp.135-180.

3. Policies

The sharp rise in unemployment in the 1970s was accompanied by an even sharper rise in inflation, a phenomenon at the time termed 'stagflation'. This combination was clearly unprecedented and there was neither theoretical guidance nor experience to guide policy. Given that there had been no seismic shocks in the structure of the labour market it was not unreasonable that there was a hope that unemployment could be brought down to pre-shock levels by expansionary demand policies while inflation could be attacked in other ways. But attempts at macroeconomic expansion in the 1970s appeared only to re-ignite inflationary pressures, and it soon became the prevailing economic orthodoxy that sustainable reduction in unemployment could be achieved only by 'real' or structural policies which affected the determinants of the equilibrium unemployment rate.

i) wage-setting and the role of the trade unions

Given the critical role of trade union wage setting in the simple Keynesian model, and the consistent finding of a positive correlation between union membership (or coverage) and unemployment in numerous empirical studies, it is not surprising that trying to influence union wage-setting has been a major pre-occupation of policy-makers. Three types of policy have been attempted. The first, and undoubtedly least successful, has been incomes policy. Second, have been policies attempted with some success in the UK but not widely in Europe to weaken the power of unions. Third have been policies closer to corporatist ideals of economic management attempting to involve unions in a collective way in economic policy. This last approach has been an important element in the successful transition to lower rates of unemployment in some smaller economies such as Ireland or the Netherlands.

Incomes policies were adopted in many countries following the inflationary upsurge of the early 1970s. Incomes policies are government imposed norms, placing a limit on the rate of growth of nominal wages. They are difficult to enforce and unpopular, and generally appear to have been ineffective.

The second and more fundamental approach is to attack the source of the problem namely the power of the unions. The UK experience is particularly important in this context. The UK is a country where, for various historical reasons, the unions were powerful within the workplace but did not see their domain of responsibility as extending beyond that. Their power within the workplace resulted in large part from an anomalous legal position whereby they were exempt from legal penalty for any costs they imposed on others, while at the same time their own affairs operated within a framework not subject to any legal constraint. At the same time their control over the Labour Party placed their legal privileges above political scrutiny. During the 1960s Britain had a large and powerful union movement. But unlike many other countries particularly in continental Europe, the union movement was not supported either by legislation or by special institutional arrangements such as the role given to the 'Social Partners' in many European countries. Instead the unions used to operate to a large extent outside the law, being freed from liability from normal civil law damages by the Trades Disputes Act of 1906, but not governed by any other legislation, they were in some respects able to exercise economic power with no legal constraint. And while they had no formal role in government, their close association with the Labour party, which they largely financed, gave them a powerful if formally unaccountable position in the centre of the political system. During the 1960s and 1970s when Labour was in power this placed them at the centre of government.

In economic terms, the unions played a central role in the evolution of inflation and unemployment in the UK economy. The presence of powerful and decentralised unions gave each an incentive to bargain for higher money wages to improve its members' living standards. The upward pressure on money wages led to job losses and confronted governments with the dilemma of seeing unemployment rise or else accommodating the wage inflation by higher aggregate demand which, during the 1950s and 1960s when the exchange rate was fixed, led to balance of payments crisis. These were countered initially by a deflationary reversal of demand ('stop-go'), but by the second half of the 1960s by devaluation. By the 1970s the exchange rate was floating and wage inflation could be directly accommodated by price inflation.

Of course governments were aware of these dangers and attempted to forestall them by encouraging the unions to restrain their wage demands through various forms of incomes policies. But in the British context these were doomed to failure because of the decentralised nature of the union movement. Even if union leaders could be made to sign up to the policies there was no way of enforcing them on their members. There were times when incomes policies were conspicuously successful, for example the £6 a week limit introduced in 1975 after inflation had reached 25% after the first oil price shock. But generally they either failed to have any effect, or their effects were soon reversed after they had come to an end. Most conspicuously, the attempts of the Labour government in 1978/79 to pull down inflation through limiting wage increases led to a series of public sector strikes ('the winter of discontent') which precipitated the election of the Thatcher Government in the spring of 1979.

The new government's strategy may in retrospect be seen as having two components. First, to set its face against any accommodation of wage increases, and let unions confront the consequences of their wage claims for jobs irrespective of the economic costs. This arm of the strategy led to a sharp recession and the very rapid rise in unemployment in the early 1980s. The second component of the strategy was to gradually introduce the law into governing the conduct of union activities. The Thatcher government did not remove the unions' legal immunities but it restricted their scope in ways, which gradually undermined the power of the unions. For example, for a strike to be official, a union had first to obtain the support of a majority of its members in a ballot, and second to give 7 days' notice. Though unofficial strikes were not made illegal, legislation on unfair dismissal was revised such that employers were allowed to dismiss employees involved in unofficial strikes. The forms strike action could take were also restricted, for example secondary picketing became illegal, and legislation was introduced to ensure picketing was non-violent and not intimidating. Likewise, legislation has ended the closed shop, that is the arrangement whereby all employees in a firm or plant were required to join the union. All these measures have within the UK context significantly eroded the power of unions at the level of the firm. They have introduced a better balance of legal responsibilities where the firms many and various duties towards its employees are balanced by corresponding duties and responsibilities of unions.

The other unusual feature of British industrial relations has been the role of the public sector. Strikes in the public sector tend to be highly publicised and highly political. They are a matter of immediate public concern, because the public services affect everyone and there are no immediate substitutes, and despite any protestations concerning the autonomy of the management of nationalised industries or local authorities, the government is seen to be the paymaster, and to have ultimate responsibility. The tendency of the government to give in to public sector strikes had to some extent set the pattern for the nation's employers. (It could almost be argued that the private sector was fairly irrelevant in the inflation/unemployment

trade-off.) The traumatic effects of the national coal strike in the winter on 1973/74, which had forced the introduction of the 3-day working week, led to the election defeat of the then Conservative government in February 1974. During the successor Labour government of 1974-79 the unions were seen to have an excessive influence on government policy. The unions became politically unpopular especially during the local authority workers' strikes in the winter on 1978/79.

In terms of political influence, the decisive turning point was the miners' strike of 1984. The Thatcher government again showed unprecedented resilience in the face of the concerted attack of workers in a major nationalised industry, and the collapse of the miners' strike radically changed the attitudes of workers and unions towards the effectiveness of strikes. By the mid-1980s, the union movement was essentially crushed.

The third approach is to involve the union movement in implementing wage moderation. Such an approach takes its inspiration from the successes of the Scandinavian economies in maintaining low rates of unemployment throughout the 1970s in response to the OPEC shocks. This outcome was attributed to the recognition by the unions that oil price increases would inevitably lead to lower real consumption wages and that to attempt to counter such losses by higher nominal wage demands would create inflation and reduce competitiveness. However, the process of wage bargaining in other smaller economies such as the Netherlands had not led to this happy outcome, but the unions were prepared to recognise that their approach needed to be reconsidered and agreed a new approach, with the employers in 1982 (the 'Wassenaar Agreement'). This provided a framework for economic policy, not wholly unlike the Medium Term financial Strategy introduced in the UK two years earlier, but stressing also the need for wage moderation. Very importantly for what follows, the Agreement also entailed opening up the Netherlands labour market and eliminating various restrictive practices affecting in particular part-time employment.

The Wassenaar Agreement enabled the Netherlands both to sustain existing markets and at the same time to accommodate the increase in labour supply resulting from higher female participation.

Nickell and van Ours²⁶ conclude that changes in wage bargaining institutions constitute the main force leading to reduced equilibrium unemployment in both the Netherlands and in the UK, but the nature of the change is opposite in the two countries. In the Netherlands it is attributed to improved union co-ordination following the Wassenaar Agreement, while in the UK it is primarily attributable to the fall in union membership and in the proportion of workers covered by collective bargaining following the Thatcher reforms.

ii) Unemployment benefits and active labour market policies

Concern over unemployment benefits arises for two reasons. First, in many models of wage-setting, unemployment benefits create a floor below which wages cannot fall and if this floor is high relative to the productivity of low skill workers, benefits may have the effect of raising wages above market-clearing levels and thus creating unemployment. But a second reason is that benefits may affect the behaviour of the unemployed and in particular their intensity of job search and how selective they are over the jobs they are willing to accept. There is fairly

²⁶ Nickell, S and van Ours, J. (2000) 'The Netherlands and the UK: a European Employment Miracle?' *Economic Policy*, 30, pp.135-180.

consistent evidence that higher levels of benefits are associated with higher unemployment and in particular that countries with long duration benefit entitlement tend to have longer durations of unemployment.

Despite these findings few countries have made reducing the levels or duration of benefits a major element of policy. It is appreciated that most unemployed people are genuinely looking for work and that while unemployed they are in a state of poverty. The estimated impact of changes in benefits on job-finding is quite small, suggesting the extent of abuse of the system (that is of claimants who already have, or could easily find, work) is quite limited. Therefore the approach of policy has tended to be towards greater conditionality, that is to say requiring claimants to show evidence of job search, or disqualifying from benefit those who turn down suitable job offers.

But at times of high unemployment, conditionality is no great help in that if there are very few jobs available there is little point in making the unemployed apply more vigorously. Creating a situation in which there are hundreds of applications for each job that becomes available is not only demoralising for the unemployed, since nearly all the applicants will be rejected but also can create difficulties for employers.

Many countries have instead tried to get unemployed people back into work through various forms of assistance coming under the general heading of active labour market policies. These include a wide range of measures from advice and assistance with job search to the provision of various types of training to the creation or subsidisation of new jobs or placements. The general view is that such measures can on balance be helpful, but need to be carefully designed and very often do not provide a very good return on the money spent. (The results of a recent survey of OECD experience are summarised by Grubb and Martin, 2001²⁷). A more sceptical assessment based on Swedish experience is given by Calmfors *et al.* (2002)²⁸. In many countries, though, active labour market policies have been seen as a necessary counterpart of benefit conditionality. This is because benefit withdrawal may be a credible threat only if there is some job or alternative activity for the unemployed person to take up, and active labour market policies provide such an alternative. This is often termed a ‘stick and carrot’ strategy, where the incentive for unemployed people to avail themselves of the assistance provided by active labour market policies is secured by the stick of the threat of benefit withdrawal.

We consider next some issues surrounding the provision of active labour market policies.

a) job-matching services

In most countries there is a public employment service which provides information to unemployed people on job vacancies. Usually this takes the form of an employment exchange which may either (or both) post up notices of jobs that are available or offer ‘over the counter’ assistance with job search. Sometimes the employment exchange is expected to assist employers by selecting suitable people to send in relation to particular vacancies. Generally

²⁷ Grubb, D. and Martin J. (2001) ‘What works and for whom: a Review of OECD Countries’ Experiences with Active Labour Market Policies’ IFAU – Office of Labour Market Policy Evaluation Working Paper 2001:14, Uppsala.

²⁸ Calmfors, L., Forsslund, A. and Hemstrom, M. (2002) ‘Does Active Labour market Policy Work? Lessons from the Swedish Experiences’ IFAU – Institute for labour market Policy Evaluation, Working Paper 2002:4, Uppsala.

the staff at the employment exchange are expected to provide advice to unemployed job-seekers.

Greater assistance to job search can take a number of forms. One is to provide specialist 'counsellors' at employment exchanges who can discuss with job-seekers their interests and skills and offer advice as to the types of job which might be appropriate for a particular individual given the local labour market. A second type of assistance is with the mechanics of job application, for example help with telephone applications, filling in forms and advice on handling interviews. The next step is not only to provide these opportunities, but to require unemployed job-seekers to make use of them. For example, the 'Restart' programme launched in the UK in 1986 required unemployed people to attend interviews every six months at which they would discuss their approach to finding a job with a counsellor. Failure to attend such interviews could lead to benefits being withdrawn at least temporarily.

It is perhaps not very surprising that such assistance appears to improve the prospects of individual unemployed people finding work. Both advice and support can be helpful, and the possibility of sanction may activate the idle or demoralised. Many however have doubted whether such measures can help the overall situation, particularly at times of high unemployment. When there are relatively few vacancies anyway and the only way unemployment can be significantly reduced is by increasing the total number of jobs rather than filling more quickly the existing stock of vacancies. It is fairly unusual for employers to claim that their expansion is inhibited by a shortage of labour (except of specific skills) so it appears unlikely that more effective job-search assistance will lead to the creation of more jobs.

Equally, if the problem of long-term unemployment is linked to the lower intensity and reduced effectiveness of job search on the part of the long-term unemployed, then evidently improved support for job search must to some extent lessen this problem.

b) training

The second main element of active labour market policy, and regrettably the most obviously unsuccessful, has been the provision of training. Clearly, more skilled and better qualified people tend to enjoy a better labour market experience in terms of more stable and better paid jobs, and lower unemployment rates, so it might appear that offering training courses to unemployed people leading to some sort of qualification would be of obvious value.

There have been many studies of the effectiveness of training programmes on the subsequent earnings and employment prospects of participants (recently surveyed by Heckman *et al.*, 1999)²⁹ which have remarkably negative results. Of course it is never clear whether those participating on training schemes have characteristics different in other ways from other unemployed people and it is these other characteristics which explain their lack of success. Indeed, it has sometimes been alleged that employers regard participation on such programmes as a sign of lack of enterprise and initiative and discriminate against those who have been on training schemes. These studies include some 'experiments', in which groups of unemployed people are randomly assigned some to training schemes and some not, to obviate any such bias, but the results are no different.

²⁹ Heckman J., Lalonde R. and Smith J. (1999) "The economics and econometrics of active labor market programs, in O. Ashenfelter and D. Card (eds) *Handbook of Labor Economics* Vol 3a (North Holland, Amsterdam)

The probable explanation for the poor results of training programmes is that employers are looking both for general competence, to which formal education may make an important contribution but may not be much assisted by short duration training courses, and for specific skills, which tend to be best learnt on the job. According to Grubb and Martin (2000)³⁰, the most effective training courses are those linked to local employers. And those who derive the greatest benefit are found to be adult women returning to the labour market, whose employment skills may have become obsolete during their absence from the labour market and therefore perhaps have more to learn in terms of updating skills.

More fundamentally, one might ask why, if training is beneficial in a particular context, it will not in any case occur without the need for government intervention. Obviously training is useful, but that does not mean that in all circumstances more training is productive. It could be that many of the unemployed simply will not get much benefit from training except in the context of a specific job, but once back into work they will acquire any new skills they need.

c) youth measures

According to conventional wisdom, youth measures are the least effective of any form of labour market policy. Numerous econometric studies have found that neither the employment prospects nor the wages in work of young people are improved as a result of participation in youth activities. Such activities may include training as well as the direct provision of jobs. A major issue identified in the OECD studies is that of the ‘attitude’ of the young people towards the activities being provided. These are often regarded not so much as a form of help to them but rather as a form of ‘workfare’ in which they are required to earn their benefit by performing some tasks perceived as inherently useless.

In the UK, the present Labour government has given great prominence to its ‘New Deal’ for unemployed young people. The centrepiece of this is the combination of benefit withdrawal after six months with a guarantee to find for each young person still unemployed at that stage a job, a place on a training scheme or whatever. This scheme was introduced at a time when unemployment was in any case falling rapidly, and it has not proved easy to work out whether the New Deal itself has had any net effect. Equally, in these relatively benign labour market circumstances, it has been easier to place the young unemployed and the principle of benefit limitation has been achieved without much protest. Whether this will achieve a fundamental shift in young people’s attitudes towards work remains to be seen.

d) subsidised placements

Subsidies to firms taking on unemployed workers appear relatively helpful to the unemployed workers concerned, but these policies are none the less the most difficult to evaluate. It is in particular always difficult to tell whether the job subsidised is a ‘new’ job, or one which would have existed anyway, and if the latter the extent to which the gain to the unemployed person taking it exceeds the loss to the person displaced. If it is a ‘new’ job for the firm, does this correspond to an increase in the total number of jobs in the economy, or does some other job somewhere else disappear? To the extent that it is possible to answer these questions, answers quoted in the OECD study are of the order of 90 per cent displacement. To the extent that the rest of the labour market is reasonably flexible, high displacement rates are not

³⁰ Grubb, D. and Martin J. (2001) ‘What works and for whom: a Review of OECD Countries’ Experiences with Active Labour Market Policies’ IFAU – Office of Labour Market Policy Evaluation Working Paper 2001:14, Uppsala.

too much of a problem: the market will in time create jobs for all who want them, and if the unemployed are reactivated the number of jobs will in time increase in line.

An overall assessment of the value of active labour market policies is that they help primarily where the cause of unemployment has to do with the reluctance of unemployed people to take work. Such reluctance may be overcome by helping unemployed people find better jobs, through job search assistance, training or some forms of work experience, or for some people simply by the threat of benefit withdrawal. But they are of little help where there is a genuine shortage of jobs, and the effect of policies is only to intensify competition for the jobs available. What is then required are measures to increase the total number of jobs in the economy, and such measures must be focussed more on job creation and making employment more profitable, including for example reductions in non-wage labour costs, to which we now turn.

iii) measures to reduce non-wage labour costs

There has been long-standing concern that taxes, particularly those directly levied on employment add to the costs of employing labour and thus diminish the stock of jobs. In the European context, reducing taxes, particularly on low-paid workers has been a central component of the policy the EU has urged on member states from the Delors White Paper (1993)³¹ to the Broad Economic Policy Guidelines³² which have accompanied the move to Economic and Monetary Union.

The evidence on the effect of minimum wages and taxes on unemployment is not wholly clear-cut. The impact of minimum wages was surveyed by Dolado *et al.* (1996)³², and their main finding was that over most of the labour market there was no significant or unambiguous impact on jobs, but where there was evidence of adverse effects it tended to be concentrated on youths. They conclude that there is a strong case for having a lower minimum wage for some workers (p. 357). Some countries, and in particular in France, there was a significant effect on the employment of youths. This is linked in part with the fact that in France, unusually, the minimum wage for youths is the same as for adults, and also with the fact that in France labour taxes are relatively high even at the lower end of the distribution.

To some extent this concern gets linked up with the mechanism for setting wages, in that in many models taxes, whether levied on workers or their employers, are ultimately incident on labour, and therefore do not add to the costs of employment. For this reason many studies look at the overall tax wedge, and in many cases (e.g. Blanchard and Wolfers, 2000)³³ find it has a significant effect. But there is also concern that labour taxes have particularly adverse effects on employment, being a 'tax on jobs'. In principle this might be the case where the adjustment of wages is restricted, most obviously where there is minimum wage legislation or where benefits place a floor beneath low wages. There is also evidence (Daveri and Tabellini,

³¹ European Commission (1993) 'Growth, Competitiveness, Employment, the Challenges and Ways Forward into the 21st Century'. [*Delors White Paper*]

³² Dolado, J., Kramarz, F., Machin, S., Manning A., Margolis, D. and Teulings, C. (1996) 'The Economic Impact of Minimum Wages in Europe' *Economic Policy*, 23, pp. 317-372.

³³ Blanchard and Wolfers (2000) 'The Role of Shocks and Institutions in the Rise of European Unemployment: the Aggregate Evidence' *Economic Journal*, Conference Papers, March, pp. C1-33.

2000)³⁴ that higher taxes create unemployment in labour markets where wages are inflexible due to wage bargaining institutions.

iii) employment protection

Employment protection covers the various administrative procedures employers are required (usually by law) to go through prior to dismissing a worker, and include for example requirements for written warnings, periods of notice, contractual procedures in relation to unfair dismissals and severance pay. Such measures have an obvious and direct benefit to existing employees, in that their jobs are more secure, but equally are likely to make employers more cautious about hiring and hence may make it more difficult for unemployed workers to get hired. Employment protection more than any other policy can be said to offer clear benefits to insiders at the expense of outsiders, and such measures very often criticised for their alleged adverse effects on the functioning of the labour market.

As far as direct effects on the unemployment rate are concerned, however, the evidence is not overwhelming. Jackman *et al.* (1996)³⁵ found that employment protection tended to be correlated with increase in long term unemployment, but had no net effect on total unemployment while Nickell and Layard (1999)³⁶ found more of an effect on the employment to population ratio than on unemployment. The first finding is consistent with the idea that employment protection may reduce inflows into unemployment but increase the average duration of unemployment spells, whilst the second, perhaps more significantly, suggests that some of those who find it more difficult to get work may drop out of the labour force.

More indirectly, employment protection may serve to discourage entrepreneurs and new business start-ups. Fonseca *et al.* (2001)³⁷ have shown that countries where employment is protected tend also to discourage business start-ups. They report that at one extreme in Spain new businesses have to satisfy 17 separate procedures and the process takes on average almost six months, whilst at the other extreme in Denmark only two procedures are required and the process takes on average only one week. Fonseca *et al.* further show that impediments to business start-ups are strongly and negatively correlated with the employment to population ratio (Figure 11). This is further evidence that employment is constrained by a shortage of jobs in circumstances of economic change.

4. Conclusions

The general theme of this paper is that over the past thirty years labour markets have been subject to massive change resulting in part from the labour demand effects of very rapid technological developments in particular sectors and in part from the labour supply effects of major demographic and social change. It is further clear that the adjustment and adaptation of the labour market to such shocks is itself difficult, but by and large can only be achieved by

³⁴ Daveri, F. and Tabellini, G. (2000) 'Unemployment, Growth and Taxation in Industrial Countries' *Economic Policy*, 30, pp. 47-104.

³⁵ Jackman, R., Layard, R. and Nickell, S. (1996) 'Combating Unemployment: Is Flexibility Enough?' in *Macroeconomic Policies and Structural Reform*, OECD, Paris pp. 19-58.

³⁶ Nickell, S. and Layard, R. (1999) 'Labour Market Institutions and Economic Performance' in Ashenfelter, O. and Card D. *Handbook on Labour Economics*, volume 3C.

³⁷ Fonseca, R., Lopez-Gardia, P. and Pissarides, C. (2001) 'Entrepreneurship, start-up Costs and Employment' *European Economic Review*, 45 pp. 692-705.

institutional arrangements supporting new job creation rather than by focussing on the protection of existing jobs. We have argued that the evidence of differential participation rates suggests that some countries have failed to encourage new job creation, while protecting existing jobs, with the outcome that a smaller proportion of their population is in work, and consequently per capita income is lower. Such countries are in a worse position to face either new technological developments or the demographic implications of longer life expectancy.

A recurring theme in political economy is why reforms which promise increased economic efficiency are so often resisted by governments. Generally such resistance is explained on the grounds that most reforms create losers as well as gainers, and though, if the reforms increase efficiency, it would be possible to fully compensate the losers and still leave the rest of the community better off, such compensation may be impractical. Even so, where reforms promise substantial efficiency gains one might expect the gainers to outnumber the losers, and hence be attractive to elected politicians.

Resistance to reform is then generally explained in terms of an asymmetry between the effects of policy on clearly identified groups on the one hand and the community as a whole on the other. Specific groups can organise to exert political pressure (e.g. producers in a particular sector) while disparate and unorganised groups, such as the unemployed, or ill-defined groups such as taxpayers who might benefit from reforms reducing the budgetary costs of unemployment, cannot bring similar political pressure to bear. There have been attempts to explain the attachment to labour market rigidities in some political systems along these lines (Saint-Paul, 1996)³⁸. It none the less remains unclear why countries such as those of Western Europe, facing much the same economic conditions, have reacted in different ways in terms of economic policy.

What does seem clear, however, is that low employment in many Western European countries does not reflect the wishes of the people involved, but rather a lack of adequate labour market opportunities. This lack of opportunity is at root a failure of policy, and reflects a political environment within which the interests of established groups have priority over the well-being of the community as a whole. Resources are devoted to the protection of existing jobs rather than to the encouragement of new job creation. In the United States, just over 74 per cent of people of working age have jobs. Several European countries (the Nordic countries, Switzerland and the Netherlands) do as well, but the European average is substantially lower. What distinguishes the European countries with high employment rates from the others is primarily that their labour market institutions differ, and these differences result from differences in policy. Policy initiatives to raise the employment rate would not only increase economic opportunities for people now excluded from the labour market, but improve the government budget and increase economic welfare.

It is the contention of this paper that the main cause of continuing high unemployment in some European countries lies on the demand rather than the supply side of the labour market. This means that for example active labour market policies, though they may assist some individuals, are not likely to be the most effective mechanism for addressing the problem. What is likely to be more helpful is a reduction in non-wage labour costs, particularly in the form of barriers to new business start-ups, and in the form of legislation and regulations which impose administrative costs on employers.

³⁸ Saint-Paul, G. (1996) 'Exploring the Political Economy of Labour Market Institutions' *Economic Policy*, 23 pp.263-315.

Table 1
Employment and Unemployment 2000
Persons aged 15-64

	Employment- population rate (%)	Unemployment rate (%)	Participation rate (%)		
			All	Men	Women
<u>Europe</u>					
Austria	67.9	4.7	71.3	80.1	62.5
Belgium	62.9	6.6	65.2	73.8	56.6
Denmark	76.4	4.5	80.0	84.0	75.8
Finland	67.0	9.9	74.3	76.5	72.0
France	61.1	10.1	68.0	74.4	61.7
Germany	66.3	8.1	72.2	81.1	63.2
Greece	55.9	11.3	63.0	77.1	49.7
Ireland	64.5	4.4	67.4	79.1	55.7
Italy	53.4	11.0	59.9	73.8	46.2
Netherlands	72.9	2.7	74.9	83.9	65.7
Norway	77.8	3.5	80.7	84.8	76.5
Portugal	68.1	4.1	71.0	78.8	63.6
Spain	56.1	14.1	65.3	79.1	51.8
Sweden	74.2	5.9	78.9	81.2	76.4
Switzerland	79.6	2.7	81.8	89.4	73.9
UK	72.4	5.6	76.6	84.3	68.9
EU	65.7	6.3	70.1	78.9	59.8
<u>Other OECD</u>					
US	74.1	4.0	77.2	83.9	70.8
Japan	68.9	5.0	72.5	85.2	59.6
Australia	69.1	6.3	73.8	82.0	65.5
Canada	71.1	6.9	76.3	82.1	70.5
New Zealand	70.7	6.1	75.2	83.2	67.5
Korea	61.6	4.2	64.3	76.9	51.8

Source: OECD Employment Outlook 2001 Table B

Table 2
Labour Market Participation 2000
Adult Workers (25-54)

	Employment/population ratios (%)		Unemployment rate (%)		Participation rate (%)	
	Men	Women	Men	Women	Men	Women
<u>Europe</u>						
Austria	89.7	73.5	4.2	4.4	93.6	76.8
Belgium	87.9	67.8	4.6	7.4	92.1	73.2
Denmark	88.3	80.4	3.5	4.7	91.5	84.3
Finland	84.1	77.6	7.2	8.8	90.8	85.0
France	87.0	69.6	7.6	11.1	94.1	78.4
Germany	89.4	70.8	6.7	8.0	95.8	76.9
Greece	88.6	52.6	6.1	14.7	94.3	61.7
Ireland	88.1	62.7	4.3	3.6	92.0	65.0
Italy	84.6	50.7	6.4	12.5	90.4	57.9
Netherlands	92.2	70.9	1.7	3.0	93.8	73.0
Norway	88.7	81.6	2.9	2.3	91.4	83.6
Portugal	90.2	73.9	2.7	4.1	92.7	77.1
Spain	85.4	50.7	7.9	18.7	92.8	62.4
Sweden	85.8	81.7	5.2	4.6	90.6	85.6
Switzerland	95.2	75.6	1.6	3.1	96.7	78.0
UK	87.5	73.1	4.8	4.0	91.9	76.1
EU	87.5	65.7	6.1	8.9	93.1	72.2
<u>Other OECD</u>						
US	89.0	74.3	2.9	3.3	91.6	76.8
Japan	93.5	63.6	3.9	4.4	97.1	66.5
Australia	85.6	67.4	5.2	4.6	90.3	70.7
Canada	85.9	74.0	5.7	5.8	91.1	78.6
New Zealand	87.3	70.3	4.4	4.6	91.3	73.8
Korea	88.0	56.3	4.3	2.7	92.0	57.8

Source: OECD Economic Outlook 2001, Table C

Table 3
Youth Employment Rates 2000
(Persons aged 15-24)

	Employment-population Ratios (%)			Education enrolment (%) (1999)	Birth rate per 1000 (1995)	Unemployment rate (%)
	All	Men	Women			
<u>Europe</u>						
Austria	52.5	56.5	48.6	45.6	10.9	4.7
Belgium	30.3	33.7	26.7	54.1	11.4	6.6
Denmark	67.1	70.3	64.0	51.7	13.4	4.5
Finland	39.8	39.8	39.9	56.7	12.4	9.9
France	23.3	26.7	20.0	51.2	12.5	10.1
Germany	48.4	52.5	44.2	53.3	9.3	8.1
Greece	26.9	31.9	22.0	47.4	9.8	11.3
Ireland	48.2	52.7	43.7	45.9	13.4	4.4
Italy	26.1	30.2	22.0	42.1	9.2	11.0
Netherlands	68.4	69.9	66.7	52.7	12.3	2.7
Norway	57.7	60.2	55.0	54.1	13.8	3.5
Portugal	41.9	47.7	36.1	45.8	10.7	4.1
Spain	35.9	42.8	28.7	47.6	9.1	14.1
Sweden	46.1	46.7	45.4	56.6	11.7	5.9
Switzerland	65.0	66.5	63.4	49.2	11.6	2.7
UK	61.5	63.9	58.9	45.7	12.9	5.6
EU	40.8	44.8	36.7	---	---	6.3
<u>Other OECD</u>						
US	59.8	62.0	57.6	47.2	15.3	4.0
Japan	42.7	42.5	43.0	N/a	9.9	5.0
Australia	60.5	60.6	60.4	51.1	14.5	6.3
Canada	56.3	56.7	55.8	45.8	13.2	6.9
New Zealand	54.7	56.6	52.7	44.4	16.3	6.1
Korea	28.5	23.3	33.1	49.4	---	4.2

Sources: Columns (1) – (3) OECD Employment Outlook 2001 Table C
Column (4) calculated from OECD Education at a Glance Table C1.2
Column (5) UN Demographic Yearbook, 1995 Table 4

Table 4
Employment Ratios for older people, 2000
(55-64)

	Employment-population Ratios (%)			Life Expectancy (years)		Unemployment rate (1992)
	All	Men	Women	Men	Women	
<u>Europe</u>						
Austria	29.2	41.4	17.8	73.3	79.7	N/a
Belgium	25.0	35.1	15.4	72.4	79.1	7.8
Denmark	54.6	61.9	46.2	72.5	77.8	7.8
Finland	42.3	43.7	40.9	72.8	80.2	13.0
France	34.2	38.4	30.2	72.9	81.2	10.2
Germany	38.6	48.2	29.0	72.8	79.3	4.8
Greece	39.0	55.3	24.4	74.6	80.0	N/a
Ireland	45.2	63.0	27.1	72.3	77.9	16.1
Italy	27.3	40.3	15.2	73.8	80.4	10.5
Netherlands	37.9	49.9	25.8	74.2	80.2	6.8
Norway	67.1	73.1	61.2	74.2	80.3	5.9
Portugal	51.7	62.5	42.3	71.2	78.2	4.1
Spain	36.8	55.0	20.1	73.4	80.5	18.1
Sweden	65.1	67.8	62.5	76.1	81.4	4.8
Switzerland	70.0	77.0	60.8	75.1	81.6	N/a
UK	50.5	59.8	41.4	74.2	79.4	9.9
EU	38.5	48.9	28.4	N/a	N/a	N/a
<u>Other OECD</u>						
US	57.7	65.6	50.5	72.2	78.8	7.3
Japan	62.7	78.4	47.8	76.6	83.0	2.2
Australia	47.1	58.5	35.4	75.0	80.9	10.7
Canada	48.4	57.7	39.3	73.0	79.8	11.2
New Zealand	57.2	68.3	46.3	72.9	78.7	10.3
Korea	57.6	68.2	47.5	N/a	N/a	N/a

Sources: Columns (1)-(3) OECD Employment Outlook 2001, Table C
Columns (4) and (5) UN Demographic yearbook 1995, Table 4
Column (6) OECD Employment Outlook 1993, Table K

Figure 1: Standardised unemployment rates
(Source: OECD, Economic Outlook 1990, Employment Outlook; own calculations)

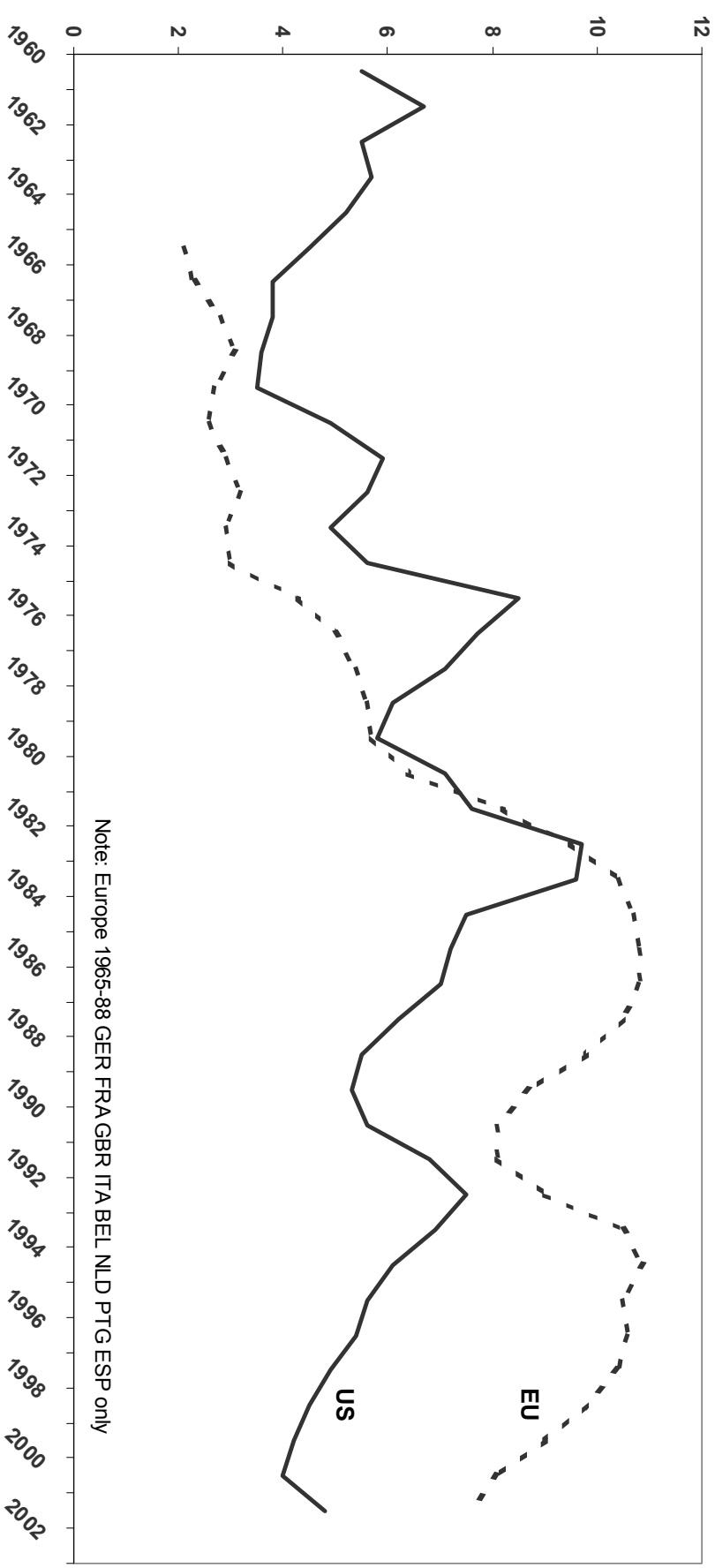


Figure 2: Standardised unemployment rates
(Source: OECD)

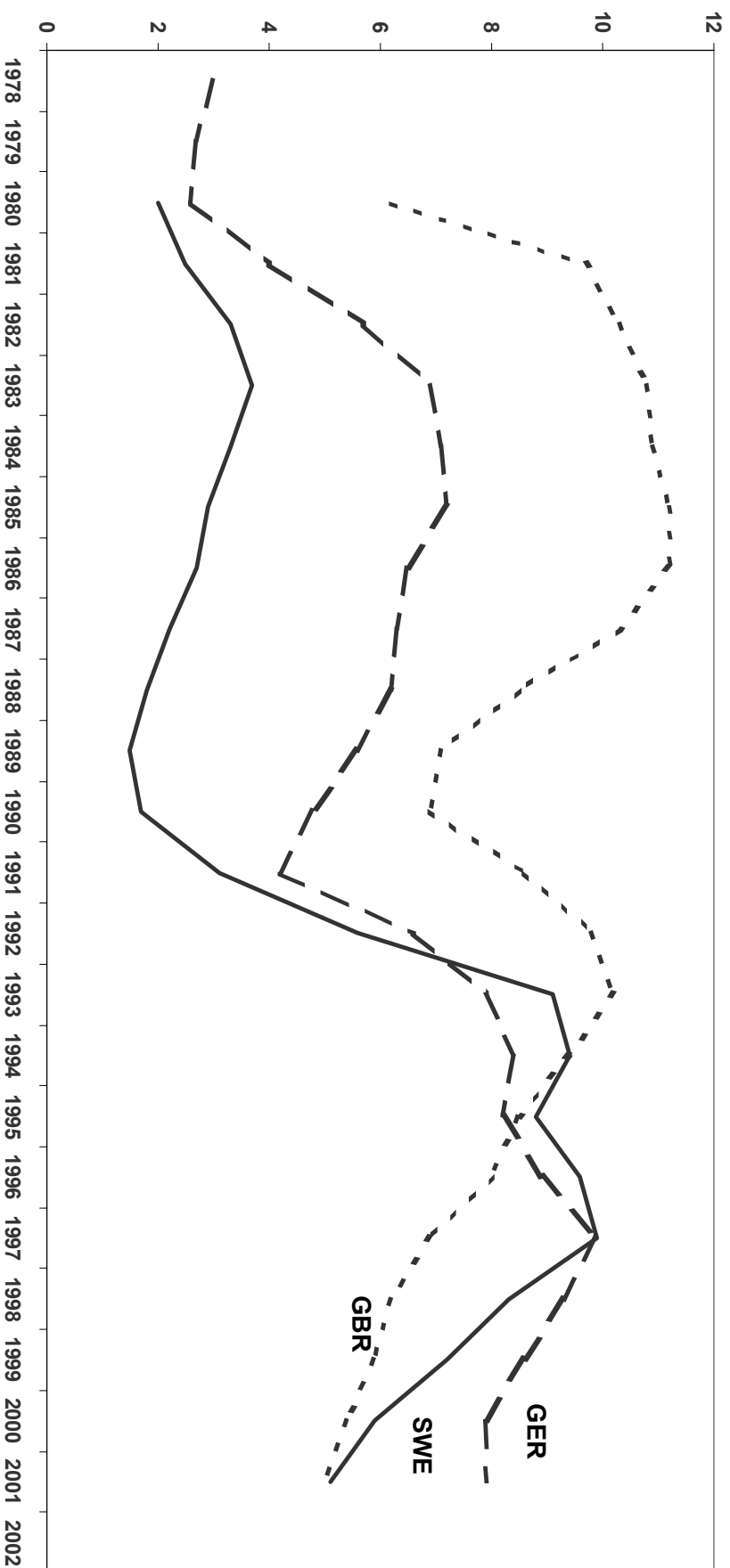


Figure 3: Standardised unemployment rates
(Source: OECD)

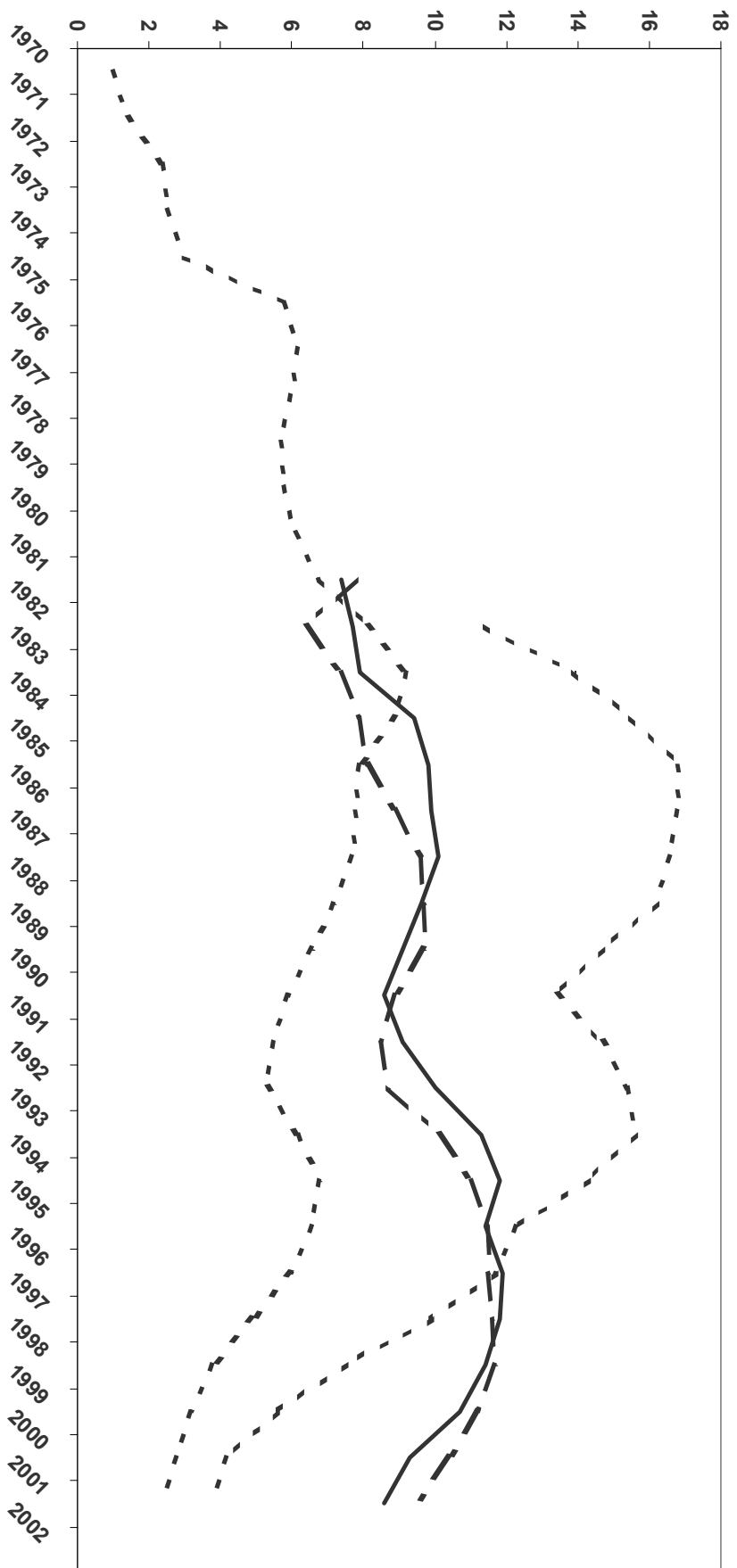


Figure 4: Unemployment vs participation in 2000
 (Source: OECD, Employment Outlook 2001)

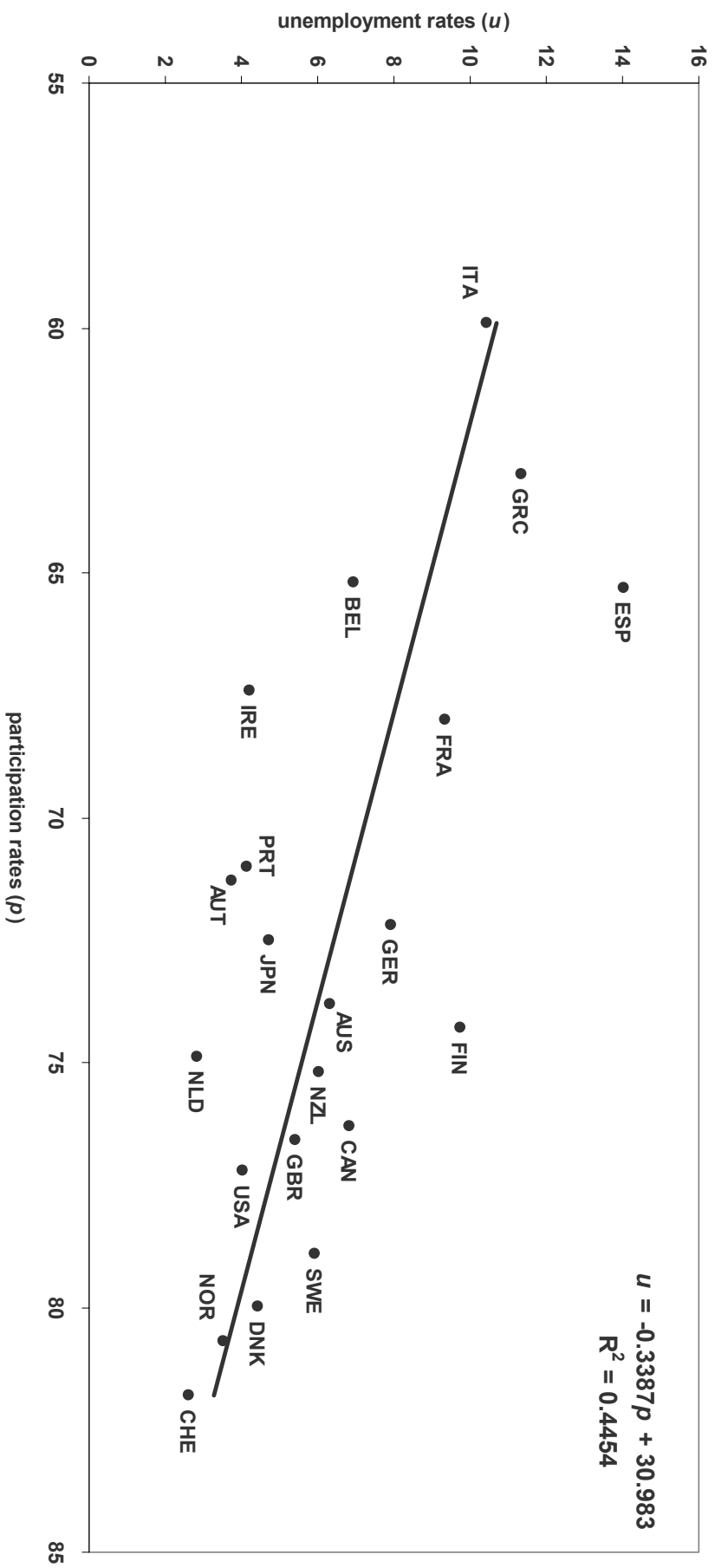


Figure 5: Unemployment vs participation (1990-2000)
 (Source: OECD, Employment Outlook 2001)

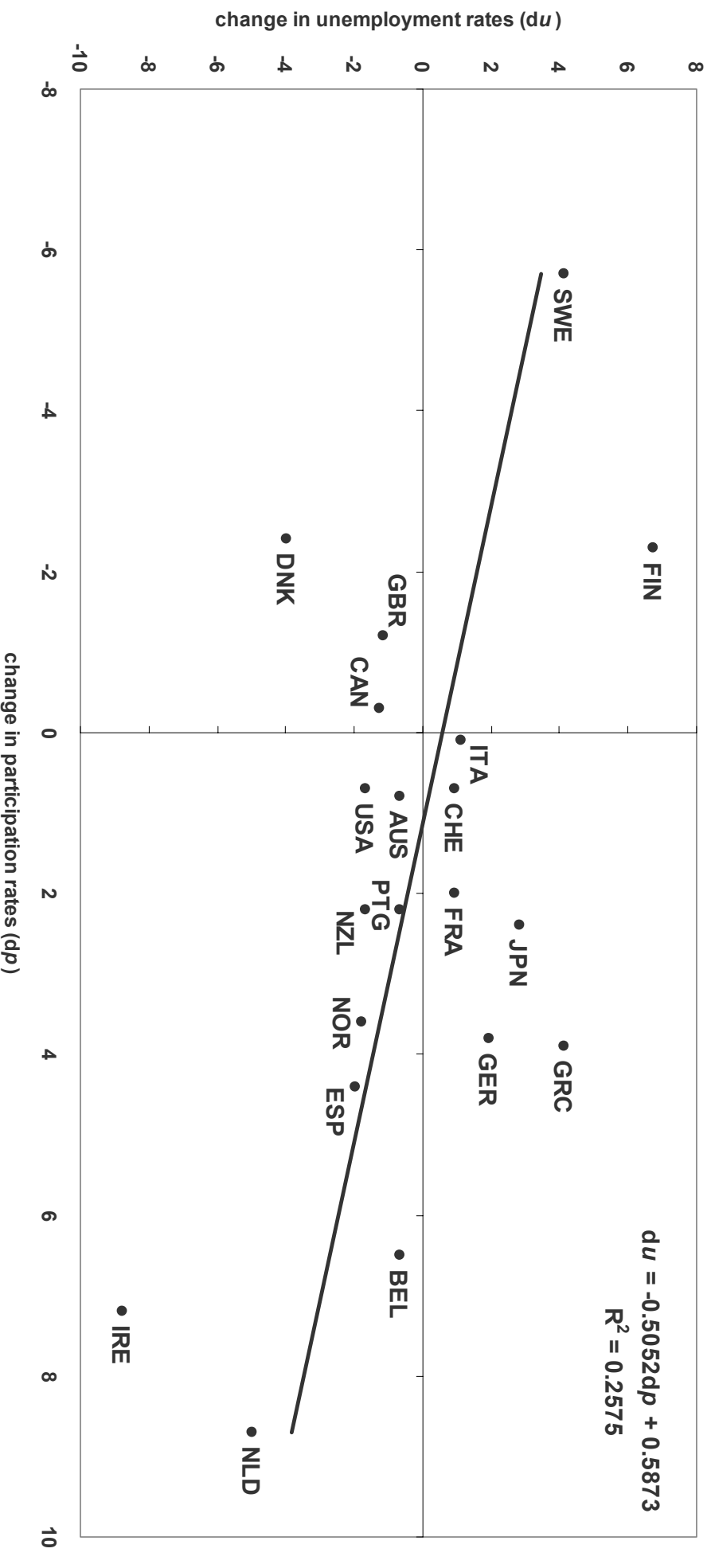


Figure 6: Labour force participation rates
 (Source: OECD, Employment Outlook 1992,99-2001)

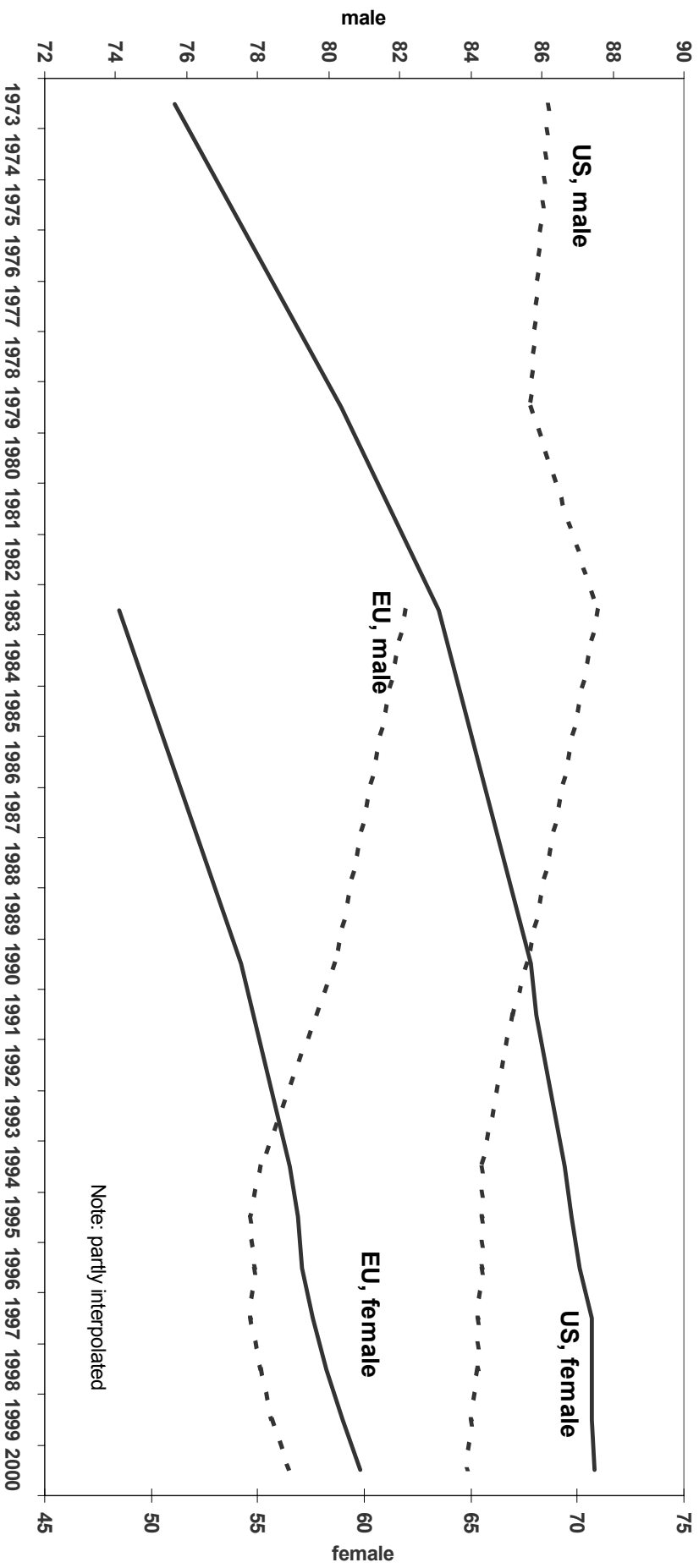


Figure 7: Female unemployment vs participation in 2000
 (Source: OECD, Employment Outlook 2001)

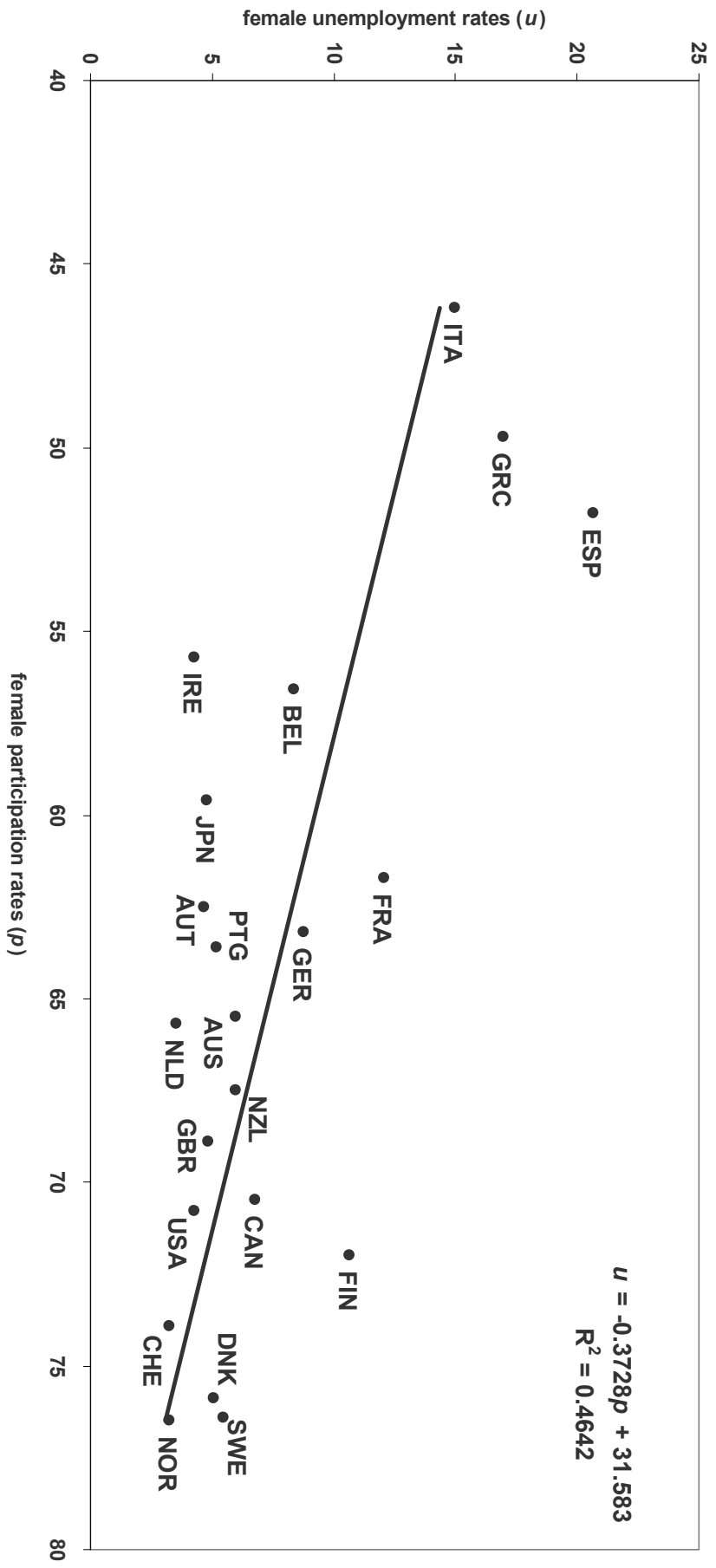


Figure 8: Youth (15-24) employment/population ratios vs unemployment rates in 2000
 (Source: OECD, Employment Outlook 2001)

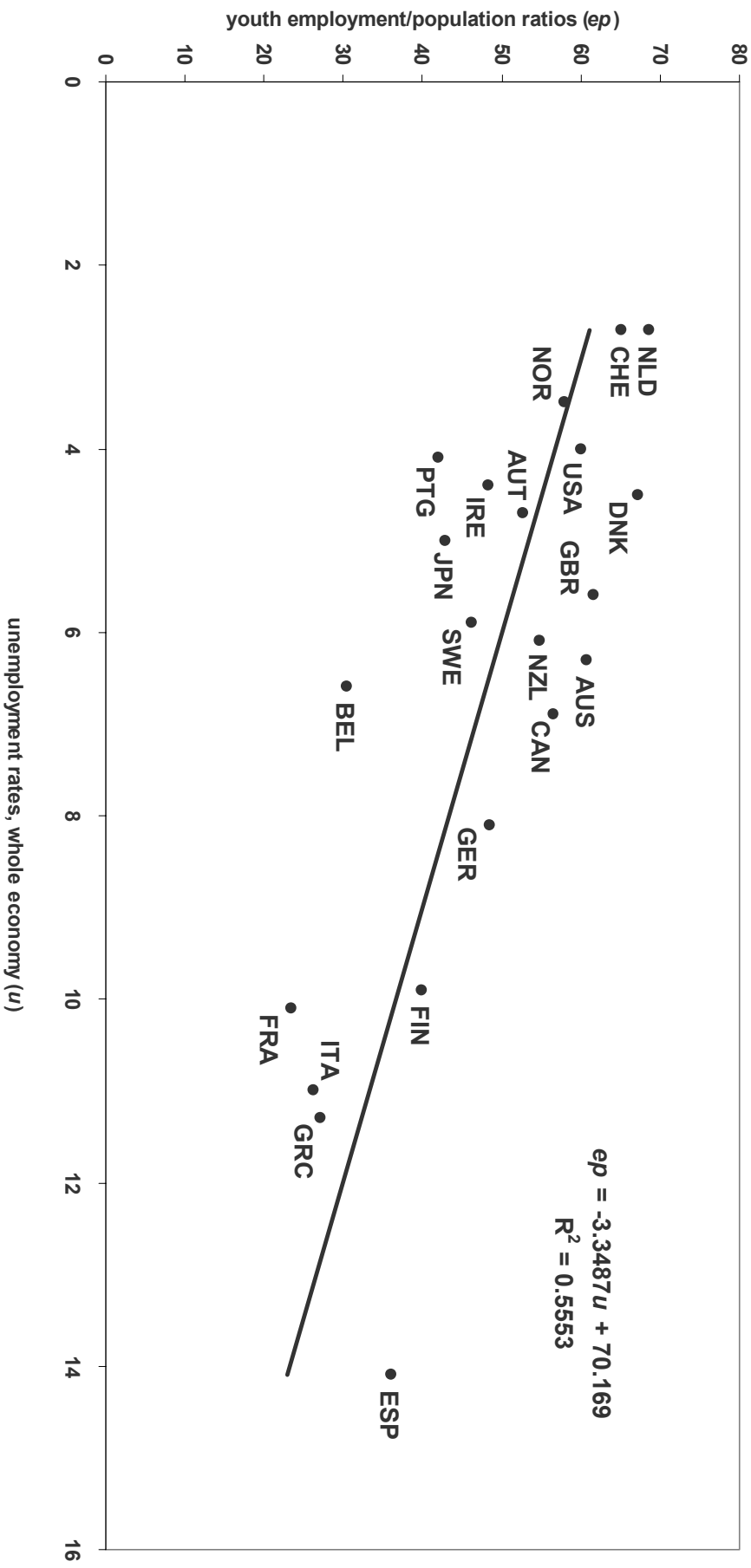


Figure 9: Old age (55-64) employment/population ratios 2000 vs unemployment rates 1990

(Source: OECD, Employment Outlook 2001)

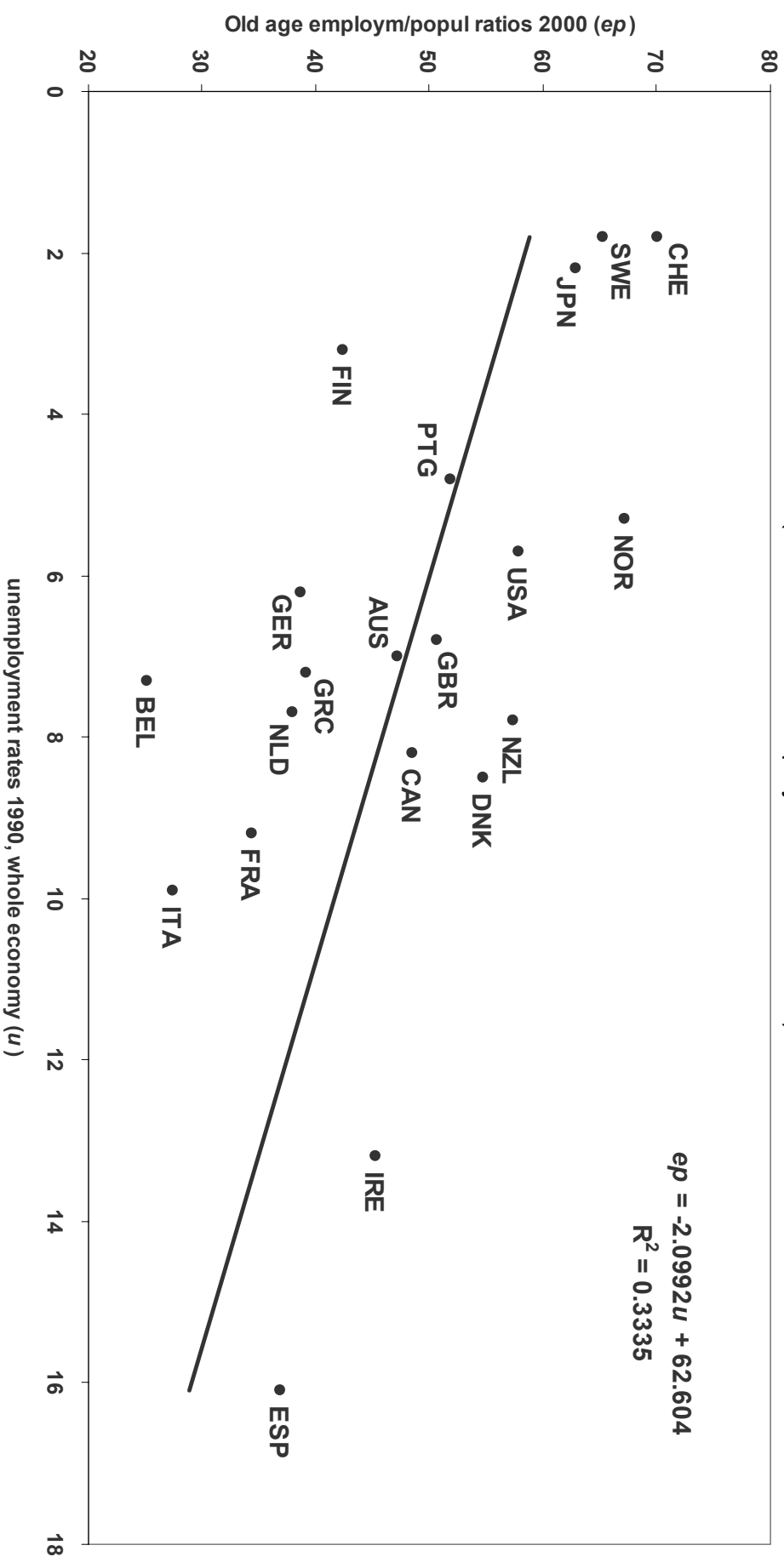


Figure 10: Female labour force participation rates
 (Source: OECD, Employment Outlook 1992, 99-2001)

