

# Why are European Countries Diverging in their Unemployment Experience?

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Unemployment has been relatively high in many European countries for more than 30 years. However, since the 1990s some countries have managed to reduce unemployment substantially, like the United Kingdom, while others seem to be stuck at high unemployment levels, like Germany and France. This divergence among European countries offers evidence about the causes and cures of unemployment. This paper begins by presenting some evidence that the countries who got out of the unemployment problem implemented a number of labor market reforms. I then discuss the potential obstacles to labor market flexibility and offer some perspectives to explain why some countries have reformed their labor markets and others have not.

## What Have We Learned?

### Basic Facts

Unemployment had been historically very low in most European countries during the 1960s. However, it rose sharply in the early 1970s across most of Europe. Since the mid-1980s, Europe has seen a diverging unemployment pattern. The only big country that seems to have escaped from persistent long-term unemployment is the United Kingdom, but unemployment has also fallen in Ireland, the Netherlands, Denmark and Portugal. The three largest continental economies, France,

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Table 1

**The Evolution of Unemployment Rates in the European Union**

Country	Unemployment rate				
	1970	1980	1990	1995	2000
Austria	1.6	1.6	4.7	5.9	5.8
Belgium	1.9	7.9	8.7	12.9	10.6
Denmark	1.3	6.9	9.4	10.2	5.8
Finland	1.9	4.7	3.2	15.4	9.1
France	2.5	6.2	8.9	11.6	10.3
Germany	0.6	3.2	6.2	8.1	8.7
Greece	4.2	2.8	7.0	10.0	10.9
Ireland	5.6	7.0	12.9	12.2	5.0
Italy	4.0	5.6	9.1	11.7	11.2
Netherlands	0.9	4.0	6.0	7.1	3.2
Norway	1.4	1.7	5.2	4.9	3.8
Portugal	5.8	9.5	4.7	7.2	4.3
Spain	2.7	10.9	15.7	22.7	14.0
Sweden	1.5	2.0	1.7	7.7	4.5
United Kingdom	2.4	6.1	5.9	8.6	6.0
EU Average	2.1	5.0	7.4	10.5	8.4

Italy and Germany, have all seen continued high unemployment. In Spain, unemployment has fallen sharply in recent years, but that was from a pathologically high level, and it remains higher there than in most other European countries. Scandinavian countries escaped the rise in unemployment of the 1970s, but experienced a sharp increase in the 1990s, due to external macroeconomic shocks. Since then, unemployment has fallen back to secular low levels in Norway and Sweden, but not Finland. Table 1 illustrates these patterns. In some sense, one should no longer talk of a common European unemployment problem.

These high and low unemployment rates in different countries cannot be explained by obvious measurement issues, like cross-country differences in the definition of unemployment. For example, France uses a definition of unemployment that does not include government relief jobs or early retirement, and France also has the lowest work week in Europe for full-time employed workers (OECD, *Labor Force Statistics*, 2003), but the unemployment rate in France is high nonetheless. Indeed, the cross-country correlation between hours worked per employee and unemployment, computed using the OECD Economic outlook database, is essentially zero. Spain has a very low labor force participation rate, which might seem to suggest that many unemployed are being classified as out of the labor force, but Spain has a high unemployment rate nonetheless. Also, the correlation across countries between unemployment and labor force participation in 2000 was  $-0.5$ , so countries with high unemployment tend to have lower labor force participation. The popular view that a lot of unemployment in the Netherlands is hidden as

disability is not inaccurate, but it does not explain the fall in unemployment there: the fraction of workers on disability benefits has *also* fallen. Thus, the divergence in unemployment rates across Europe represents a real difference in labor markets, not a statistical artifact.

### Potential Explanations

When European unemployment started to increase in the 1970s, the cause was typically ascribed to the first oil price shock in 1973–1974 (Bruno and Sachs, 1985). Then came the second oil price shock in 1979–1980, followed by contractionary monetary policies in the 1980s. Thus, through the 1970s and into the 1980s, there was always some immediate cause for higher unemployment that could be formulated in terms of short-run fluctuations.

But in the later 1980s and 1990s, as European unemployment failed to return to its historically low level, a rough consensus emerged that high unemployment in Europe was due to labor market rigidities. Some of these increase the equilibrium rate of unemployment by boosting the incumbent employee's bargaining power in wage setting, like high minimum wages, strict work rules or extensive employment protection (which includes limitations on firings and dismissals as well as restrictions on the employer's freedom to assign tasks and workplaces to workers). These also include provisions for mandatory collective bargaining and extension of collective agreements negotiated by unions and employer's organizations to a whole sector, regardless of how representative these organizations are. Other rigidities improve the fallback options of employees, by methods like increasing the level and duration of unemployment benefits and other welfare payments or by loosening the standards for receiving such benefits. Taxes that increase the wedge between workers' marginal productivity and their take home pay also tend to reduce employment (their effect on unemployment is smaller because they also reduce participation, although in my view still negative). Finally, the degree of centralization and coordination of wage setting (like whether wages are negotiated at the national, industry, regional or firm level) is also an important factor. Coordination between unions setting wages for, say, different industries has two conflicting effects. It enhances the monopoly power of the unions, but also induces them to internalize the negative effects of higher wages in one sector on the purchasing power of workers in other sectors. As a result, the dominant view is that very high or very low centralization of wage setting generate less wage pressure than intermediate levels of centralization (Calmfors and Driffill, 1988). Multiple bargaining levels that set floors but not caps on wage increases are also observed and obviously tend to increase wage pressure (for example, Blanchard et al., 1995).

While rigidities tend to push wages up, ultimately wages must be compatible with productivity. Because, everything else equal, a higher rate of unemployment reduces workers' fallback options, it tends to reduce wages. Thus, the equilibrium rate of unemployment adjusts to make wage demands compatible with productivity (Layard, Nickell and Jackman, 1990). If institutions become more rigid, wages

will tend to go up. But if that wage increase is not justified by productivity, employment will fall until the resulting increase in unemployment exerts enough downward pressure on wages to offset the impact effect of greater rigidity. That is the mechanism by which institutional rigidities increase the natural rate of unemployment.

This hypothesis must pass two tests. First, have labor market rigidities across Europe increased or become more relevant during the high unemployment period as compared to the 1960s? After all, European labor markets already exhibited rigidities in the 1960s. Second, do divergences across countries in these rigidities help to understand the subsequent divergence in unemployment? My answer to both questions is a qualified yes.

Nickell (2003) provides a concise and synthetic assessment of the evolution of labor market institutions in Europe and their impact on unemployment. It shows that in most countries, labor markets are more rigid now, along a number of dimensions, than in the 1960s. Virtually all European countries except the United Kingdom saw a sharp increase in unemployment benefits in between 1960 and 1999. Indices of employment protection legislation have gone up in Austria, Belgium, France, Germany, Ireland, Portugal, Sweden and the United Kingdom. They have fallen (but only slightly) in Finland, Italy, the Netherlands, Norway and Spain. Finally, taxes on labor have gone up everywhere.<sup>1</sup>

Moreover, countries that managed to reduce unemployment in the 1990s did so by implementing some wage moderation mechanisms, often through a comprehensive reform package. For example, the Netherlands experienced an increase in the strictness of unemployment benefit administration, better coordination in wage setting (the “Wassenaar agreement”), lower labor taxes and less strict employment protection. The United Kingdom has a less clear pattern, since the duration of unemployment benefits rose, but had many changes that went in the direction of lower unemployment: unemployment benefits replaced a lower share of income, stricter benefit administration, much reduced union coverage, lower union density, lower labor taxes. Ireland experienced similar institutional changes as the United Kingdom. It is the country where unemployment has fallen most rapidly in the second half of the 1990s, and during that period, all institutional indicators went in the direction of lower unemployment, except the duration of unemployment benefits (whose lengthening was probably innocuous as in the United Kingdom in

<sup>1</sup> Thus, it is excessive to claim, as some authors do, that institutions are not responsible for the rise in European unemployment, because European labor markets were already rigid in the 1960s. For that reason, it is unlikely that unemployment is *only* due to shocks and different persistent responses to these shocks (see Blanchard and Wolfers, 2000, for an analysis); at a minimum, these shocks should affect the political dynamics of institutions so as to change them permanently. It also contradicts the view that the rise in European unemployment is *entirely* explained by a shift from a “good” equilibrium to a “bad” one under constant institutions (as in Blanchard and Summers, 1988; Saint-Paul, 1995). Such a shift is possible, but then the “good” equilibrium itself is likely to have deteriorated.

the light of the sharp fall in the share of previous income replaced) and employment protection, which remained untouched.<sup>2</sup>

Conversely, countries that did not implement significant and widespread reforms have experienced continuing high unemployment. For example, between 1980 and 2000, benefit duration lengthened in France, union coverage went up, coordination of wage setting went down and employment protection became stricter. In Italy, another high unemployment country, the size of unemployment benefits relative to income went up and so did labor taxes. In Germany, the duration of unemployment benefits lengthened.

Nickell (2003) summarizes these diverging experiences by correlating the change in unemployment across countries in the 1990s with labor market reforms and finds the expected sign. Therefore, evidence supports the traditional view that rigidities that reduce competition in labor markets are typically responsible for high unemployment. Reducing these rigidities across the board seems to work.

But the empirical evidence is much less clear about how much would be gained, if anything, by increasing labor market flexibility along one or two dimensions only. If one takes unemployment benefits, for example, there is a general tendency for the replacement ratio, which is the share of income replaced by such benefits, to fall during the 1990s. But using the Database for International Comparisons in Europe (DICE) of the University of Munich's Institute for Economic Research, one finds that the correlation between lower unemployment benefits and lower unemployment is positive, as expected (+0.37), but insignificant. However, researchers have found a positive and statistically significant association between shorter duration of unemployment benefits and the unemployment rate (for example, Bean, 1994).

### **Additional Evidence: The Evolution of Rents**

Instead of attempting to measure the impact of changes in labor market institutions, a different approach is to look at direct quantitative measures of the labor market's competitiveness. Along these lines, Saint-Paul (2004) tries to measure labor market competitiveness by constructing indices of the welfare difference between an employed workers and a similar unemployed worker—that is, what is the rent to being employed? To measure rents, Saint-Paul (2004) uses two different approaches. The first one exploits variation across industries of wages, which are one measure of worker rents (Krueger and Summers, 1988). A related approach is

<sup>2</sup> One intriguing fact is that most of the gains in the low unemployment club were realized during the expansionary phase of the second half of the 1990s. From a layman's perspective, this makes sense, from an intuitive belief that structural reform is useless if the jobs are not there. But economists know that the connection between economic growth and job creation isn't obvious. We know that plenty of jobs are created during recessions (Davis, Haltiwanger and Schuh, 1996). Moreover, we typically think that the relationship between labor market tightness and wage (or inflationary) pressure is convex, so that the increase in labor demand triggered by structural reforms should create more jobs in recessions than in expansions.

to look at wage differentials across firm size. The second approach, as in Cohen (1999), tries to estimate a dynamic process for individual transitions between employment and unemployment and to use the estimated coefficients to compute the present discounted value of being employed and the present discounted value of being unemployed for any given category of worker.

The results suggest that, with the possible exception of Ireland, there is no robust evidence that worker rents have fallen in the 1990s. While these findings may be due to data problems, the results lend themselves to several interpretations. One is that, in the countries that reformed their labor market, competition between outsiders and insiders has not increased; unemployment has been reduced simply by lowering the welfare of the unemployed. Another interpretation, however, is that while labor deregulation reduces worker's rents along some dimensions, it increases it along others. In particular, wages may be more tightly linked to individual productivity, which may increase wage dispersion and measured employee rents.

If one takes these negative results as indicating that the reforms that reduced unemployment in a number of countries did not increase competition between insiders and outsiders, then that outcome is disappointing from a perspective of allocative efficiency. Nevertheless, these countries' labor markets improved relative to those who did not implement reforms.

## **Obstacles to Reform**

A number of European countries have failed to implement substantial labor market reforms, despite evidence from nearby countries that such reforms could help to reduce their high unemployment rates. Why have they failed to act? This section discusses considerations of political economy, ideology and agency that can affect whether a country will undertake certain labor market reforms.

### **Political Economy**

Across Europe, powerful constituencies of incumbent employees may seek to block labor market reforms. Political support for labor market rigidities will arise when a sufficiently large fraction of the workforce earn rents, when these rents can be enhanced by manipulating market outcomes through institutions, and when alternative, less distortionary means of redistributions are not feasible. Alternatively, one may view manipulating labor market institutions by means of voting and lobbying activities as a way for incumbent employees to achieve monopoly power at the economy-wide level. They achieve that monopoly power at the expense of other social groups.

While many people tend to think of labor issues as a conflict between labor and capital, labor market rigidities are more usefully thought of as pitting some workers against others. After all, international capital mobility implies that capital adjusts

very elastically to changes in its rate of return, so redistribution away from capitalists can only occur in the short run. In the medium run, labor market rigidities redistribute between different categories of workers. For example, wage rigidity may benefit employed “unskilled” or “moderately skilled” workers at the expense of skilled ones. Similarly, rigidities may redistribute in favor of workers in one sector at the expense of workers in other sectors, by raising the relative price of that sector and then the wages of its workers.

The political economy approach to explaining the persistence and growth of labor market rigidities makes a number of predictions, as spelled out in Saint-Paul (1996, 2000, 2002). First, labor market institutions will be determined more by the interests of employed workers than unemployed ones. Consequently, labor market institutions will not be designed to achieve full employment, and they will imply more wage rigidity and more employment protection than socially optimal.<sup>3</sup>

Second, the gains and losses to the insiders from labor market institutions depend on the economic environment. For example, when the elasticity of labor demand is high, regulation does a poorer job at increasing the wages of incumbent employees—because a given wage rise will reduce employment by a larger amount. If insiders are exposed to possible unemployment, then the more they will take the concerns of the unemployed into account and the greater the value that will be placed on reforms that boost job creation. Conversely, if insiders are extremely sheltered from job loss, they will not gain from such reforms. Greater underlying inequality of skills also affects the political support for labor market institutions; for example, a compressed wage structure will destroy more jobs if the underlying distribution of skills is more unequal, and that may reduce the support for such an institution.

Third, some labor market rigidities create their own constituency, which leads to a bias in favor of the status quo. For example, if employment protection maintains a number of workers in unproductive jobs that would not exist absent employment protection, these workers will favor maintaining employment protection.

Fourth, complementarities across rigidities arise: The existence of one institution often creates political support for another institution (Saint-Paul, 2000, chapter 9; Orszag and Snower, 1998, explain how complementarities may also arise from other economic mechanisms). For example, employment protection reduces workers’ exposure to unemployment, which they value if they earn rents. Assume there exists an institution that increases the wages of some categories of workers and therefore creates rents for these workers. Then the political support for employ-

<sup>3</sup> They may imply either more or less generous unemployment benefits than socially optimal, depending on whether the insurance effects of unemployment benefits dominate their effects on wage formation (Saint-Paul, 2000, chapter 5). Note also that the socially optimal degree of employment protection need not be zero if there exists microeconomic frictions in the labor market and if there is a limited set of policy instruments to cope with them (Saint-Paul, 2000, chapter 4).

ment protection is greater if that institution is present than if it is not. Conversely, if employment protection exists, workers are less exposed to job loss. This makes them more likely to support any institution that raises labor costs, for they are less likely to lose their jobs as a result. This insight helps to explain why packages of labor market reforms seem to have been more efficient than isolated reforms.

Many European reforms of employment protection legislation have offered exceptions for temporary workers, thus liberalizing the labor market at the margin by creating a “two-tier” labor market.<sup>4</sup> For example, temporary contracts have been used in this way in Spain, France, Italy, Portugal and Germany. These examples are illustrative of how political constraints may shape reforms. By leaving the insider’s employment protection unchanged, the government can buy their political support for its reforms. Furthermore, these reforms typically take place at times when insiders are exposed to unemployment—that is, at times when they have more to gain from boosting job creation (Saint-Paul, 1996).

Two-tier reforms may also start political dynamics that are conducive to further reforms. If those who hold flexible or temporary contracts become numerous enough, they can become a political constituency to support further reforms. In Spain, for example, temporary contracts soon accounted for one-third of employment, and so reforms reducing employment protection for workers with permanent contracts were implemented in the 1990s in exchange for further restrictions in the use of temporary contracts. By contrast, in France, Italy and Germany, where temporary contracts account for only 10–15 percent of total employment, virtually no reform of employment protection for permanent workers took place.

The political dynamics of temporary contracts raises an interesting question: can political constraints lead to labor market reforms that are worse for job creation than no reforms? For example, a number of authors have argued that a two-tier system of employment protection may be detrimental to employment and/or welfare—for example, if workers with temporary contracts bear most or all of the burden of labor turnover and wage adjustment (Bentolila and Dolado, 1994; Cahuc and Postel-Vinay, 2002). While one may dispute the benefits and costs of a two-tier employment system, let us focus here on the broader question of whether reducing the power of insiders can be bad for job creation.

As a starting point, recognize that the main force opposing insiders in the political design of labor market institutions is not the unemployed, who are unorganized and command little political influence, but rather employers. Thus, the question can more fundamentally be reformulated as follows: can a reform be good for employers, bad for labor market insiders and detrimental for net job creation? Examples of such policies readily come to mind. We know from the

<sup>4</sup> These are analyzed in Saint-Paul (1993, 2000, chapter 8) from a political economy viewpoint. Economic analysis of these reforms include Bentolila and Saint-Paul (1992), Jimeno and Toharia (1993), Bentolila and Dolado (1994) and, more recently, Güell-Rotllan (2000) and Cahuc and Postel-Vinay (2002).



theoretical literature that a reduction of firing costs may reduce employment (Bentolila and Bertola, 1990; Bentolila and Saint-Paul, 1994), yet it unambiguously increases profits. Increases in total labor supply through immigration or subsidies to young or female workers' participation in the labor market are unlikely to reduce equilibrium unemployment, but would benefit firms.

However, there is often a convergence of interests between employers and the unemployed. The reason is that higher profits for the former increases hirings and, thus, the probability of exiting unemployment. One can actually show that in equilibrium, if there is free entry of firms, a change in labor regulation that increases profits upon impact raises the equilibrium welfare of the unemployed (see Saint-Paul, 2000, chapter 2, for a formal result along these lines). That in-built convergence of interests between the unemployed and firms implies that reforms pushed by employers eventually benefit the unemployed, so that the relative lack of power of the unemployed is compensated for by the influence of employers. However, recall that this is true only under free entry—that is, if firms fully compete to attract workers. If product market regulation hinders entry, firms may in principle advocate reforms that harm both the employed and the unemployed. An interesting implication is that greater product market deregulation may make it more likely that labor market deregulation has positive effects on the welfare of the unemployed.

### **Ideology and Beliefs**

Ideologies and representations about the functioning of the economy play an important role in shaping beliefs about what should be done. The combination of a given policymakers' preferred "school" and some emotional discourse about "helping people" may lead to misguided policies that will not cure unemployment, although they will often benefit some interest groups, who will gain from promoting the underlying "school" or ideology.

Some examples of ideologies may help illustrate this point. Of course, in the real world these ideologies are often mixed together or stated in implicit or concealed ways.

First, consider the view that all unemployment is Keynesian and that the long-run equilibrium rate of unemployment is zero or very low. Advocates of this view will respond to unemployment by arguing that expansionary fiscal and monetary tools have not yet gone far enough.<sup>5</sup>

Second, union leaders often argue that an increase in wages will help reduce

<sup>5</sup> Ironically, this view can, in fact, be accommodated within mainstream economics: the literature provides mechanisms by which a temporary demand shock may permanently affect the natural rate of unemployment (Blanchard and Summers, 1986; Gottfries and Horn, 1987). Yet as argued by Layard, Nickell and Jackman (1990), it is unlikely that persistence mechanisms are strong enough to explain high European unemployment for 30 years. Incidentally, defenders of the Keynesian view rarely if ever refer to hysteresis.

unemployment and end a recession, because the higher wages will stimulate consumption.<sup>6</sup> Such an effect will occur only if workers spend more than capitalists, and even then, any positive effect on employment is bound to be short-lived, while the long-term effects are likely to be negative.

Third, the “lump of labor” fallacy holds that the total amount of work is fixed and can only be shared among those who want to work. This view has led to many misguided policies, such as preretirement to “make room” for younger workers or working time reduction. These policies have been quite prominent in France, but also have had some impact in the Netherlands, Germany and Belgium. They are likely to have harmed employment, as recently shown by Crépon and Kramarz (2002).

Another ideology is the general skepticism about the allocative role of prices in general and of wages in particular. Dismissing the commonsense view that less labor is demanded when its price goes up amounts to dismissing all policies that would lead to reductions in wages, or in the total cost of labor, with the goal of creating jobs. To be sure, it can be difficult in econometric studies to show conclusively that substantially less labor is demanded when its price goes up. However, this *must* eventually be true for high enough wages, and recent studies have made a rather convincing empirical case that increases in labor costs reduce employment, at least when starting from levels as high as those that prevail in European countries (Dolado et al., 1996; Laroque and Salanié, 2002).

Finally, people also tend to be more confident about the direct effects of policies than about their indirect ones (Gersbach and Schniewind, 2001). Thus, the direct effect of a reduction in the minimum wage is to reduce the income of minimum wage earners; subsequent job creation only comes later. The direct effect of reducing employment protection is that some workers will lose their jobs; the benefits in terms of job creation come later. Reductions in the generosity of unemployment benefits impose “hardship” on the unemployed, but their beneficial effects on employment involve the complex process of wage bargaining.

To understand how ideologies like these may interact with political economy, consider an economy with three categories of labor: high-skilled workers, for whom the labor market is perfectly competitive; medium-skilled workers; and low-skilled workers. Assume the medium-skilled workers are perfect substitutes for the low skilled, but more productive. On the other hand, the high-skilled workers are complementary with these two factors of production. Let us introduce a binding minimum wage  $\bar{w}$  so that the least skilled are not fully employed. In equilibrium, their wage is precisely equal to the minimum wage. The wage of the medium skilled will be larger than the low skilled, by a constant factor equal to the ratio between their productivity and that of the unskilled. Finally, the minimum wage reduces the

<sup>6</sup> A typical example can be found in a text from the French Union CGT (Confederation Generale du Travail), “*Sortir du bourbier des bas salaires*,” at (<http://www.construction.cgt.fr/communication/tracts/tractsalaires.doc>).

wage of the high skilled, since firms use less of the complementary inputs in production.

In this setting, an increase in the minimum wage benefits the medium skilled, since their greater productivity guarantees that they remain at full employment (at least as long as *some* low skilled remain employed), and their wage is a multiple of the minimum wage, because of substitutability between them and the low skilled. That is, a greater minimum wage increases the medium skilled's income because it reduces competition between them and the low skilled. On the other hand, an increase in the minimum wage unambiguously harms the highly skilled, as the reduction in employment of the low skilled, with whom they are complementary, lowers their productivity.

What about the welfare of the low skilled? An increase in the minimum wage raises the wage of those who are employed, but increases the number of those who are unemployed. Assume that, at the time society decides on the level of the minimum wage, low-skilled workers do not know in advance whether they will continue to be employed after the minimum wage is enacted and, in fact, are quite uncertain even about the probability that they will lose their jobs. Consequently, to the extent that the low skilled's opinion matters to the policies that are followed, it is in the interest of the medium skilled to promote the ideology that the elasticity of the demand for unskilled workers is quite low, while the high skilled have an incentive to promote the opposite views.<sup>7</sup> These incentives hold regardless of the true value of the elasticity and whether these groups know it or not.

The next question is by what means can a group manipulate the views of the another group; for example, how can the medium skilled convince the low skilled that minimum wage hikes destroy only a few jobs? The research on how beliefs are formed and why some beliefs are more popular is not very conclusive. But neuroscientists, for example, have shown that statements that are often repeated tend to be believed regardless of the rational basis for considering them as true (Camerer, Loewenstein and Prelec, 2003; Gilbert and Gill, 2000). One may then expect that the high skilled and the medium skilled would compete with each other in sending repeated messages to the low skilled, using the media and the education system. Moreover, if the actual effect of the policy is not as advertised, then there will be an incentive to create unnecessary complexity in labor market institutions, because it will prevent or slow learning about how the economy actually operates.

There is some evidence that beliefs about labor market institutions are unlikely to be grounded on knowledge of facts. Postel-Vinay and Saint-Martin (2003), using socioeconomic surveys, construct indicators of workers' subjective assessment of their job security for a number of European countries. They find that countries

<sup>7</sup> One can think of a number of other plausible examples. For example, to buy the support of skilled workers, unions may convey the view that their policies redistribute between labor and capital, whereas in a world of international capital mobility they in fact redistribute between skilled and unskilled workers. That example was suggested to me by Olivier Blanchard.

where workers feel more insecure are countries where employment protection is *stricter*. However, these authors do not investigate how these beliefs are created and sustained. Another piece of evidence is given by Blanchard and Philippon (2003), who argue that the degree of trust between labor and capital, if measured by strike activity, statistically explains part of the divergence between high and low unemployment countries. When trust is not present, unions do not believe firm's statements about labor costs and profitability and stick to their view of the world. Clearly, disagreements over ideology can hinder the formation of trust.

Finally, the methodological problems that plague social sciences can be taken advantage of by interest groups to promote their views in the media. Let us give two telling examples in the French context of how interest groups can intervene directly to manipulate the production and dissemination of knowledge.

In the context of the debate in France over limiting the length of the work-week, the lump of labor fallacy was repeatedly put forward. Studies were produced showing that working time reduction created a number of jobs during a given number of years, on the basis of short-run Keynesian models that were grossly unsuitable for dealing with these kind of issues (Cette, 2000; Cette and Taddei, 1998). Indeed, these studies took such a crude approach to wage formation and aggregate supply, that they actually predicted that the long-term effect of working time reduction on employment would be zero, simply because the long-term equilibrium rate of unemployment was modelled as exogenous. As a result, these studies predict a long-run effect of working time reduction on total hours worked which is negative, so that GDP should go down as well! Nonetheless, the studies conveyed to the public the false impression that experts agreed that working time reduction created jobs, based on the short-run effects of this policy that were purely Keynesian (employment increased in the short run because aggregate demand fell less than productivity per worker) and therefore could have been obtained at a much lower cost with traditional fiscal stimulus.

In the other episode, which took place in 2000, unions at the French statistical administration, INSEE, protested against the publication in its journal of an econometric study by two leading economists, Guy Laroque and Bernard Salanié, which showed that the French minimum wage destroyed jobs. The unions insisted that alternative studies pointed to an opposite conclusion, and they pressured the management of that administration to state publicly that it did not endorse that study.<sup>8</sup> Clearly, the union's preference for the alternative studies is unlikely to be based purely on a rational scientific assessment. That episode squares well with the argument that it need not matter too much about whether an ideology is correct, as long as key interest groups know which ideology will benefit them. In this way, public beliefs about economics may well be determined by the political power of

<sup>8</sup> An English-language version of their paper can be found in Laroque and Salanié (2002). The open letter sent by the unions (in French) can be read at the website (<http://cgтинsee.free.fr/dossiers/etudes/Larosala.htm>).

different groups, and there is no reason to expect “truer” views of the world to prevail.

### **Agency**

Economists often tend to assume that economic policies may be implemented without obstacle, as if the government were an integrated command structure similar to an army. But governments are replete with agency problems, a number of which are analyzed by Laffont and Tirole (1993). For example, some economists argue that a tight monitoring of the unemployed’s job search activity is desirable. In turn, this belief leads to a recommendation that instead of reducing social insurance by lowering unemployment benefits, one should just monitor the behavior of the unemployed and stop paying benefits to those who do not attempt to find suitable jobs or who turn down such jobs. However, the employment agency workers who are supposed to implement such policies often consider the unemployed, not the taxpayers, as their clients. After all, they are in contact with the unemployed on a daily basis, and civil servants typically lack any incentive mechanism to internalize the government’s objective. It is all too easy, for example, for the employment agency worker to believe quite readily that a job offer was “unsuitable” after all.

One can get an idea of the magnitude of the government agency problem by looking at the functioning of the unemployment agencies or public employment services in the related area of placement. Public services typically do a poor job at bringing unemployed workers and vacant positions together. The OECD (1991) politely reports that “it seems likely that at least in many EC countries, many people becoming unemployed during the eighties were not contacted with any proposal to apply for a specific job during their first year of unemployment. For many unemployed people, this may carry the message that . . . the authorities are not really very concerned to encourage continued job search.” As confirmed by Table 2, in many countries, the public employment service is virtually useless for workers seeking a job: the first column shows the stock of vacancies at the employment office per unemployed worker, while the second column shows the average interval between two consecutive contacts with an employer that an unemployed gets via the employment office.

The problem is compounded by the fact that in several European countries, the public service has (or had, until recently) a monopoly on job placement. That is, while employers can directly advertise their vacant jobs, intermediation between the employers and job seekers was the monopoly of the state; private intermediaries were prohibited. This fact seems to have some explanatory power. The European countries that allowed private placement companies in 1990—Ireland, the Netherlands, Portugal, Switzerland and the United Kingdom—are all in the low-unemployment club in 2000. Among those that preclude these companies, only the Scandinavian countries plus Austria (all thought to have highly centralized wage setting) are in the low-unemployment club. However, since then, state monopoly of

Table 2

**The Efficiency of the Public Placement Service in the 1980s**

<i>Country</i>	<i>Vacancy per unemployed</i>	<i>Interval between vacancies (months)</i>
Spain	0.01	37.4
Portugal	0.02	—
Belgium	0.03	20.6
France	0.03	21.1
Netherlands	0.05	15.8
UK	0.07	7.8
Germany	0.1	7.4
Finland	0.12	4.3
Austria	0.25	3
Norway	0.22	1.7
Sweden	0.58	0.9

job placement services has recently ended in Austria, Denmark, Finland, Germany and Spain.

From a theoretical perspective, centralizing all matches at a public service may yield welfare gains because of economies of scale and because that service could internalize congestion externalities exerted by participants on each other. These externalities have been well understood in the literature (Diamond, 1981; Pissarides, 2000): an unemployed worker looking for a job exerts a positive externality on firms by increasing the speed with which vacancies are filled and a negative externality on other unemployed workers by reducing their job finding probability. These externalities generate too low a level of search relative to the optimum if there are aggregate economies of scale in search activities—for example, if doubling the number of unemployment workers and vacancies would more than double the hiring flow. However, there is no evidence of such economies of scale (Blanchard and Diamond, 1989). As Moen (1995) has shown, in the absence of economies of scale, profit-seeking competitive placement services correctly price congestion externalities, thus yielding an efficient outcome. Public employment services appear to have little incentive to match the unemployed to vacancies. Perhaps bureaucratic logic dictates that they focus on the stock of unemployed workers using their services, rather than on the exit rate from unemployment. Or political economy considerations may also be relevant: if the public employment service is managed by labor unions (as is the case in some countries, including France), then the unions have an interest in managing job placement so as to reduce competition between the employed and the unemployed (Saint-Paul, 1998).

A well-intended reform that overlooks the problem of government agency may not only be ineffective but actually make things worse. In 1999, the French employers' association managed to negotiate with a fraction of the unions a reform

of the unemployment benefit system that was generally intended to monitor the job-seeking efforts of the unemployed more closely. However, to get support from the (then left-wing) legislature and the other unions, the scheme had to be amended; in particular, the commitment asked from the unemployed worker evolved toward a pledge for job search, and the previously existing pattern of declining unemployment benefits over time was abolished. It is not clear at all, then, whether the positive effects (on unemployment) of a more intense job search will dominate the negative effects of the fact that benefits are no longer decreasing with time.

### **Explaining Divergence: Research Directions**

Can the kinds of factors discussed here explain the observed divergence in unemployment among European countries in the 1990s? Ideally, one would like to show that in the low-unemployment club, political constraints, ideologies or agency constraints were less important than in the high-unemployment club. It would be bold to claim that as an established fact; the general problem is that there are only a handful of observations and that these countries differ in a number of dimensions. However, the preceding discussion can at least suggest a few hypotheses for future research that are likely to have some explanatory power.

#### **Different Shocks?**

One potential explanation is that the countries that have reformed their labor markets faced different shocks, which led them to different preferences regarding labor market rigidities. There is some evidence that changes in employment protection legislation are affected by current business cycles conditions. In addition, some well-known reforms, like the Spanish liberalization of temporary labor contracts in 1984, seem to have been triggered by a situation of very high unemployment that forced insiders to make concessions. In principle, an economic environment that increases the exposure of employed workers to unemployment should increase support for reforms.

A fiscal crisis could be another shock increasing the drive for labor market reforms. Problems in financing unemployment benefits often force legislators to reduce their generosity (however, they typically also increase payroll taxes at the same time, so that the net effect on unemployment is unclear). Other financial problems of the welfare state, such as funding public pensions or public health insurance, also may have spillover effects on labor market reforms. A fiscal crisis points to a need to increase employment, both because employment offers a tax base for other programs and because savings in unemployment benefits may be used to ease fiscal problems elsewhere. In Germany, for example, a fiscal crisis has prompted the government to propose a wide package of reforms, including a number of labor market liberalizations (EEAG, 2004).

However, it seems unlikely that different economic shocks to employment can explain all of the stark divergence across European countries with respect to the evolution of unemployment and labor market institutions. Business cycles are pretty similar and synchronized across European countries and so are the financial problems faced by their welfare states.

### **The Euro?**

A correlation seems to exist between whether or not a country belongs to the euro area and a country's ability to reduce unemployment in the late 1990s. The three non-euro countries in the European Community—Denmark, Sweden and the United Kingdom—are all in the low-unemployment club. In addition, Switzerland, which is not a member of the European Union and therefore not in the euro zone, has maintained a low unemployment rate throughout.

Exchange rate flexibility may help an economy to cope with shocks. The benefits of such devaluations are not very long-lived, but exchange rate flexibility may play a useful role in boosting the political acceptability of labor market reforms. A number of labor market reforms have short-run costs, like wage losses for workers who have rents or employment losses for protected workers, with benefits that only materialize in the longer run. Using macroeconomic stimulus to accompany a reform can alleviate these short-run costs (Bean, 1998; Saint-Paul and Bentolila, 2001). Belonging to the euro area shuts down one instrument of macroeconomic stimulus, monetary policy, which in turn may deter labor market reforms unless they are coordinated among euro countries.

While this argument about the benefits of exchange rate flexibility is correct in principle, it does not seem to reflect the actual experience of European countries in the 1990s—that is, the non-euro countries do not seem to have had a clearly more expansionary policy than the euro countries. A euro country like Ireland did well at implementing reforms and reducing unemployment. While some elements of labor market reforms are contractionary in the short run, like reductions in unemployment benefits or deregulation of employment protection, others reforms such as cuts in labor taxes are expansionary. A balanced package of both types of reforms maintains macroeconomic equilibrium, which means that monetary stimulus is not necessary.

### **Path Dependence?**

Another hypothesis is that European countries in the high-unemployment club did fewer reforms because of greater status-quo bias. To go beyond tautology, one would have to investigate the reason for such differences. For example, perhaps higher employee rents are a source of status-quo bias. However, the evidence on employee rents reported earlier does not suggest that countries with lower estimated rents match those in the low-unemployment club.



### **Small versus Big?**

It seems that smaller, more open economies have had an easier time implementing labor market reforms than larger ones. Out of the five European Union countries with 40 million inhabitants or more, four are in the high-unemployment club; of the remaining 10, only three are in the high-unemployment club. In political economy terms, there is clearly more scope for raising one's own wage at the expense of others in a large, closed economy, than in a small, open one. In a small economy, specialized in producing only a few products, the relative price of a good is pinned down by international prices, which also create a force for factor price equalization. Thus, the scope for redistribution between different categories of workers by manipulating prices, which is what labor market rigidities achieve, is much more limited. In contrast, one should expect more direct fiscal redistribution as a substitute. This pattern reflects the experience of Scandinavian countries, for example.

### **Latin versus Anglo-Saxon?**

Countries that have been successful in reducing unemployment typically belong to Anglo-Saxon or Nordic cultures, while "Latin" (or southern European) countries still live with high and persistent unemployment. If one considers the following list of six countries as defining the Latin group—Portugal, Spain, Italy, France, Belgium and Greece—then five of them are in the high-unemployment club. Only two of the remaining nine EU countries are in the high-unemployment club.

One popular explanation is that unemployment is more socially acceptable in Latin countries (Bentolila and Ichino, 2003). For example, perhaps the unemployed have an easier time in Latin countries because the family still acts as a safety net. This claim remains more of a stereotype than an established fact. And even if it is true, why wouldn't the generous welfare states of many Nordic countries make unemployment equally acceptable there? Another possibility is that southern European countries have more political resistance to labor market reform. In particular, Marxist parties have had more support in France, Italy, Spain and Portugal than elsewhere in Europe. But we would still need to explain why people develop and maintain such different views of the economy in different countries.

One potentially productive research direction is to explain that discrepancy in terms of multiple equilibria; that is, there may exist several self-sustaining beliefs about the underlying functioning of the economy.<sup>9</sup> Even if one manages to make such an argument, one must then explain how the equilibrium is connected to "culture." Another research direction, popularized by La Porta, Lopez de Silanes and Shleifer, insists on the role of legal origins. In a recent paper, joint with Djankov and Botero (2003) they show, using a cross-section of countries, that

<sup>9</sup> See Piketty (1995) for an argument among those lines in another context.

countries with French legal origins tend to regulate labor market more than common law countries. The puzzle then becomes thus: Why are legal origins so important? They cannot be interpreted as a proxy for “culture,” because their effects are identified by comparing groups of countries with similar legal origins but very different cultures. One promising hypothesis is that legal origins shape prior beliefs; for example, if markets are not left to operate freely, there is less room for learning about how they work.

## Conclusion

Since 1990, some European countries have managed to address their unemployment problem, while others remain stuck with it. The evidence suggests that successful countries typically have implemented a number of labor market reforms. As this validates the orthodox view that rigidities are an important cause of unemployment, one important implication is that it is unlikely that in the future growth or a boom will persistently reduce unemployment in those countries that have failed to reform so far. Political economy considerations, in connections with beliefs and the economic environment, seem to play a role in explaining the different geographical patterns of reform, but much remains to be understood about the deeper causes of why some countries have reformed and others have not.

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