

The Myth of Labor Market Flexibility and the Costs of Bad Macroeconomic

Policy: U.S. and European Unemployment Explained

Abstract

This paper examines whether labor market inflexibility or bad macroeconomic policy have been responsible for Europe's high unemployment. The paper marshals evidence that shows the inflexibility evidence to be inconsistent, and also provides evidence strongly supporting the macroeconomic policy hypothesis. It then links the debate to the natural rate controversy by showing how natural rate thinking has led policy makers to mistakenly focus on labor market flexibility while also giving a deflationary tilt to macroeconomic policy.

JEL ref.: E6

Keywords: European unemployment, labor market flexibility, natural rate.

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Paper prepared for the "Modell USA" conference to be held at the John F. Kennedy -
Institut, Freie Universitat
Berlin, 19 - 20 November,
1998. Published as "The
Myth of

Labor Market Flexibility and the Costs of Bad Macroeconomic Policy: U.S. and European
Unemployment Explained," in S. Lang, M. Mayer, and C. Scherr (eds.), Jobswunder
U.S.A., Munster: Westfalisches Dampfboot, 1999

I Introduction

Over the last five years a great debate has emerged as to whether the traditional European social economy model is viable any longer. Europe, which has had a decade of high unemployment, is contrasted with the U.S where the unemployment rate has fallen to twenty five year lows. The claim is that this superior U.S. performance is attributable to the U.S. having flexible labor markets, whereas Europe has labor markets that are inflexible and sclerotic. The policy assertion is that Europe must abandon its long-standing social economy model which has given extensive social and economic protections to working people.

This characterization raises important questions regarding how successful the U.S. economy has been compared to Europe, and whether it is labor market flexibility or some other factor that is responsible for the differential employment performance. When the evidence is carefully assessed, it transpires that the U.S. has succeeded in some dimensions and failed in others, and the same holds for Europe. Moreover, macroeconomic policy rather than flexible labor markets is the principle explanatory factor behind the difference in unemployment rates.

II The U.S. and Europe compared

In an early contribution to the debate over the U.S. model, Bernstein and Mishel (1995) identified the key stylized facts distinguishing the U.S. from Europe. Over the last decade, the U.S. has enjoyed unambiguously faster job creation and a lower rate of unemployment than Europe. Average real hourly wages have stagnated in the U.S., and there has also been a significant increase in income inequality and poverty. In Europe, job creation has been

negligible and unemployment rates have been much higher. For the most part (the U.K. is an exception corresponding more closely to the U.S.), European income inequality has remained relatively unchanged and average real hourly wages have risen. Europe has also enjoyed relatively faster rates of productivity growth, as well as having much lower rates of poverty and a more equal income distribution.

These stylized facts reveal that the U.S. economy has performed well with regard to jobs and unemployment, but it has failed with regard to wages, income distribution, poverty, and productivity growth. Contrastingly, European economies have performed well with regard to wages, income distribution, poverty, and productivity growth, but have failed with regard to unemployment and job growth. The lesson is that neither the U.S. model nor the European model are right: rather, both have flaws and a new hybrid that takes the best of both is needed.

III The myth of labor market flexibility

The leading explanation of the U.S.'s better employment performance is that U.S. labor markets are flexible, whereas European labor markets are inflexible. This flexibility applies to both real wages and relative wages, and it also involves higher costs of firing workers.

In an important paper, Krueger and Pischke (1997) have examined the consistency of this explanation, and they find it comes up short. Echoing Bernstein and Mishel (1995), Krueger and Pischke find that the superior job creation of the U.S. is largely attributable to significantly faster population growth. With regard to Europe's higher unemployment rate, they reject the argument that it is attributable to a higher wage floor. If this were so, there

should have been a relative increase in unemployment amongst those at the bottom of the skill distribution, yet this has not happened. The argument that relative wage rigidity has prevented Europe from adjusting to a shift in demand away from unskilled to skilled workers is also rejected. If this were true, there should have been an increase in unemployment amongst unskilled workers, and a decrease in unemployment amongst skilled workers. However, unemployment amongst skilled workers has actually risen, while the proportion of skilled to unskilled unemployed workers has remained little changed. Finally, higher firing costs cannot explain European unemployment either theoretically or empirically. Instead of lowering employment, they serve to reduce the cyclical volatility of employment (Bentolila and Bertola, 1990).

There are other arguments that cast doubt on the labor market flexibility hypothesis. While the U.S. has enjoyed a lower rate of unemployment than Europe, it is also the case that the unemployment rate has been higher than it was in the 1950s and 1960s. However, the real value of the minimum wage has decreased, as has unemployment insurance coverage, and union density (Palley, 1998a). Each of these developments should have reduced labor market inflexibility and reduced the unemployment rate, yet it has still risen with regard to the past.

There has also been an increase in labor market flexibility in Europe. Thus, Blank (1997) notes that Germany, France, and Belgium weakened their dismissal laws: Spain and the Netherlands decentralized wage bargaining, while Italy eliminated automatic wage indexation. This should have reduced European unemployment yet unemployment did not

fall. Taken together, these arguments suggest that labor market flexibility is not the cause of the U.S.'s lower unemployment rate.

IV The costs of bad macroeconomic policy

An alternative to the labor market flexibility hypothesis is that high European unemployment is attributable to bad macroeconomic policy (Solow, 1994). When this is linked with differences in labor market flexibility, there emerges a coherent and comprehensive account of both unemployment performance and wage developments (Palley, 1998b).

The causes of the differences in unemployment and wage performance are shown in Figure 1. This figure contains a two-by-two matrix describing the policies pursued by the U.S. and Europe. These policies are described as "maintenance of the wage floor" and "expansionary macroeconomic policy". Box B corresponds to the mix of policies pursued within U.S economy, where the wage floor has been undermined (i.e. labor market flexibility has been pursued) but macroeconomic policy has been relatively expansionary. This policy combination has increased income inequality and lowered wages, but also lowered the unemployment rate: the former is attributable to undermining of the wage floor, while the latter is attributable to expansionary macroeconomic policy. Box C corresponds to the policy mix adopted by Europe, where the wage floor has been maintained but macroeconomic policy has been contractionary. The result has been unchanged income inequality accompanied by rising unemployment.

Less attention has been given to macroeconomic policy hypothesis, yet there is substantial evidence supporting it. Figure 2 provides a scatter plot of the average

unemployment rate and average real treasury bill interest rate in Canada, France, Germany, the U.K., and the U.S. over the period 1981 - 1996.¹ The figure shows a clear positive relation between the real interest rate and the unemployment rate.² The simple regression equation is given by:

$$(1) \text{ AVUNEMP} = 4.07 + 1.11\text{AVINT} \quad \text{Adj.R}^2 = 0.77$$

(3.17) (3.76)

Figures in parentheses are t-statistics. According to the regression, every 1 percent point increase in the real interest rate raises the unemployment rate by 1.11 percent points. The diagram and regression strongly suggest that tight monetary policy has raised Europe's unemployment rate, and those countries which have pursued tighter monetary policies have paid for it with higher unemployment rates.

Not only has the level of real interest rates contributed to high unemployment, but so too have decisions regarding the timing of changes in the direction of monetary policy. Whereas U.S. monetary policy has been broadly counter-cyclical (especially during the 1990s) with rates falling as unemployment has risen, French and German monetary policy have not been so. This is clearly visible in figures 3, 4, and 5.

Figure 3 shows U.S. real interest and unemployment rates. In the early 1980s the real interest rate was allowed to fall from the excessively high levels generated by the Volcker Fed's experiment with monetarism, and this decline helped lower unemployment. The Greenspan Fed mistakenly raised rates in 1988 and 1989, thereby contributing to the

¹. Data on the unemployment and inflation is taken from the OECD Economic Outlook, 62, December 1997. Data on treasury bill interest rates is drawn from the IMF International Financial Statistics Yearbook, December 1997.

². Ranking by unemployment rate, France was highest, followed by Canada, the U.K., Germany, and the U.S.

recession of 1990. However, it then dealt with the recession in an appropriate counter-cyclical fashion by cutting nominal rates such that the real rate fell to almost zero.

Figure 4 shows French real interest and unemployment rates. Beginning with the introduction of the Mitterand government's *franc fort* policy, which tied the franc to the Deutsche mark, French real interest rates systematically increased from 3% in 1983 to 8.5% in 1992. Not only did this represent a tightening of monetary policy, but it was also destabilizing. Thus, real rates increased despite unemployment rising from 8.3% in 1983 to 10.4% in 1992. Since 1992 real rates have come down, but as is shown below, this improvement in monetary policy has been offset by adverse developments in fiscal policy, and hence the continuing rise in unemployment rates.

Figure 5 shows German real interest and unemployment rates. Unemployment rose precipitously between 1981 and 1983 as a result of the high real rates engendered by the Bundesbank's monetarist stance. In 1983, despite unemployment of 7.9%, the Bundesbank again allowed real interest rates to increase and this contributed to entrenching high unemployment in the German economy. Between 1986 and 1988 the unemployment rate fell marginally from 8% to 7.6%, but the Bundesbank then engineered a further rise in real rates which peaked at almost 9% in 1990. Since then nominal rates have been cut such that real rates have been able to fall. However, whereas the U.S. Federal Reserve was willing to engage in vigorous counter cyclical monetary policy that pushed real rates close to zero, the Bundesbank has held real rates steady at around 2.5%. This in conjunction with adverse fiscal developments and unemployment resulting from unification with East Germany, has resulted in a continuing sharp rise in Germany's unemployment rate.

Tight monetary policy constitutes one part of the macroeconomic policy explanation of European unemployment: inappropriate fiscal policy constitutes another. In this regard, European fiscal policy has been conducted in a destabilizing pro-cyclical fashion as is evidenced by the relationship between the budget deficit and unemployment. Figure 6 shows the U.S. budget deficit and unemployment rate. Apart from a brief hiatus in 1984 - 1986, the budget deficit has moved counter-cyclically in a stabilizing fashion. The one exception was between 1984 and 1986 when the Reagan tax cuts and increase in military spending kicked in when the economy had already begun to recover from the recession of 1981-82.

Figure 7 shows the French budget deficit and unemployment rate. Though there are periods when the deficit has moved counter-cyclically, there are also two critical periods when it has moved pro-cyclically. First, between 1983 and 1988 the deficit decreased even as unemployment was increasing. This corresponds to the period when the Mitterrand government abandoned its full employment policy and shifted to a policy of *franc fort*, an element of which was fiscal austerity designed to build currency market confidence in the franc. Second, since 1993 the budget deficit has again been falling despite rising unemployment. This corresponds to the period of implementation of the Maastricht Treaty which required that governments reduce their deficits below 3% of GDP in order to qualify for membership in the euro. The bulk of the increase in the French unemployment rate took place during these two periods of destabilizing pro-cyclical fiscal policy.

Figure 8 shows the relationship between the German budget deficit and unemployment rate. From 1981 to 1985 fiscal policy was destabilizing, with the deficit falling despite

unemployment moving from 4.5% to 8%. From 1991 to 1996 fiscal policy again tended to be destabilizing, with the deficit having a slight tendency to fall even as unemployment was rising from 6.7% to 10.3%. As with France, fiscal outcomes in this latter period reflect the impact of the Maastricht Treaty requirements.

This comparison of U.S., French and German macroeconomic policy clearly reveals how bad macroeconomic policy has contributed to higher European unemployment. The U.S. enjoyed expansionary fiscal policy in the 1980s, and fiscal policy has also been conducted in a counter-cyclical stabilizing fashion. Side-by-side, monetary policy has also been run in counter-cyclical fashion, and in the recession of 1990-91 the Fed pushed real rates to zero. Contrastingly, both French fiscal and monetary policy have been pathological, reflecting the combined effects of the franc fort policy and the Maastricht Treaty requirements. In Germany, policy has also been pathological. Here, the Bundesbank's enamored with monetarism and the theory of the natural rate of unemployment has been important, and this has kept real interest rates high and insufficiently responsive to cyclical conditions. At the same time, the Maastricht Treaty requirements have contributed to fiscal policy being deflationary and destabilizing.

Not only may European discretionary fiscal policy have been destabilizing, it is also possible that Europe suffers from a public finance system that is deflationary in design. In particular, European governments have tended to rely significantly on value added taxes (VAT) to raise revenue. It is well known that such taxes are regressive, and to the extent that lower income households have an higher marginal propensity to consume, the VAT system has tended to reduce aggregate demand. A second problem is that the VAT system

may have shifted the burden of taxes on to households, thereby further lowering demand. In an important paper Besley and Rosen (1998) find that sales taxes are shifted in ways counter to competitive theory. They find that taxes on some commodities are over-shifted: that is, an increase in tax revenue of one dollar per unit increases the price by more than one dollar. This suggests that Europe's tax system may be even more deflationary and distortionary, which argues for a move away from VAT towards direct income taxation.

Finally, Germany, has also had to contend with the additional special factor of German unification which has greatly increased unemployment since much of East German industry was obsolescent and unprofitable. Unification increased Germany's population by approximately 25%, and is analogous to the U.S. absorbing Mexico. Were this to have happened, the U.S. unemployment rates would also undoubtedly have increased.

V Restoring European prosperity: the case for a new policy regime

The above analysis shows that Europe's unemployment problem is not due to labor market rigidity, just as the U.S.'s employment success is not due to labor market flexibility. Instead, Europe's problem is the result of pathological macroeconomic policy, while the U.S.'s success is the result of better macroeconomic policy.

The policy implications are clear. First and foremost, the European social economy model remains intrinsically viable, but it can only work if accompanied by pro-growth full employment macroeconomic policies. Second, far from contributing to prosperity, U.S. style labor market flexibility actually promotes wage stagnation and income inequality, and it yields nothing in the way of superior job market performance.

In terms of figure 1, the needed policy mix is one that corresponds to box A, with its combination of maintained wage floor/expansionary macroeconomic policy. Unfortunately, much policy advice emanating from the OECD and the IMF is the exact opposite, and encourages governments to adopt the policy mix in box D with its combination of undermined wage floor/contractionary macroeconomic policy. In Europe, there is a push to lower the wage floor and reduce worker protections under the guise of creating greater labor market flexibility. This is the policy that the OECD has endorsed in its jobs strategy (OECD, 1997, see Chapter III). Meanwhile, the Maastricht Treaty accord requires governments to keep their budget deficits below 3% of GDP regardless of cyclical circumstance, or face very large fines. Simultaneously, the U.S. is headed for tighter fiscal policy owing to its budget surplus, while the Fed has contributed to high real interest rates by maintaining high nominal rates despite a fall in the rate of inflation.

The push toward box D is the result of both an adverse structure of incentives that exists in today's globalizing economic environment, and bad policy advice resulting from adherence to the mistaken economics of the theory of the natural rate of unemployment.

With regard to the structure of incentives, increased competition in international trade exerts a persistent pressure to improve competitiveness, and this has encouraged countries to implement policies that lower the social wage. At the same time, greater economic integration means that economies are becoming more open, and characterized by greater import demand leakages. This means that domestic macroeconomic policy has become less capable of stimulating domestic employment, since a greater proportion of any domestic demand stimulus now leaks abroad as imports. Consequently, countries that try

to expand domestic demand are left burdened with both trade and fiscal deficits. This is principal the lesson of the failed Mitterand government economic experiment in the early 1980s, and it explains why European governments have been unwilling to adopt sufficiently expansionary policies. Finally, increased exposure to imported inflation combined with increased international capital mobility have given monetary authorities an incentive to curry favor with foreign exchange markets by raising rates fractionally above the average. However, when all try to do this, the result is merely to push up the general level of interest rates.

In effect, national policy makers are caught in a prisoner's dilemma such as is illustrated in figure 9. Country's that seek to expand are punished by foreign exchange markets and run into balance of payments problems. Policy makers therefore have a private incentive to adopt contractionary policies, and in the absence of international policy co-ordination, this leads to a sub-optimal equilibrium described by box D. The only way out of this is if countries pursue coordinated expansionary policies, in which case the adverse structure of private incentives is circumvented by agreement and box A becomes a sustainable equilibrium.

The introduction of the euro offers a potential way out of this foreign exchange market trap, though the euro also brings dangers of its own.³ However, what is clear that the Euro will not succeed in lowering unemployment if the new European Central bank persists with the misguided monetary policy of the Bundesbank. It will also fail to lower unemployment

³. These include the possibility that Europe's economies fail to converge to a common business cycle, in which case monetary policy will have to confront recession in some countries combined with boom in others. A second danger is that countries continue to have different inflation processes owing to different institutional arrangements in product and labor markets, and different sensitivities to international trade.

if governments persist with the pathological fiscal policies evidenced in France and Germany. These considerations reveal how critical macroeconomic policy is to the future prosperity of Europe. Unfortunately, there are also indications that Europe will not get it right. The principle mandate of the European central bank appears to be price stability, while the Maastricht Treaty obliges governments to run deficits of less than 3% of GDP independent of cyclical circumstance or face massive punitive fines.

A second impediment to getting the policy mix right has been adherence to the theory of the natural rate of unemployment. This has influenced policy in two critical dimensions (Palley, 1998c). First, it has shifted the focus of policy makers away from macroeconomic demand management towards the microeconomics of labor market flexibility. Second, it has given a contractionary bias toward macroeconomic policy that has resulted in self-fulfilling high rates of unemployment.

Natural rate theory maintains that macroeconomic demand management policy cannot impact the equilibrium rate unemployment, which instead is determined by the institutions and microeconomic policies impacting transacting in labor markets. As a result, policy makers have been encouraged to give up on demand management to reduce unemployment, and have instead been encouraged to adopt policies promoting labor market flexibility.

Side-by-side, natural rate theory maintains that if policy makers try and push unemployment below the natural rate, the only result will be accelerating inflation. This has encouraged monetary authorities to start raising rates as the economy has approached their point estimate of the natural rate. In effect, this has created a structural unemployment policy trap whereby high unemployment becomes self-fulfilling because policy makers

raise rates before the unemployment rate has fallen and before there is any evidence as to whether inflation really does accelerate.

The OECD has firmly bought into the theory of the natural rate, and in particular as it applies to encouraging labor market flexibility. However, the above evidence shows that labor market flexibility founded on stripping workers of social and employment protections does not promote low unemployment, and instead causes wage stagnation, increased economic insecurity, and increased income inequality. The notion that an excessively high marginal cost of labor is the cause of the European unemployment problem cannot be supported. Rather, the problem is explained by misguided contractionary and destabilizing macroeconomic policy.

Finally, to the problem of the natural rate must be added the problem of the saving shortage hypothesis. There is a widespread belief amongst finance ministries and amongst economists at the OECD and IMF that saving causes investment. This in turn has promoted a view that investment is low because there is insufficient saving, and this calls for a policy of raising national saving. Applied to fiscal policy, it implies that governments should reduce government deficits as they constitute negative national saving. This partly explains Europe's pathological fiscal policies over the last decade, and it also explained why policy makers are mistakenly heading for the policy combination described by box D in figure 1. However, the empirical evidence (Palley, 1997) suggests that it is investment that causes saving, and there is a real danger that policy is now headed in a direction that will have both the U.S. and Europe saving themselves out of prosperity.

VI Conclusion

The last decade has been a lost decade for much of Western Europe, with European economies being wracked by needlessly high unemployment. Some European policy makers are now threatening to compound this damage by undoing Europe's system of social and economic protections in the name of labor market flexibility.

Europe's unemployment problem is not attributable to lack of U.S. style labor market flexibility. Such flexibility does nothing to create jobs and merely creates economic insecurity and a worsened income distribution. Instead, what is needed are macroeconomic policies that restore Europe's earlier expansionary pro-growth full employment environment.

There is a widely used aphorism to the effect that "Seeing is believing". However, in the realm of economic policy that aphorism might be better stated as "Believing is seeing". Nowhere is this more true than with regard to the debate over the causes of Europe's high unemployment rate. Despite the evidence against the labor market flexibility hypothesis and the evidence for the bad macroeconomic policy hypothesis, believers in the theory of natural rate of unemployment continue to argue that Europe's high unemployment is attributable to sclerotic inflexible labor market practices that have raised the natural rate. As long as such thinking dominates policy makers' mind sets, Europe will remain caught in a structural unemployment policy trap whereby bad macroeconomic policy makes for self-fulfilling high unemployment. Moreover, if this mind set results in the adoption of flexible labor market policies that strip workers of social and employment protections, there is a danger that Europe will experience a U.S. style leap in wage inequality.

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		COUNTRY A	
		Expand	Contract
COUNTRY B	Expand	A. Coordinated Policy	B.
	Contract	C.	D. Uncoordinated Policy

Figure 9 Policy and the prisoner's dilemma. Source: Palley (1998b).

		WAGE FLOOR MAINTAINED	
		yes	No
EXPANSIONARY MACRO POLICY	yes	A.	B. U.S.
	No	C. Europe	D.

Figure 1 Taxonomy of policy configurations. Source: Palley (1998b).

Figure 2 Five country (Canada, France, Germany, U.K., U.S.) average unemployment and real interest rates, 1981 - 1996.

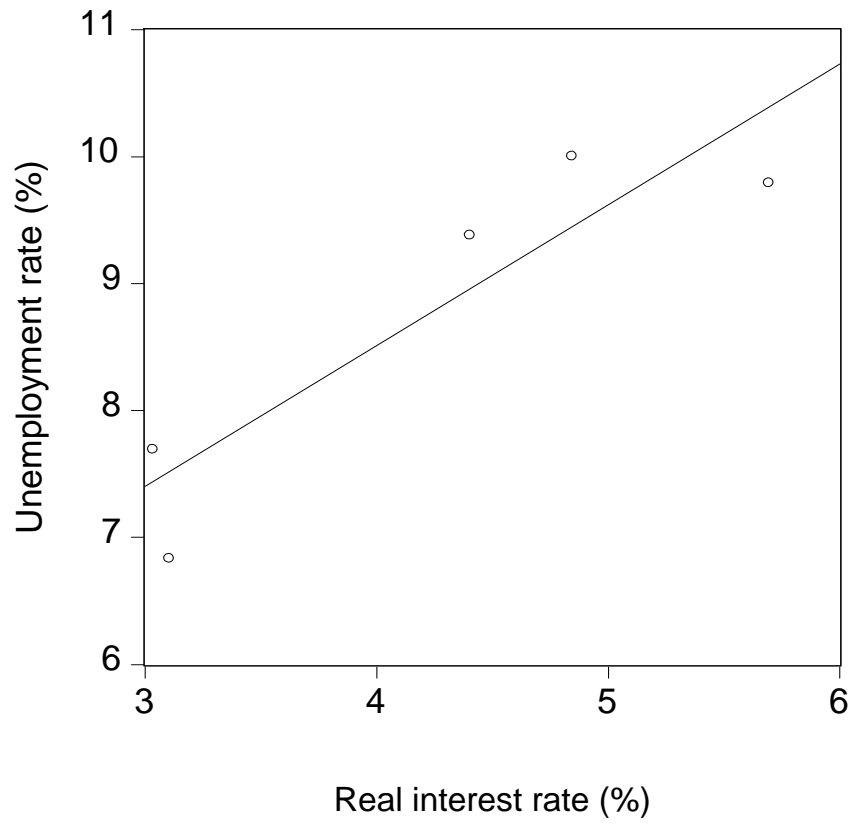


Figure 3 U.S real interest rate and unemployment rate

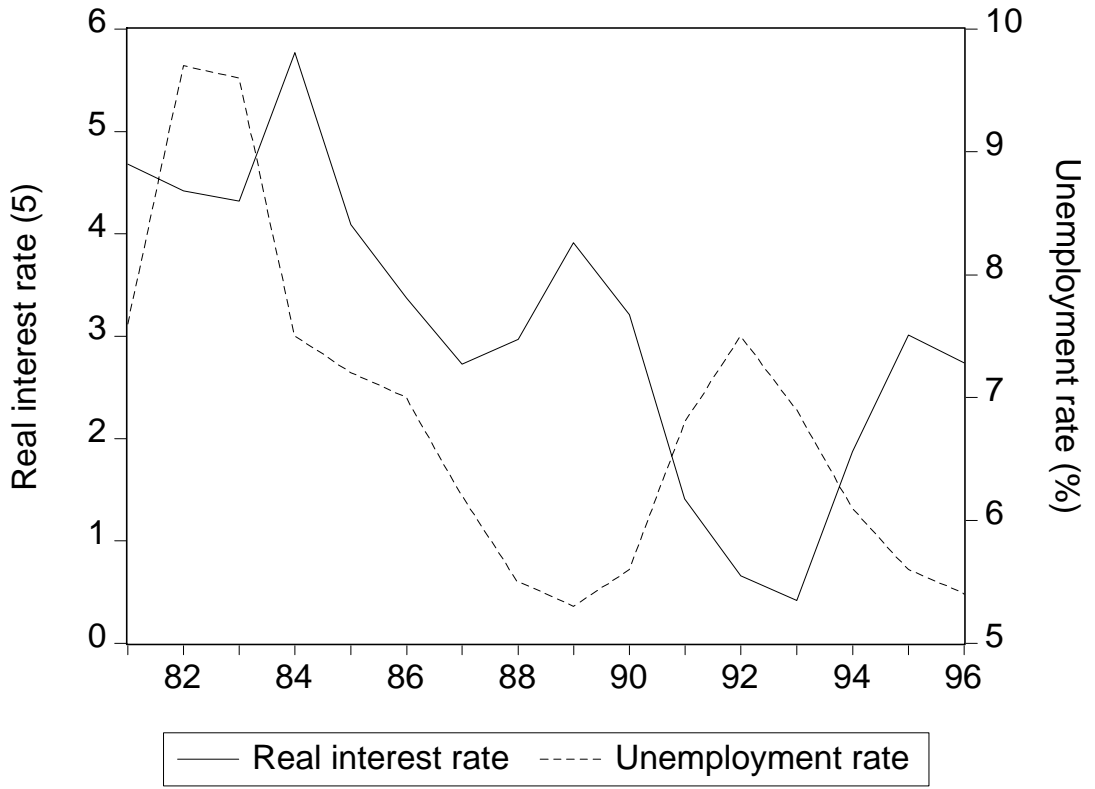


Figure 4 French real interest rate and unemployment rate

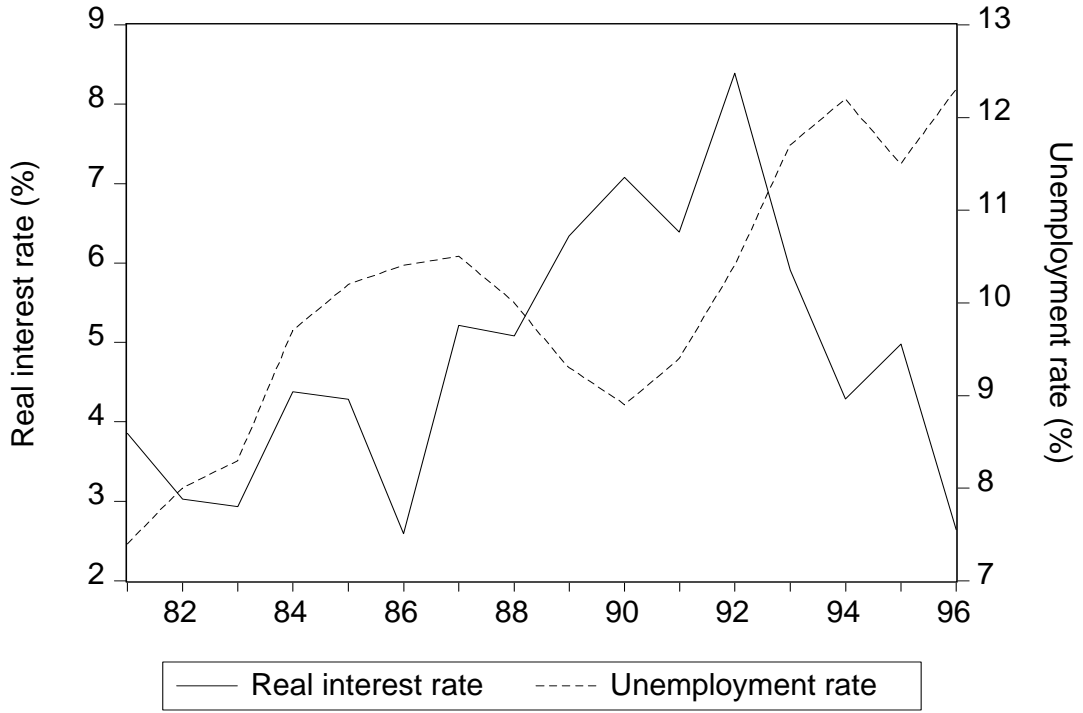


Figure 5 German real interest rate and unemployment rate

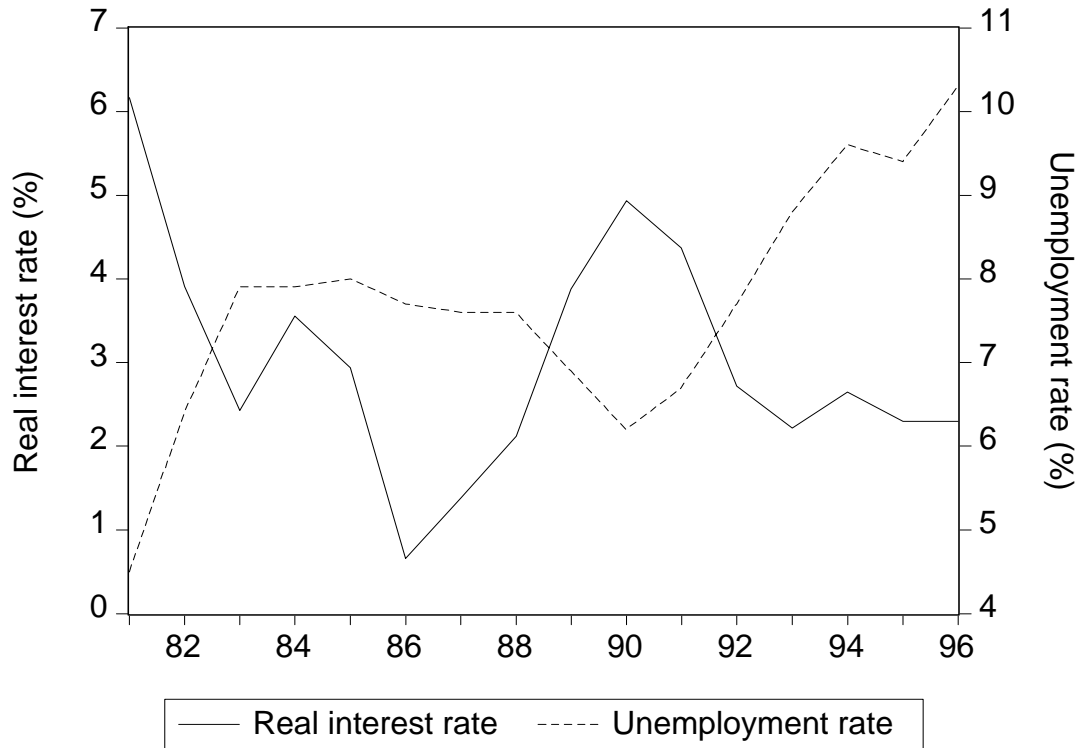


Figure 6 U.S. budget deficit and unemployment rate

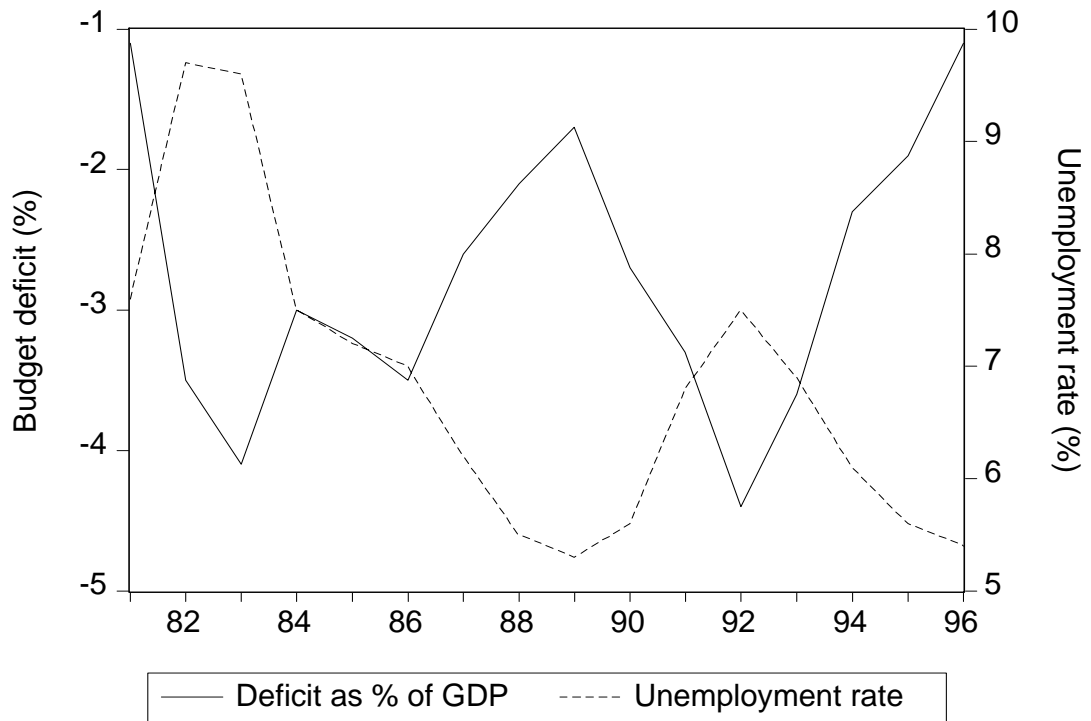


Figure 7 French budget deficit and unemployment rate

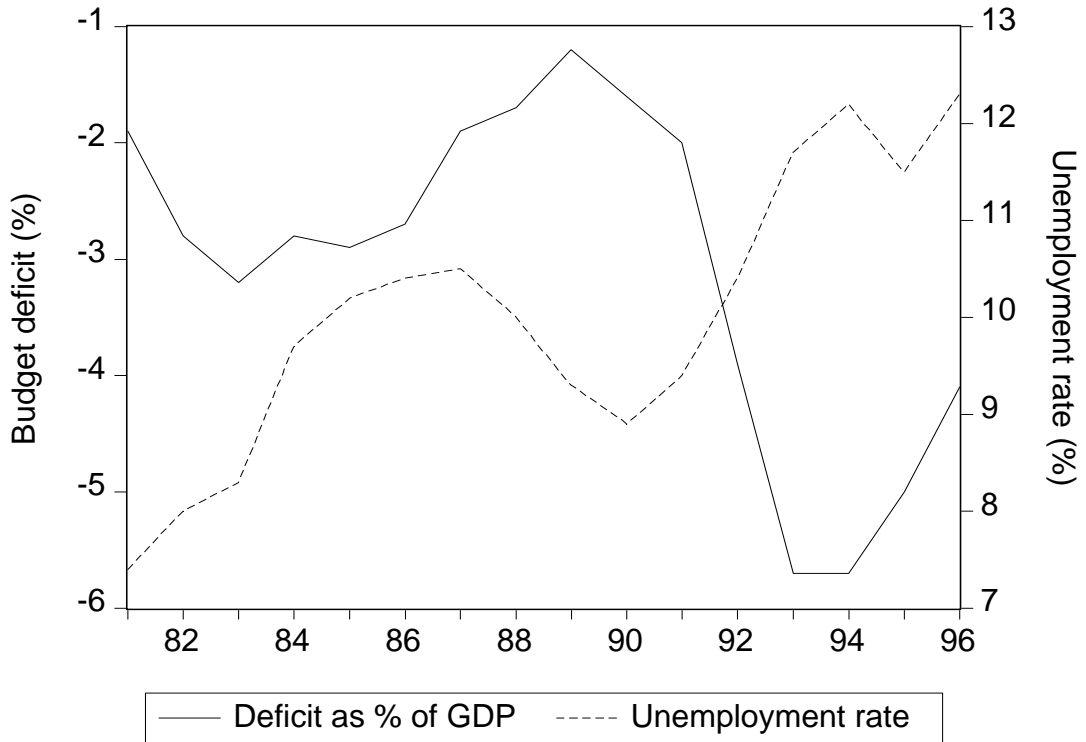


Figure 8 German budget deficit and unemployment rate

