

The (New) OECD Jobs Study: Introduction and Assessment

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In 1994, the OECD presented the Jobs Study analyzing the causes of high unemployment in Europe. The study identified inappropriate labor market regulations and legislation as a key determinant of high unemployment. The OECD recommended deregulation and liberalization of labor market institutions as a remedy. Meanwhile, new empirical research has explored the influence of labor market institutions on unemployment and has only partly confirmed the recommendations of the Jobs Study. In a reevaluation, the OECD now concludes that different combinations of institutions may foster good labor market performance. Like the Scandinavian countries, Austria is a country with strong labor market institutions and low unemployment.

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1 Introduction

Persistently high unemployment in numerous European countries remains one of the most pressing economic policy issues. A number of economists and international organizations have argued in recent years that joblessness in (Continental) Europe is basically a structural phenomenon, caused by the institutional provisions governing labor markets (labor market institutions – LMIs). To eliminate unemployment would require LMI reform, such as easing labor dismissal provisions, reducing unemployment benefits and cutting taxes on labor.

This was also the central message of the *Jobs Study* that the Paris-based Organisation for Economic Co-operation and Development (OECD) published in 1994. The policies advocated by the OECD in this study had a great influence on policymakers' thinking. They have guided the policy recommendations adopted in the OECD's economic reports and are also mirrored by the recommendations that the European Union (EU) has made

on labor market policy (Aiginger, 2006).

While conventional wisdom has it that rigid LMIs are at the heart of high unemployment in several countries in Europe (Siebert, 1997), reforms of these institutions are often unpopular and meet with resistance from vested interests. The measures that need to be taken appear to be clear, only their implementation is difficult. Luxembourg's Prime Minister Jean-Claude Juncker may well have had labor market reform in mind when he said: "*We all know what to do. We just don't know how to be re-elected once we've done it.*" (The Economist, 2006).

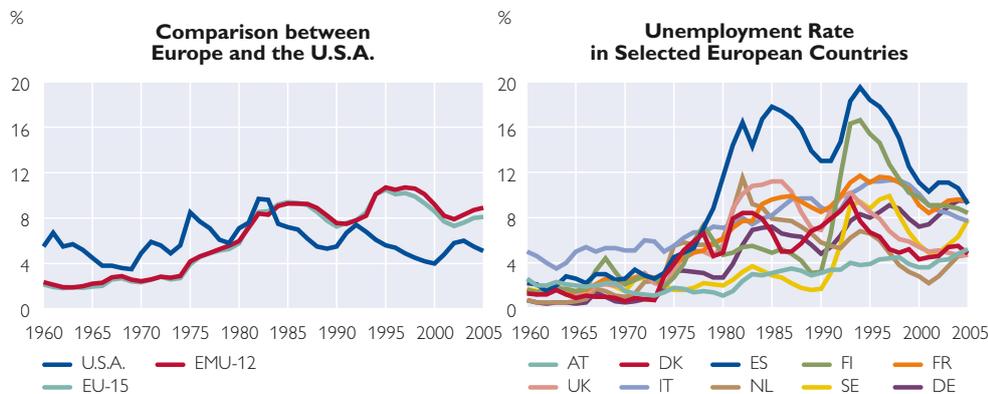
In June 2006, the OECD published a reassessment of the *Jobs Study*: The entire issue of its annual publication on the labor market, the *Employment Outlook*, is dedicated to this topic (OECD, 2006). In this reassessment, the OECD took the edge off some of its original recommendations or changed them: The labor markets do not necessarily need to be deregulated to reduce joblessness in

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Chart 1

Unemployment since 1960



Source: AMECO database.

countries with high unemployment. Much rather, various combinations of LMIs appear to be suited to promoting employment and keeping unemployment low. This paper summarizes the results of the *Jobs Study* and the recent literature.

2 Some European Countries Suffer from High Unemployment

2.1 High and Persistent Unemployment

Chart 1 (left panel) shows a familiar problem: Until the 1980s, unemployment in Europe (the EU-15² countries or the member states of Economic and Monetary Union, EMU) was lower than in the U.S.A. Between the mid-1970s and mid-1980s, unemployment in the EU rose rapidly and has since remained persistently high, with cyclical fluctuations. The divergent development of unemployment is generally ascribed to the fact that the U.S. jobless rate fluctuates

around a stable equilibrium value. By contrast, in Europe the equilibrium unemployment rate itself is assessed to have risen in the course of time, preventing unemployment from sinking to a lower level in times of stronger economic growth.

2.2 Large Differences in Unemployment Rates among European Countries

Chart 1 (right panel) shows the development of unemployment rates in selected countries and reveals that there is no overall “European” unemployment problem. Some European countries – including the U.K. with its comparatively unregulated labor market as well as Austria, the Netherlands and Denmark – have posted jobless rates roughly as low as those in the U.S.A. The persistently high unemployment rates seem to be concentrated mainly in the large Continental European countries – Spain³, France, Italy and Germany.

² Unemployment rates were also high in some of the New Member States. However, this is probably because these economies were socialist and centrally planned until about 1990 and then underwent a massive systemic change to which they need a long time to adjust. Therefore, with the exception of former East Germany, which is included in the data series on the EU and Germany from 1991, they are not treated in this contribution.

³ However, within the past decade Spanish unemployment roughly halved from an initial rate of nearly 20%, as chart 1 indicates.

The design of the individual European countries' LMIs (section 4) also differs. In its 1994 *Jobs Study*, the OECD had asserted that distinctive institutional features played a crucial role in the development and persistence of unemployment.

3 The Jobs Study: An Influential Report

In response to the rise in unemployment in its European member states, the OECD was commissioned to draw up an extensive study on the causes of unemployment and to compile a list of policy recommendations. This study was published in 1994 (OECD, 1994a and 1994b; followed by a number of related publications).

The policy recommendations were summarized in ten bullet points (see box below):

As the list indicates, the OECD did not find unemployment to be rooted exclusively in LMIs. Apart from its emphasis on macroeconomic policy (recommendation 1), the study stresses structural aspects such as innovation, research, entrepreneurial climate, education/training and competition policies (1, 2, 4, 8 and 10). Nonetheless, as many as five recommendations (3, 5, 6, 7, 9; emphasized in bold print in the box) apply to institutional arrangements on the labor market. A closer look at these recommendations follows.⁴

Empfehlungen der Jobs Study:

1. Set macroeconomic policy such that it will both encourage growth and, in conjunction with good structural policies, make it sustainable, i.e. non-inflationary.
2. Enhance the creation and diffusion of technological know-how by improving frameworks for its development.
3. **Increase flexibility of working-time** (both short-term and lifetime) voluntarily sought by workers and employers.
4. Nurture an entrepreneurial climate by eliminating impediments to, and restrictions on, the creation and expansion of enterprises.
5. **Make wage and labour costs more flexible** by removing restrictions that prevent wages from reflecting local conditions and individual skill levels, in particular of younger workers.
6. **Reform employment security provisions** that inhibit the expansion of employment in the private sector.
7. **Strengthen the emphasis on active labour market policies and reinforce their effectiveness.**
8. Improve labour force skills and competences through wide-ranging changes in education and training systems.
9. **Reform unemployment and related benefit systems** – and their interactions with the tax system – such that societies' fundamental equity goals are achieved in ways that impinge far less on the efficient functioning of labour markets.
10. Enhance product market competition so as to reduce monopolistic tendencies and weaken insider-outsider mechanisms while also contributing to a more innovative and dynamic economy.

Note: The original does not contain the emphasis in bold print highlighting recommendations with an immediate relevance for the labor market.

⁴ Note that the literature reviewed for this paper does not accord increased flexibility of working time (recommendation 3) any importance.

The *Jobs Study* has exerted great influence on the economic policy discussion and on the issues discussed in the applied economics literature.⁵ The same is true of the book *Unemployment* by Layard, Nickell and Jackman, which was first published in 1991 and which was reissued unchanged in 2005 except for an updated introduction with a longer literature survey (Layard et al., 2005). According to this book, LMIs also play a key role in understanding unemployment in Europe.

4 Labor Market Institutions: A First Overview

4.1 What Are Labor Market Institutions, and Why Do They Exist?

Following North (1991), LMIs may be seen as formal and informal rules that direct the actions of players on the labor market. Blau and Kahn (1999) consider LMIs the framework of laws, programs and conventions that influence labor market activity and that cause the labor market to function differently from a spot market.

The empirically oriented literature reviewed here is, actually, not based on formal definitions. Much rather, it uses a widely accepted list of LMIs. The discussion covers unemployment benefits, employment (dismissal) protection, labor unions and wage bargaining systems, active labor market programs and the amount of taxes due on labor income. The distinction between LMIs and other institutional rules is not clear-cut (Nickell and Layard, 1999): Product market regulation is frequently motivated by worker health and safety

considerations (e.g. shop opening hours), but is not conventionally considered an LMI, whereas specific aspects of the tax system whose importance extends far beyond the labor market are (e.g. income tax).

Why, indeed, do LMIs exist in the first place? They are typically seen as having evolved to offset market imperfections such as uncertainty and asymmetric information (Agell, 1999). According to Agell (2002) economic history shows that labor market problems led to the establishment of LMIs (unemployment insurance, labor unions) rather than vice versa. Yet more critical views of LMIs also exist, according to which labor market institutions basically serve vested interests (e.g. insiders versus outsiders, that is, employed persons versus the unemployed or those with precarious employment contracts) and help the given interest groups to secure economic rents (Blau and Kahn, 1999).

4.2 Institutional Diversity

LMIs are very prevalent in most countries in Europe. However, their relative importance differs from country to country:

- *Magnitude and duration of unemployment compensation:* Unemployment benefits tend to be generous in Scandinavian and Central European countries (among them Austria). By contrast, they are markedly lower in the U.S.A. and in the U.K., and are in fact quite low in some Southern European countries, such as Italy (OECD, 2006).
- *Employment protection:* Periods of notice differ among OECD mem-

⁵ Consider the assessment by Blanchard (2006): “The [*Jobs Study*] was – and its general line still is – extremely influential.” (p. 26).

- ber states, as do unfair dismissal provisions. Employment security is very low in the U.S.A. and in the U.K., moderate in Denmark, Finland and Austria⁶ and very high in France and Spain (OECD, 2004a).
- *Labor union coverage*: Labor unions negotiate collectively agreed (minimum) wages for more than 90% of all employees in some countries in Europe (e.g. Austria, Finland, France and Sweden). The corresponding share in the U.K. is around 30%, and only 14% in the U.S.A. A strong influence of the labor unions is linked to high membership figures in the Scandinavian countries, with the percentage of membership exceeding 70% (OECD, 2004b).
 - *Wage bargaining system*: Whereas wage setting is decentralized and is done at the enterprise level in the English-speaking countries, it is conducted at the sectoral and/or regional level in many others (e.g. in Austria or Germany.) Wage negotiation is highly centralized at the country level in some Scandinavian countries. Decentralized wage bargaining may nevertheless be coordinated, as is the case for Austria and Finland (OECD, 2004b).
 - The importance of *active labor market policies* also varies: Expenditure is minimal in the U.S.A. (2004: 0.16% of GDP), at a medium level in Austria and the U.K. (around 0.5%) and high in the Netherlands and in Denmark, meaning it is above 1% (OECD, 2006).
 - *Labor taxation*: Taxes on labor (income tax, social security contributions and other payroll taxes) are high in Italy, Finland and Sweden, at mid-level in Denmark and Austria, and low in the U.K. and the U.S.A. (OECD, 2006).

4.3 Institutions and Quantitative Institutional Variables

Institutional rules on the labor markets are complex. Academic researchers and in particular the OECD itself have invested much effort in the construction of indicators aiming at depicting the essential features of institutional provisions in the labor market.

These indicators have been steadily revised and improved over time. While they are often quite good at showing differences across countries today, past values are quite likely to be less accurate. In fact, many LMI variables exhibit low variation over time. They are difficult to determine and are thus not available for every single year, which is why many researchers resort e.g. to interpolations.

4.3.1 Unemployment Insurance

The amount of unemployment insurance is regularly mapped by means of *replacement rates*, by the *duration* of payment of unemployment benefits or by a combination of both factors. The replacement rate in this case is the ratio of unemployment benefits to the last net wage payment in the first year of unemployment. Typically, an average is calculated for several wage levels and family types (sole wage earner; double income household;

⁶ Employment protection has become much weaker in Austria since the introduction of the new severance payment scheme. The OECD highly commends this reform as exemplary (editorial in OECD, 2006).

with/without children). A combined measure of replacement rates and the duration may be calculated on the basis of the averages of the first, second, third and further years and by attaching lower weights to the values of the later years (Nickell et al., 2005).

4.3.2 Employment Protection

Employment protection refers to the set of rules governing the hiring and firing process. These provisions include dismissal protection rules (notice periods, prohibition of dismissal, protection of individual workers against unfair dismissal, the obligation to notify the public employment service in advance of dismissals, requirements for collective dismissals) and the regulation of temporary forms of employment. This comprehensive framework is empirically implemented by the formation of aggregated indices (see contribution by Pointner in this issue).

4.3.3 Labor Unions and Wage Bargaining Systems

In most OECD member countries, wages (frequently minimum wages for various sectors and professions) are not negotiated individually between employers and employees. Employees are usually represented by unions. By the same token, employers often do not negotiate wages individually; they are represented by employers' associations.

Empirical studies frequently use the union density rate (the ratio of union members to all employees) to represent the influence of labor

unions. An alternative variable, namely the union coverage rate (i.e. the share of employees to whom collective wage agreements apply), would be more meaningful, but it is much harder to determine.

Wage bargaining systems are also characterized by the level at which negotiation takes place and by the role employers' association play. According to the usual classification, wage negotiations may be conducted decentrally (at the enterprise level), at the sectoral level or at the national level. Alternative indicators capture whether individual wage negotiations are largely isolated from one another or whether they are coordinated.⁷

4.3.4 Active Labor Market Policies

The 1994 *Jobs Study* advocated the wider use of active labor market policies to supplement the established passive measures (such as unemployment benefits). Following a conventional classification, such policies include the provision of job referrals and job search support, training measures, wage subsidies and programs for persons with disabilities. The first two categories – job referrals/search support and training measures – are the most important ones. Empirical research usually expresses the importance of active labor market policy programs by the size of expenditures relative to the extent of unemployment in a country.⁸

4.3.5 Taxation of Labor

Usually, the degree of taxation is measured as the difference between

⁷ Sometimes, wage bargaining systems are also characterized by their degree of corporatism, meaning the strength of political participation by employers' and employees' associations. As a rule, corporatist structures go hand in hand with centralized or coordinated wage bargaining systems (Flanagan, 1999; Aidt and Tzannatos, 2002).

⁸ OECD (2006) uses the following measure: expenditure for activation measures per unemployed person as a percentage of per capita GDP.

total labor costs (gross wages plus employers' contributions to social security) and net wages (gross wages minus employers' contributions to social security and income tax plus transfer payments). Some economists also take indirect taxes into account (e.g. Nickell et al., 2005).

The OECD regularly publishes values indicating the size of the *tax wedge* between total labor costs and net wages, typically providing averages of the tax wedges for different types of employees.

5 Labor Market Institutions and Unemployment

5.1 Theoretical Considerations and Criticism of Indicators of Labor Market Institutions

The prevailing literature uses mostly static but also dynamic models to explain equilibrium unemployment (i.e. unemployment adjusted for cyclical fluctuations).⁹ Static models of imperfect competition on labor and product markets explain unemployment in terms of the interaction between wage setting and price setting (NAIRU – nonaccelerating inflation rate of unemployment – models). All factors that raise prices (at a given wage level) and wages (at a given price level) result in higher unemployment.

Dynamic models see unemployment as a dynamic equilibrium between inflows and outflows. Such flow models take into account that time is needed to match the unemployed to vacancies, as both vacancies and unemployed workers are hetero-

geneous. Every institution or economic policy measure that accelerates this matching process leads to a decline in equilibrium unemployment.

The theoretical effects of various LMIs on unemployment are discussed below. It must be pointed out, however, that the variables used may not be suited to capturing the nature of the true impact of LMIs.

Certainly, the impact of an LMI on unemployment is not the only criterion to judge labor market performance. A more comprehensive evaluation must also include other aspects, such as welfare gains resulting from higher income security (Agell, 1999 and 2002; Pissarides, 2001). The impact of LMIs on longer-term economic growth is also relevant.¹⁰

So as not to exceed the scope of this paper, another target variable of economic policymaking, namely the employment rate (i.e. the percentage of employed persons in the entire working-age population), is not discussed either. Some economists consider the employment rate to be a better labor market indicator than the unemployment rate, because the latter masks unemployment hidden by active labor market policies and excludes discouraged workers (i.e. those who have given up looking for a job). What would weigh against choosing the employment rate as the primary target indicator of the labor market is the fact that it reflects different preferences for leisure, cultural differences (above all in female employment) and other special factors, such as the incidence of early retirement.

⁹ See Carlin and Soskice (2006) for an introductory presentation, and Cahuc and Zylberberg (2004) for a more in-depth discussion.

¹⁰ See Nickell and Layard (1999) for a general discussion of the growth impact of labor market institutions. Aidt and Tzannatos (2002) relate a comprehensive discussion of the effects of labor unions and wage bargaining systems on the economy.

A more detailed discussion of the impact of LMIs should also take the employment rate into account. In fact, OECD (2006) makes reference to this indicator more than the original *Jobs Study* did (see also European Commission, 2004). Moreover, it is commendable that the more recent OECD work analyzes unemployment and employment more in terms of different groups in the labor market – gender, age, qualification levels – than the older studies.

5.1.1 Unemployment Insurance

Higher unemployment benefits and longer benefit duration increase the time that unemployed persons take to search for a new job. Moral hazard becomes a problem, in particular if the search efforts are not constantly monitored (or because complete monitoring is not possible).

Under *ceteris paribus* conditions, the generosity of unemployment benefits (in terms of the replacement rate and the duration) raises the wage to which the jobless person is entitled, preventing the job market from being cleared. In fact, microstudies indicate that the likelihood of unemployed persons taking a job increases sharply just before their entitlement to unemployment benefits ends. At the same time, unemployment benefits allow people to seek a job that is a better match for their individual productivity (OECD, 2006; Arpaia and Mourre, 2005).

Basically, the meaningfulness of the indicators chosen to reflect the generosity of unemployment benefits should be critically questioned, as they fail to capture other important design elements of unemployment insurance. It has become widely accepted that the payment of unemployment benefits should be condi-

tional on the intensive search for a position. This requirement is implemented e.g. by close supervision, activation, individual case management and, in the event that an unemployed person does not cooperate, by various sanction mechanisms.

5.1.2 Employment Protection

In an economy in which it is difficult to fire jobholders, companies will be wary of new hires. In other words, unemployed persons have a harder time finding a job, as there will be fewer vacancies for a given number of jobless people. At the same time, fewer people will lose their jobs, which lowers the ratio of unemployed persons to a given number of vacancies. It is not clear *a priori* which of the two effects dominates.

Like unemployment insurance, employment protection reduces the risk of losing one's income in the event of dismissal. Hence, the two institutions should not be considered separately. As to the indicator itself, it is simply the sum total of the various aspects of employment protection – with the caveat that there is no established consensus as to the weight with which the individual elements (regular dismissals, temporary work options and the like) should enter the aggregate index of employment protection.

5.1.3 Labor Unions and Wage Bargaining Systems

Principally, more powerful labor unions make higher wages possible, which raises equilibrium unemployment under *ceteris paribus* conditions. That said, labor unions generally have an eye on the employment situation, and they also take the reaction of price setting to nominal wages into account. Calmfors and Driffill (1988)

show that low unemployment is compatible with both highly decentralized and centralized wage bargaining systems. In decentralized wage bargaining systems (e.g. in enterprise-level negotiations), union representatives will immediately see how (too) high wages affect the demand for labor. Wage bargainers who have the macroeconomic perspective in mind will also take into account the real purchasing power of the agreed nominal wages. In the Calmfors-Driffill model, mid-level wage bargaining systems – those at the sectoral or similar levels – perform worst. These systems do not adequately take into account the impact on labor demand (as all enterprises in the sector have to pay the same wages), nor do they adequately reflect the repercussion of higher prices on real wages.

Later studies argued that the formal characterization of the negotiation level was less important than the way in which the individual wage negotiations are coordinated. More coordinated wage bargaining systems will tend to be more capable of wage moderation and will thus help keep unemployment low. Stronger competition on the product markets also leads to greater wage moderation.

More powerful unions result in more equitably distributed incomes (OECD, 2004b). Frequently, economists argue that unions compress the wage distribution and thus reduce employment opportunities for low-productivity labor. Critics respond that there is no empirical confirmation of the wage compression hypothesis and that European countries with more equitably distributed incomes also display more balanced education levels (Nickell and Layard, 1999; Schettkat, 2003; Howell, 2006).

Here, again, it must be questioned whether the institutional variables used adequately reflect the impact of labor unions or wage bargaining systems. Comparing union behavior in the U.K. and in Germany, Freeman (2005) observes a lack of responsibility on the part of British unions in the 1970s but a heightened sensitivity to their enterprises' business situation in the 1990s. The opposite was true in Germany. It is improbable that aggregate indicators like union density rates could capture such effects. Blanchard (2006) presumes that the trust between employers and employees may have a decisive influence. He cites countries with a social partnership orientation, where labor relations are comparatively harmonious (e.g. few strikes). Other countries (such as Italy or France) have more contentious labor relations, leading to less wage moderation.

5.1.4 Active Labor Market Policies

In principle, active labor market policies, especially job search assistance or reskilling programs for the unemployed, speed up the process of matching job seekers and vacancies. How successful the matching process is depends not just on the amount of expenditure but also on the effectiveness of the placement and retraining measures, which may take many forms (OECD, 2005). Empirically evaluating the effectiveness of such policy measures is particularly difficult. Therefore, it appears questionable whether the usual expenditure indicators can appropriately capture the effects of active labor market policies.

5.1.5 Taxation of Labor

The labor supply and labor demand elasticities determine how strongly

labor supply and labor demand react when a tax is imposed. Even the direction of the effect is not clear a priori – both substitution and income effects are possible. Which side of the labor market is affected more strongly also depends on the respective relative strengths of labor and employer representation. Empirical evidence suggests that the wage elasticity of labor supply is merely slightly negative or even positive at times for male employees. Conversely, the wage elasticity of labor demand is found to be comparatively higher and clearly negative (Cahuc and Zylberberg, 2004).

Static labor market models represent higher tax wedges by causing changes in price-setting behavior to raise the equilibrium unemployment rate. However, using a search-theoretical approach, Blanchard (2006) illustrates that taxes raise labor cost only if they are levied exclusively on labor. By contrast, more broadly based taxes, such as income taxes or excise duties, do not increase wage costs. Also, it must not be forgotten that social contributions have direct benefits, such as health or pension insurance (Disney, 2004). Consequently, Blanchard considers the tax wedge data used in the empirical studies to have little informative value. Furthermore, Cahuc and Zylberberg (2004) note that these values only represent averages and that the theoretical effect of changes of average tax

rates must be distinguished from changes in *marginal* tax rates.

5.2 Empirical Findings

Table 1 provides an overview of the results of panel regression studies on the link between LMIs and unemployment. The top part of the table summarizes some recent work: a study by the International Monetary Fund (IMF, 2003), the study by Nickell et al. (2005), the empirical results of Baker et al. (2005) and the findings of an OECD working paper (Bassanini and Duval, 2006) on the reassessment of the *Jobs Study*.

Such a presentation masks many methodological details, as each team of authors used several specifications for its regressions. The authors use different indices, control variables for the business cycle and other macroeconomic shocks and other determinants, and they refer to different time periods and different groups of countries. In addition, the empirical studies use a multitude of variables to capture the interaction between different LMI variables,¹¹ and some studies use variables representing interactions between LMIs and macroeconomic shocks.¹² For reasons of space constraints, however, only the main effects of the respective variables are presented in table 1.

To highlight the trends of the results, the bottom part of table 1 shows whether the individual variables in

¹¹ Because labor market institutions are interlinked, it makes good sense to include interaction variables. However, it is often not quite clear at the outset which specifications should actually be included in the regressions. There are very many possible specifications for interactions between labor market institution variables, whereas the degrees of freedom are limited, especially considering that many of these variables exhibit only a small time variation (Freeman, 2005).

¹² Blanchard and Wolfers (2000) argue that it appears implausible that labor market institutions should be singlehandedly responsible for high unemployment in some countries. Much rather, the interaction between macroeconomic shocks and relatively stable labor market institutions could explain the development of unemployment. Conversely, Nickell et al. (2005) conclude that most (55%) of the change in unemployment could be explained by the change in labor market institutions themselves.

the studies in the literature survey in OECD (2006) increase (+) or decrease (–) unemployment.¹³

Table 1 demonstrates the mixed results in the empirical literature. Not all LMIs reviewed are found to cause unemployment to rise:

- A clear majority of studies concludes that more generous unemployment benefits are correlated with higher unemployment.
- The results are even clearer for labor taxation: *ceteris paribus* higher taxes on labor drive up unemployment.
- Also, the finding that centralized or coordinated wage bargaining systems correlate with lower unemployment is fairly robust.
- Furthermore, the result that active labor market policies reduce unemployment also appears to be clear. However, many studies – above all the more recent ones – do not take this explanatory variable into account.
- The evidence that higher labor union power results in higher unemployment is relatively weak.
- The same is true of employment protection: the number of studies that finds no influence on unemployment clearly outweighs the number of studies that finds that employment protection measures raise unemployment.

Table 1

The Influence of Labor Market Institutions on Unemployment – Empirical Results

Source	Variable for labor market institutions						
	Period covered	Un-employment benefits	Active labor market policies	Labor union power	Centralization/coordination of wage bargaining	Labor tax wedges	Employment protection
Individual studies:							
IMF (2003) ¹	1960 to 1998	(+)	x	(+)	(–)	(+)	(+)
Baker et al. (2005) ²	1960 to 1999	(–)	0	0	(–)	0	0
Nickell et al. (2005) ³	1961 to 1995	(+)	x	(+)	(–)	(+)	0
Bassanini and Duval (2006) ⁴	1982 to 2003	(+)	x	0	(–)	(+)	0
Literature survey in OECD (2006):⁵							
● Number of studies in which the labor market institution variable...	...raises unemployment	9	0	5	2	12	6
	...lowers unemployment	1	6	1	10	0	1
● Number of studies in which the labor market institution variable has no (unambiguous) effect on unemployment		2	1	11	3	5	8

Note: (+): variable raises unemployment; (–): variable lowers unemployment; 0: no statistically significant effect; x: variable was not analyzed.

¹ Variant (4).

² Table 3.6, Specification (3).

³ Table 5, Specification (1).

⁴ Tables 1.2 and 7.A1.1, Baseline specification.

⁵ Table 3.3, table 3.5, table 3.8, table 3.9, table 3.12 and table 3.13.

¹³ The studies mentioned in the first four lines of table 1 are included in the OECD literature survey as well.

5.3 Discussion

5.3.1 Empirical Results that Lack Robustness and Debatable Policy Conclusions

There is often a considerable gap between the rigorous theoretical models and empirical methods economists use and the way in which they derive policy conclusions (McCloskey, 1983). Frequently, economists tend to disregard the issue of how robust and how contradictory the results are (Baker et al., 2005; Freeman, 2005).¹⁴

Against this backdrop, what do the empirical findings summarized above mean for the recommendations of the *Jobs Study*?

- Recommendation 5 (“*Make wage and labour costs more flexible*”) may be interpreted as a recommendation to abandon centralized wage bargaining systems and to achieve more flexible wages e.g. by negotiation at the enterprise level. The unemployment reduction effect of coordinated wage bargaining systems would, however, contradict such a recommendation.
- Recommendation 6 (“*Reform employment security provisions*”) has also been interpreted as a recommendation to dilute employment protection provisions. Yet the empirical results would support this

recommendation only to a certain extent.

- Recommendation 7 (“*Strengthen the emphasis on active labour market policies*”) is corroborated by the empirical results.
- Recommendation 9 (“*Reform unemployment and related benefit system*”) is commonly interpreted as a recommendation to disburse unemployment benefits less generously. Generous unemployment benefits do in fact correlate with high unemployment.

Did the recommendations of the old *Jobs Study* contribute to reducing unemployment? Chart 2 represents a scatter plot of the change in trend unemployment and a collective indicator used in an OECD Working Paper (Brandt et al., 2005) to capture the intensity of labor market reforms made from 1993 to 2003 inspired by the *Jobs Study* (lower taxes on labor, more temporary work options, stricter rules for unemployment insurance and the like). To compile the collective indicator, steps taken to reform various LMIs were evaluated and the values were simply added up.¹⁵

Chart 2 suggests that the reduction of unemployment does not correlate very strongly with reform intensity, in particular if one considers that the jobless rate is low in some

¹⁴ The IMF (2003) uses a model simulation to argue that reductions of unemployment benefits, employment protection and labor taxes in the euro area to the U.S. level would cut unemployment by 3 ¼ percentage points in the long run (p. 141). However, in the underlying results of their panel regressions, the replacement rate of unemployment benefits has a significant impact in terms of raising unemployment in only one of four cases, and in another case it even has a significantly reducing influence. Coordination of wage bargaining – a variable that has a marked reducing effect on unemployment – is not taken into account in the simulation, though (p. 147). Layard et al. (2005) interpret an easing of employment protection as a good reform (p. xxxviii f.), even though in their literature survey (p. xvii) they conclude that there is no decisive evidence that employment protection increases unemployment.

¹⁵ The authors are aware that such an approach does not, of course, take into account interactions or complementarities between labor market institutions.

Chart 2

Intensity of Reforms Inspired by the Jobs Study and Change in Trend



Source: AMECO database, Brandt et al. (2005).

Note: Red dots denote countries whose unemployment rates were higher from 1994 to 1999 than that of the U.S.A. Blue dots denote countries whose unemployment rates were lower from 1994 to 1999 than that of the U.S.A. and the U.S.A. itself.

countries, which probably had less of a need for reforms (blue symbols).¹⁶

6 Labor Market Institutions: Several Roads Lead to Rome

6.1 The OECD Has Adjusted Its Assessment

The empirical findings summarized above may be interpreted as follows: reduce unemployment benefits, increase funds for labor market activation measures, introduce coordination elements into wage bargaining and reduce taxes on labor. Yet considering the limited meaningfulness of LMI indicators and the complex relations between the individual LMIs, such a conclusion would be naive.

In fact, the reassessment of the *Jobs Study* takes fuller account of the complementary relations between various institutional provisions (Arpaia and Mourre, 2005; OECD, 2006).

Among other things, the reassessment shows that model combinations which sharply contradict the naive interpretation may in fact be quite successful: The Danish flexicurity model, for instance, effectively combines low employment protection and high unemployment compensation (and intensive active labor market policy measures) – running counter to the empirical findings summarized above that employment protection has barely any influence and that high unemployment benefits boost unemployment.

Whereas in its 1994 *Jobs Study* the OECD had broadly advocated deregulating the labor market, it concedes in its recent work that various institutional labor market models are consistent with successful labor market performance; in its 2006 *Employment Outlook*, the OECD states that “Experience shows that there is no single

¹⁶ However, Brandt et al. (2005, chart 35) point out that there is a positive correlation between the rank of the intensity of reforms and the change in the rank of trend unemployment rates. The reassessment of the *Jobs Study* also contains the statement that labor market reform had contributed markedly to reducing unemployment in the past decade. Simulations based on the results of the OECD’s panel regressions confirm this finding (OECD, 2006, chart 7.3). But simulations do not support the validity of the policy recommendations of the *Jobs Study*; much rather, they are simply evidence of the joint statistical significance of the various labor market institution variables.

Table 2

Institutional Regimes and Labor Market Performance

Labor market institution	Country group		
	Group 1 (Australia, Canada, Japan, South Korea, New Zealand, Switzerland, U.K., U.S.A.)	Group 2 (Austria, Denmark, Ireland, the Netherlands, Norway, Sweden)	Group 3 (Belgium, Finland, France, Germany, Italy, Portugal, Spain)
Employment protection	low	average	high
Generosity of unemployment benefit system	low	high	high
Expenditure on active labor market policy	low	high	average
Labor taxes	low	average	high
Labor union coverage/coordination of wage negotiations	low	high	high
Product market regulation	low	low	high
Unemployment rate in % (average from 2000 to 2005)	5.3	4.8	9.0
Employment rate in % (average from 2000 to 2005)	70.9	71.9	62.5
Income inequality	high	low	average

Source: OECD (2006, table 6.3 - simplified presentation).

golden road to better labour market performance.”¹⁷

6.2 Good Labor Market Performance of the “Anglo-American” and the “Scandinavian” Models

The current view of the OECD has largely moved away from the analysis of individual LMIs and toward a more comprehensive analysis. Table 2 presents a key finding of the OECD’s reassessment of the *Jobs Study*. As a result of an empirical analysis, the OECD member states may be catego-

rized into several groups,¹⁸ of which two country groups with highly disparate combinations of LMIs exhibit successful labor market performance (low unemployment, high employment).

The first of these groups covers countries with very little labor market regulation (the English-speaking and a few other countries), whereas the second group combines countries whose labor markets are more tightly regulated (most Scandinavian countries, Austria), in particular with regard to the generosity of unemploy-

¹⁷ It is not easy to prove this change in recommendations. Both the old and the new *Jobs Study* are lengthy documents authored by teams of experts on individual topics. In the drafting process, the OECD member states may repeatedly submit comments, as a result of which the wording is often changed (usually diluted), especially in the introductory and concluding statements. Therefore, documents like the *Jobs Study* are not always fully coherent, leaving some ambiguity about what their message actually is. Nevertheless, there seems to be a consensus view that the OECD has indeed markedly changed its position on labor market institutions (see e.g. Freeman, 2005). Some economists regret that the OECD now considers some of the more regulated economies in Europe as just as successful as the U.S. economy, arguing that: “corporatist state labor markets are not as efficient as the U. S. labor market. They are just effective in disguising long term problems.” (Heckman et al., 2006). By contrast, labor union representatives welcome the change of heart in the argumentation: “These conclusions [...] require a significant shift in the policy focus [...] to allow a more pragmatic assessment of recommendations at the national level.” (TUAC, 2006).

¹⁸ Results of a principal components analysis; see OECD (2006).

ment compensation, the importance of active labor market policies or labor union coverage, but which enjoy only moderate employment protection and which have average taxation. Product market regulation tends to be low on average in both of these “successful” country groups (high competition intensity). Additionally, incomes are much more evenly distributed in the second group than in the first.

A third group of countries displays a high degree of regulation paired with a low degree of active labor market policy measures; it is characterized by high employment protection and low competition intensity. This group includes the large Continental European countries with high unemployment – Germany, Italy, France and Spain.

These results indicate that there are different social organization forms¹⁹ of labor markets that foster high employment and low unemployment. This viewpoint helps to explain the good labor market performance of the Scandinavian countries and Austria, which has often puzzled economists.

7 Conclusion

Hardly an author denies that LMIs play a key role in explaining persistent unemployment.²⁰ The findings of the literature and the evaluation of the *Jobs Study* suggest that there are many different ways to tackle unemployment, but that the given choices are not arbitrary: There is good reason to suppose that the LMI combi-

nations prevailing in the large Continental European countries make it hard for them to decrease unemployment.

In a social market economy, new answers must be found from time to time to the question of which LMIs are best suited to fostering high employment and low unemployment in a rapidly changing society and economy and in a globalized economic environment. Some elements of a consensus on labor market policy appear to be emerging: Strong competition and marked economic change require a labor market that does not hamper reallocation dynamics. As Blanchard (2006) succinctly puts it, “*Protect workers, not jobs.*” The Danish flexicurity model described above readily meets this requirement.

But institutional arrangements should be judged not just on the strength of labor market performance. Other economic indicators, such as productivity and growth, are also crucial. U.S. performance on these indicators in recent years has outpaced the European average. Here, too, there is considerable heterogeneity among European countries. Whether various institutional combinations also lead to high productivity and high economic growth would merit research. After all, Economic and Monetary Union has placed new demands on labor markets to be flexible and adaptable, which is a fairly new situation in which labor market institutions need to prove themselves (Blau and Kahn, 1999; Bertola, 2000).

¹⁹ These organization forms reflect different legal traditions (Botero et al., 2004) and different preferences for security, income equality, state influence and public goods. Hence, a country’s choice of LMIs is also a political choice.

²⁰ See Blanchard (2006) for a discussion of other explanations. Some authors also point out, though, that countries frequently have similar LMIs but that labor market developments diverge sharply, Germany and the Netherlands being a case in point (Schettkat, 2003).

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