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Abstract

The aim of this paper is to analyse the consequences of some structural reforms on the institutional coherence of OECD countries, particularly Continental Europe, and on their economic performance, particularly employment.Because institutions in developed political economies are interrelated through a complex network of complementarities, institutional change has consequences beyond the area concerned by a reform. This also implies that there are complementarity effects in reforms themselves. A challenge of reform programs is therefore to achieve a new type of complementarities between reformed institutions. The paper presents empirical evidence questioning the compatibility of the ongoing structural reforms in product and labour markets with the existing institutional structures in some OECD countries. The coherence of the flexicurity strategy, i.e. a combination of labour market flexibility and generous welfare state, is also questioned, both from economic efficiency and political economy points of view.

Keywords: structural reforms, models of capitalism, flexicurity

JEL codes: P16, B52, J64

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1 Introduction

The received wisdom about the current situation of Continental Europe is that structural reforms are needed to boost economic performance, especially with respect to employment and growth. According to a commonly-found diagnosis (e.g. Sapir, 2004), European institutions would be at odds with the requirements of contemporary capitalism. They may once have been adapted to the post World War II catch-up period but allegedly have become a hindrance in a context of globalisation and more intense innovation-based competition. The new techno-economic paradigm would make it impossible for an economic model that lacks flexibility and adaptability to be competitive. It would therefore be impossible to maintain the institutional framework adapted to a growth trajectory based on a stable economic environment: 'too rigid' labour markets, 'excessively' regulated product markets, restrained financial markets, etc. In order to adapt European economies to the new times, a considerable effort should be made in terms of structural reforms (OECD, 2005).

Since unemployment is at the centre of the economic debate, labour market institutions have been considered the key area for reforms (Siebert, 1997). Employment protection is held to prevent several categories of the population from accessing employment: women, low-skilled, young or senior workers. It would protect unfairly those already employed – the insiders– to the detriment of those excluded from the labour market – the outsiders. Taxation, redistribution mechanisms and labour unions' influence would lead to salary scale limitations. This would have the twin effect of making the least productive workers unemployable while being a disincentive to the most qualified ones, those whose investment in human capital should be at the root of the knowledge-based growth trajectory. The insufficient flexibility of the labour market would hinder the structural change that is necessary to a transition to an innovation-based economy (Saint-Paul, 2000). It would weaken companies and discourage them from hiring, and thus from producing.

The implementation of labour market flexibilisation measures has met two types of difficulty. First, the empirical evidence in favour of positive employment effects of labour market deregulation has been less than fully convincing (Baker et al., 2005; Freeman, 2005). Second, reforms' effects may involve a J-curve aspect, i.e. benefits would appear at best in the long run but short term effects would be negative. This aspect would involve political economy problems for reforms. For these and second-best theory-related reasons, the argument has shifted in favour of the implementation of joint reforms, i.e. in several institutional areas instead of one (Braga de Macedo and Oliveira-Martins, 2006). The existence of complementarities across institutions would imply a complementarity in policy reforms. Partial reform would be detrimental to the global economic performance whereas joint reforms would permit to exploit complementarities.

Product markets are supposed to have strong complementarities with labour market reforms (Nickell, 1999), but more generally, taking into account that "*a liberal*

reform package has to be comprehensive by nature" (Braga de Macedo and Oliveira-Martins, 2006, p.4), many other institutional areas are concerned: financial systems, education systems, macroeconomic policy... To a large extent, this view has become dominant in European policy-making circles. The so-called Lisbon strategy epitomises this effort to transform the socio-economic model of Europe in order to make it "the most competitive knowledge-based economy". Given the long list of areas where structural reforms should be implemented, it appears that this is not a mere dusting of the characteristic institutions of the model but a radical change.

The difficulties in achieving the objectives of the Lisbon Agenda are related to the difficulties of transforming the European models of capitalism into a model mostly based on the prominence of market mechanisms. Many comparative political economy contributions have analysed the diversity of capitalism in developed countries and within Europe in particular (Amable, 2003). There is no single European variety of capitalism but several distinct models characterised by specific institutions and, of course, specific patterns of interdependence between these institutions. The differentiation of models within Europe should make the pursuit of a general liberal strategy more difficult. And even a coordinated liberal reform wave may affect differently the coherence of the concerned economies.

A recent literature has focused on the positive consequences that joint deregulation policies could have for employment, particularly labour and product markets (Nickell, 1999). Another literature has argued that the combination of labour market flexibility and welfare state-based security could be a solution to Continental Europe's employment problems (OECD, 2006). All these solutions are based on the alleged positive effects of liberalisation policies. The aim of this paper is to make a tentative assessment of the impact of some liberal reforms on the economic performance of affected countries, and in particular with respect to the employment effects. The paper is organised as follows. The following section presents the diversity of models of capitalism in Europe and the OECD. Section 3 gives an overview of the consequences of structural reforms for the coherence of the European model(s) of capitalism. Section 4 assesses the likely complementarity of some structural reforms and their effects on employment performance. Section 5 gives a critical look at the flexicurity strategy. A last section proposes a brief conclusion.

2 Diversity of capitalism and European models

The main idea behind every theory of the diversity of capitalism is that different socioeconomic models are neither near-identical versions of fundamentally the same 'market economy' nor random collections of economic institutions. Furthermore, it would be wrong to assume that in order to achieve the best economic performance, it would suffice to take the 'best' institutional forms in every area (labour markets, financial systems, education and training...) and combine them. The concept of institutional complementarity was first formulated by Aoki [1994], following an idea

found in Milgrom and Roberts [1992] about organisational complementarity within a firm. From an institutional complementarity point of view, combining the supposedly most efficient institutions would not produce the optimal institutional design for growth and welfare, but merely be impossible. Institutions' influence on the economy should not be considered independently from one another; they exert a joint influence on agents' strategies and therefore on the economy. Institutions affecting one area of the economy (e.g. the labour market) will have consequences beyond that particular area. In the case of wage bargaining, for instance, the outcome depends on each party's outside options. These outside options are in turn dependent on the institutions affecting other areas than the labour market. It can be the alternative job for the worker, which may depend on its skill level and hence on the institutions concerning the education and training system; the alternative option for the firm may depend on its relocation possibilities, i.e. on the regulatory environment, the liquidity of the financial market... What is to be considered is therefore how institutional forms in different areas complement each other. The existence of institutional complementarities explains how differentiated varieties of capitalism may exist, based on different complementarities between institutional forms.

In a seminal contribution, Michel Albert (1991) distinguished two types of socioeconomic models: the so-called 'Rhine' model of capitalism and the 'neo-American' model. The former characterises of course Germany, but also other European and even non-European countries such as Japan, and is characterised by long-term commitments, collective achievements and consensus. The neo-American model represents mostly Anglophone economies such as the US and, within Europe, the UK, and is defined by an emphasis on individual achievement, the importance of short-term financial benefits, or reversibility and flexibility of commitment. Albert (1991) considers that the Rhine model is 'superior' to the neo-American model and better suited to European societies. Nevertheless, free competition among varieties of capitalism should not be expected to favour the emergence of superior forms of organisation and eliminate inferior ones. The emergence and stability of a specific model depend on political action.

The opposition between a German-type and an Anglophone model of capitalism has become a classic feature of the comparative political economy of capitalism, particularly in Hall and Soskice (2001). In their 'firm-based' approach, Hall and Soskice consider several spheres in which firms develop relationships to resolve coordination problems central to their core competencies: industrial relations, vocational training and education, corporate governance, interfirm relations and the coordination problems firms have with their own employees, i.e. 'internal' coordination. Different institutional environments will lead firms to develop differentiated patterns of coordination and firms' competitiveness will depend on the quality of these coordination modes. Instead of one 'optimal' institutional model, the VoC approach proposes two models, the coordinated market economies (CMEs) and the liberal market economies (LMEs), with each having its own comparative institutional advantage.

Therefore, whereas mainstream economics' approach would predict that globalisation, by strengthening the competitive pressure on firms, would lead to convergence towards the unique optimal model of capitalism, the VoC approach contends that because of their respective comparative institutional advantage, CMEs and LMEs will respond differently to globalisation. A process of bifurcated convergence is expected: countries roughly classified as CMEs should become even more coordinated while the competitive market coordination should become more compelling in LMEs. Globalisation should therefore intensify the existing differences between CMEs and LMEs.

Hall and Soskice's binary classification of economies between LMEs and CMEs leaves a certain number of national cases occupying ambiguous positions since they do not clearly rest on market-based coordination principles nor possess strong and organised interest groups upon which non market coordination could be based. France and Italy are examples of such intermediate countries. Not being clearly identified as belonging to any 'pure' type, they are lumped along a few other 'Latin' countries in the ad-hoc category of 'Mixed Market Economies' (MMEs). MMEs are expected to degenerate since they are conceived as less efficient than pure types such as LMEs and CMEs.

A typology of the different types of capitalism, based on a binary opposition between LMEs and CMEs is much too narrow for analysing the existing diversity of capitalism. Amable (2003) has proposed a theoretical and empirical analysis of the diversity of capitalism, which leads to the distinction of not two, but five types: neo-liberal or market-based capitalism, continental European capitalism, social-democratic capitalism, "Mediterranean" capitalism, and Asian capitalism. The institutions of these types of capitalism differ in the areas of product market competition, labour market and labour relations, social security, education systems, and financial systems. The institutional complementarities associated with these particular kinds of institutions are also specific; they define distinctive types of capitalism.

Product market competition is an important element of the market-based model. Intense product market competition makes firms more sensitive to adverse demand or supply shocks. When price adjustments cannot fully absorb shocks, quantity adjustments matter, particularly concerning the labour force. Therefore, product market competition leads to a *de facto* flexibility of employment. Competitive market pressure demands that firms react quickly to changing market conditions and modify their business strategies. This is made possible by quickly reacting financial markets, which favour a fast restructuring, itself facilitated by flexible labour markets. This economic model favours fast adjustment and structural change and therefore entails a high degree of risk for specific investments. Risk-diversification for financial investments is guaranteed by sophisticated financial markets, but specific investments are particularly at risk in this model since social protection is underdeveloped. Therefore there is little incentive to invest in specific skills since these skills would not be protected either by the welfare state or by job security and a rapid structural

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change would devalue them. Competition extends to the education system. A non homogenised secondary education system makes competition among universities for attracting the best students and among students for entering the best universities more crucial.

The social democratic model is organised according to very different complementarities. A strong external competitive pressure requires some flexibility of the labour force. But flexibility is not simply achieved through layoffs and market adjustments; retraining of a highly-skilled workforce plays a crucial role in the adaptability of workers. Protection of specific investments of employees is realised through a mix of moderate employment protection, a high level of social protection, and an easy access to retraining thanks to active labour market policies. A coordinated wage bargaining system enables a solidaristic wage setting which favours innovation and productivity. A centralised financial system enables firms to develop long-term strategies.

The Continental European model possesses some features in common with the social democratic model. The latter combines a high degree of social protection with a moderate employment protection, the former is based on a higher degree of employment protection and a less developed welfare state. Here again, a centralised financial system facilitates long-term strategies and does not compel firms to respect short term profit constraints. Wage bargaining is coordinated and a solidaristic wage policy is developed, but not to the same extent as in the social democratic model. Retraining of the work force is not possible to the same extent as in the social democratic model, which limits the possibilities for an 'offensive' flexibility of the workforce and fast restructuring of industries. Productivity gains are obtained by labour-shedding strategies elaborated in complementarity with social protection, as with the early-retirement policy.

The South European or Mediterranean model of capitalism is based on more employment protection and less social protection than the Continental European model. Employment protection is made possible by a relatively low level of product market competition and the absence of short term profit constraints due to the centralisation of the financial system. However, a workforce with limited skills and education level does not allow for the implementation of a high wages and high skills industrial strategy. Increased product market competition may pressure for an increase in the flexibility of the labour market, for instance by a marked dualism of the workforce. Employees of large firm would still benefit from job security while young workers or employees of small firms would have more flexible labour contracts.

The Asian model of capitalism hinges upon the business strategies of the large corporations in collaboration with the state and a centralised financial system, which enables the development of long term strategies. Workers' specific investments are protected by a de facto rather than de jure protection of employment and possibilities of retraining within the corporation. Lack of social protection and sophisticated financial markets make risk diversification difficult and render the stability provided by the large corporation crucial to the solidity of the model.

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The above models being ideal-types, no single developed economy is accurately described by any of the five models of capitalism. Countries possess characteristics which make them close to one or the other model, without being fully identifiable with the model itself. For instance, a strict market-based economy organised following the institutional complementarities of the neoliberal model will probably never exist. It is nevertheless useful to keep the reference of these ideal-types in order to understand the institutional mechanisms upon which the coherence of the various developed economies is based. Moreover, the models of capitalism allow to go beyond the apparent dissimilarities between two economies and to identify their common structural traits.

3 Structural reforms and the coherence of institutions

Most models have experienced institutional transformations in the last decade, particularly the European models (Amable, 2003, ch. 6). From an institutional complementarity point of view, institutional reforms question the coherence of the whole model, and local institutional change most probably implies some transformation of institutions in other areas. If macroeconomic performance depends on the degree of institutional coherence (Hall and Gingerich, 2004), structural reforms are bound to deteriorate the situation in terms of unemployment or growth before possibly leading to an improvement. The existence of a J-curve effect is indeed a classic argument in the political economy of structural reforms.

Reforms recommended by the OECD,[1] the European Commission or by various expert reports (e.g. the Sapir report) aim at transforming quite substantially the labour markets and social protection systems of the Continental, Mediterranean and even social-democratic models of capitalism. One may for instance take the recommendations made in the 2008 issue of the OECD publication "Economic Policy Reforms: Going for growth". Employment protection legislation (EPL) should have its costs diminished, presumably by diminishing the level of protection itself, in the following countries: the Czech Republic, France, Greece, Japan (for regular employment), Portugal, Spain (for permanent workers) and Sweden. This list of countries concerns economies that one could associate with four distinct models of capitalism. Furthermore, social protection should be reformed, meaning that it should become less generous in Denmark (disability benefit schemes), Finland (Unemployment benefits), Hungary (disability), the Netherlands (disability), Norway (sickness and disability, pensions), Spain (pensions), Sweden (sickness and disability benefits), the United Kingdom (disability-related benefit recipients), and the US (health care costs, disability benefits). Following these recommendations would make the Conti-

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[1]It must be noted that different divisions within the OECD make different recommendations in terms of structural reforms.

nental, Mediterranean and social-democratic varieties of capitalism resembling more the market-based variety, with flexible labour markets and a less generous welfare state. The urge to go further in the direction of the market-based variety of capitalism is also found in the recommendations concerning product markets. The general advice is to increase competition in product markets, and particularly in service sectors, network industries and agriculture, in most countries. This general recommendation would have of course more important consequences for countries whose production model depends more on regulated industries than market-based economies.

More generally, there is a certain coherence in structural reforms since they, for the most part, go in the market-based direction, but the implementation of such reforms in non-market based economies implies a loss of coherence in these economies. Reforms in a few institutional areas cannot lead to functionally coherent system because of the interdependence between institutions and their consequences on agents' strategies.

For instance, financial deregulation has threatened the stability of the bank-industry relationship, a crucial element of the 'Rhine model' of capitalism (Krahnen and Schmidt, 2004), or more generally for the Continental European socioeconomic model. Firms had the possibility, with the help of what has sometimes been called 'patient capital', to devise and implement long-term industrial strategies, free from the short-term pressure of financial markets. Within the firm, agents have the possibility to invest in specific assets and the firm may offer its employees a certain degree of employment stability. The questioning of this patient financing and governance pattern and the emergence of a more short-termist financing relationship, focussing on liquidity, should threaten these arrangements and push the firm toward new types of investment, to industrial restructuring, and should diminish the possibility to offer a stable employment relationship.

Increasing product market competition could also favour labour market flexibilisation. Such a complementarity is now widely acknowledged. Increasing product market competition is expected to shift out the labour demand curve and raise the benefits brought by labour market deregulation, making the latter more politically acceptable and more economically viable. This is why both recommendations for deregulation are presented as complementary. This complementarity is held to influence positively the level of employment, which is not certain if the increase in product market competition makes firms' labour demand more sensitive to the business cycle, thereby raising employment insecurity for workers, and if labour markets possess characteristics that make workers lower their work effort when job insecurity is increased and the real wage stays constant. Maintaining a competitive level of effort will thus imply a raise in real wages which will *ceteris paribus* lower labour demand (Amable and Gatti, 2004). In this perspective, the complementarity issue is different from the most common argument (Amable and Gatti, 2006). More varied complementarities are possible, not just an all-out market deregulation. One may envisage an increase in product market competition being complementary (from the point of view of employment) with an increase in employment protection. The latter would

offset the wage increase effect of the former and permit employment growth.

Other complementarities could also be troublesome. Increased job insecurity following the decrease in employment protection legislation (EPL) could raise the demand for social protection. The combination of a decrease in job security following the increase in product market competition and a dismantling of legal employment protection is likely to increase the level of 'social insecurity'. This should provoke an increase in the demand for social protection at the time when current reforms are mostly welfare state retrenchment. This is a clear inconsistency in 'reformed' European models, an inconsistency which could only be eliminated by going further down the liberalisation road. In a market-based system, it would be up to individuals to turn to private insurance schemes. The development of insurance activities would be facilitated by the development of market-based finance.

The Lisbon agenda also goes in the direction of a market-based transformation of the European socioeconomic models. The set of 24 guidelines adopted by the Council in 2005 are the main instruments for giving a new impetus to the Lisbon agenda. This package gathers both the Broad Economic Policy Guidelines (BEPGS) and the Employment guidelines. It defines a more or less constraining framework for all EU governments, which are supposed to elaborate National Action Plans aiming at fulfilling the requirements of the Lisbon Agenda.

Guideline No.1 insists on the elimination of 'excessive deficits' and the necessity of structural reforms. A way to curb 'excessive deficits' may very well be to cut down two important elements of the European model: public expenditure (such as social expenditure) and public investment in infrastructure, particularly in a context of tax competition. Guideline No.2. deals with Government debt reduction. The aim is to reduce public spending and the public expenditure share. According to Guideline No.3, redirection of public expenditure should be done, presumably away from 'unproductive' social expenditures. Guideline No.6 deals with coordination of economic and budgetary policies: 'press forward with structural reforms that will increase euro area long-term potential growth and will improve its productivity, competitiveness and economic adjustment to asymmetric shocks, paying particular attention to employment policies'. This means strong reduction in employment protection and product market deregulation, i.e. a move towards the market-based model.

Competition is expected to deliver the proper framework for the pursuit of the Lisbon objective. Several Guidelines (e.g. No.12 & No.13) insist on liberalisation of product and service markets and a diminishing of the Public sector and more generally on 'the promotion of external openness'. Market openness may act as a (credible) threat against trade unions; increased possibilities of relocation or outsourcing will lead unions to accept cutbacks in employment protection levels, wages or working conditions and undermine collective bargaining and interest representation. This is a potential threat for redistributive policies through the wage-setting process.

A 'flexicurity' objective is mentioned in Guideline No.21: Promote flexibility combined with employment security. The latter should not be understood as employ-

ment protection but as the possibility for fired workers to find another job, which refers to the creation of 'liquid' labour markets, with no barriers between 'outsiders' and 'insiders'.

One may sum up the expected complementarities (and lack thereof) associated with ongoing structural reforms as in Table 1. Without being too functionalist, the impression is that such a large set of 'inconsistencies' is bound to affect macroeconomic performance, without mention of the political economy aspects.

	Labour market	product market	social protect.	financial sector	education	fiscal policy	mon. policy
Labour market		less invest. in specific assets; higher cost of effort & quality	incr. demand for soc. prot.; corp. management of the welf. state more difficult	increased demand for private insurance	change in demand for skills	change in tax base	less corporatism leading to inflation pressures?
product market	de facto employment protection more difficult		increased demand for social protection	inc. demand of financial markets services		increased fiscal competition	decreased inflationary pressures
social protect.	welfare state retrenchment increases the demand for protection	less protection of specific assets		increased demand for private insurance	incr. demand for general skills	less spending pressures	
financial sector	demand for more flexibility	increased profitability pressure	competition of priv. insurance		helps devel. of private education	increased fiscal competition	increased systemic risk
educat. sector	solidaristic wage setting & coll. bargaining difficult	increased skills differentiation		increased demand for private financing		less / more spending pressures (pub./priv.)	
fiscal policy	reduced tax wedge	reduced tax wedge	financing of social protection more difficult	favours dev. of the financial sector	waning of pub. educ.; dev. of priv. educ.		more weight on monetary policy
monetary policy	ambiguous effects on coll. bargaining	increased cyclicality?				less macro policy coordination	

Table 1. Structural reforms interaction matrix. Consequences of ungoing structural reforms in one institutional area (lines) for the stability of institutions in other areas (columns).

4 Complementarity of policies and employment

Testing for the general institutional coherence of institutions following the recent wave of structural reforms and their consequences on economic performance would be well beyond the objectives of this paper. This section will have a look at one particular complementarity in policies and reforms: that between labour market flexibilisation and product market competition. According to the orthodox view, the persistence of high level of unemployment in continental Europe can be explained by the institutional arrangements at works in those countries. The underlying idea is that the strength of institutional imperfections in European labour markets hinders the proper functioning of these markets, making them 'inflexible'. Besides, imperfections of competition in product markets would make labour market imperfections all the more detrimental to employment (Nickell, 1999). The policy recommendations would therefore be to remove obstacles to flexibility in labour markets: decrease unemployment benefits, weaken job protection legislation, increase mobility of labour, and to improve product market competition (IMF, 2003; OECD, 1997).

Amable, Demmou and Gatti (2007) test whether a joint policy of product market deregulation and decrease in employment protection has positive effects on employment in an analysis the institutional and macroeconomic determinants of employment for 18 OECD countries over the 1980-2004 period. Labour market performance is generally evaluated on the basis of unemployment rate or to a lesser extent on the basis of employment rate. Instead, Amable, Demmou and Gatti consider three alternative measures of employment: the joblessness rate, i.e. the part of the working age population without a job, and its two components: the inactivity and unemployment rates. The choice of a broader range of indicators is based on the following idea: statistical definitions produce a sharp divide between the unemployed and the economically inactive; in reality one should consider all those without work as being on a spectrum. At one end, one finds people defined as unemployed (i.e. those currently engaged in active job search) and, at the other end, one would have those who do not intend ever to look for a job (Gregg and Wadsworth [1998]). By analysing labour market performances through different situations of non-employment, Amable, Demmou and Gatti (2007) aim to check for substitution effects across these situations.

The model tested uses a specification common to many studies, e.g. Nickell et al. (2005). It tests a panel data specification with a lagged dependent variable and a series of macroeconomic and institutional regressors, in particular the institutional features of the labour market: employment protection legislation (EPL), unemployment benefit replacement rate, union density, tax wedge, and wage coordination. Concerning non labour market imperfections, the OECD index of global product market regulation (PMR),[2] the intensity of financialisation,[3] as well an indicator of

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[2] The use of other OECD indicators does not substantially alter the results.
[3] The ratio of assets of institutional investors to GDP.

central bank dependence are considered. The set of macroeconomic control variables is taken into account includes the role of credit constraints, competitiveness (real exchange rate and structural trade balance), and average labour productivity. The possible interdependency between regulation policies in labour and products market is analysed: is there a substitutability or a complementarity effect between product markets deregulation and labour market flexibilisation? In order to account for these effects, an interaction term between employment protection (EPL) and product market regulation (PMR) is included in the regressions. Regressions include time and country dummies. Several estimators are used, including Plümper and Troeger (2007)'s FEVD procedure for time-invariant variables in a model including fixed effects.

A few results of Amable, Demmou and Gatti (2007) regarding joblessness are presented in Table 2. Some variables have the expected effect according to the orthodox view, such as union density, which increases joblessness, or credit to the economy, which decreases it. Other results are at odds with the markets deregulation argument. In particular, one finds that financialisation and central bank independence are negatively correlated with employment. The impact of financial assets highlights a negative effects possibly working through stronger macroeconomic volatility, industrial restructuring and layoffs.

Marginal effects of product and labour markets regulation can be computed for different levels of the other interacted variable, i.e. EPL for PMR and vice versa. The marginal effect of PMR is positive and significant for all values of EPL, indicating that increased product market competition would increase all components of employment. The coefficient measuring the marginal effect of EPL is always negative and significant when PMR is set below or equal to the mean. Hence, employment protection is actually good for employment, at average or low levels of product market regulation. This finding questions both the orthodox view about the effect of employment protection and the complementarity of product market deregulation and labour market flexibilisation policies. The marginal effect of PMR is always stronger, the higher EPL. Hence, product market deregulation is most effective when EPL is kept at a highest possible level. Concerning the marginal effect of EPL, the positive impact of employment protection is larger, the lower PMR. These results taken together point to a substitution effect across the two forms of (de)regulation: increasing employment protection amplifies the positive effect of product market deregulation. The computation of the magnitude of the effects confirm the substitution view. Whereas a policy of joint deregulation would have little or no impact on joblessness for most countries of the sample (Italy and, to a lesser extent, France being exceptions), a policy of increased employment protection coupled with decreased product market regulation would significantly decrease joblessness in all countries.

The same tests are also performed for the two components of joblessness: inactivity and unemployment. Results show that both react to institutional factors. Coefficients for the unemployment benefit replacement rate and financialisation are

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significant for inactivity but not for unemployment. On the other hand, the tax wedge appears to have a more important impact on the unemployment rate than on inactivity. Concerning results on policy interdependence, Table 2 confirms that the policy substitution scenario applies to the inactive population. However, the same conclusion does not fully apply to unemployment. In particular, the marginal effects indicate that EPL does not significantly affects unemployment, except perhaps for mean values of product market regulation. More significantly, some degree of complementarity between deregulation policies seems to exist. Product market deregulation now significantly reduces unemployment for low to moderately high values of EPL.

Table 2. Summary of the results.

	Joblessness	Unemployment	Inactivity
Employment protection	$-\rightarrow NS$	$-/NS$	$-\rightarrow NS$
Product market regulation	$+$	$+$	$+$
interdependency EPL/PMR	substitution	complementarity?	substitution
coordination	$-/NS$	$-$	$+$
Central Bank dependence	$-$	$-$	$-$
Unemployment benefits	NS	NS	$NS/+$
Union density	$+$	$+$	$+$
Tax wedge	$NS/+$	$+$	$+$
financialisation	$+$	NS	$+$
Terms of trade	$-$	$-$	$-$
credit	$-$	$-$	$-$
Trend of trade balance	NS	NS	NS

$-\rightarrow NS$ means that the marginal effect of EPL is significantly negative at low values of PMR and becomes non significant as PMR is raised.

Results summarised in Table 2 question the common faith in the positive effects of liberal structural reforms. If increased product market competition decreases joblessness in all its components, it should rather be associated with an increase in employment protection rather than more 'flexibility' in the employment relationship. Effects such as those present in Amable and Gatti (2004) and (2006) may therefore be present. Employment protection could be an incentive to greater effort and exert a wage-moderating effect. Other structural reforms may not produce the expected effects either. Increased financialisation is associated with increased inactivity for instance. Also, a 'disorganisation' of collective bargaining through a weakening of trade unions would not necessarily have the positive employment effects considered by the orthodox view. If union density increases all components of joblessness, coordination of employment relations decreases unemployment. An individualisation of wage bargaining would not necessarily be beneficial to employment.

The same model is also tested for different age groups. Only results concerning the interaction between EPL and PMR are summed up in Table 3. Without surprise, the results found for prime age workers are very similar to those found for total working

age population. Results tend to show a higher sensitivity to market 'imperfections' for young and old workers (male). However, the signs of the coefficients are at odds with the standard deregulation view. For instance, EPL has a negative to insignificant effect on the unemployment and joblessness of men aged 15 to 24 and 55 to 65. The result of policy substitution is broadly confirmed for most age groups. On the whole, employment protection decreases or has no effect on employment except at very high levels of product market regulation. Product market regulation generally deteriorates employment, except for some age groups at very low levels of employment protection.

		male			female		
		15-24	25-54	54-65	15-24	25-54	54-65
Joblessness	EPL	$-\to NS$	$-\to NS$	$-/NS$	$-\to NS$	$-\to NS$	$-\to+$
	PMR	$+$	$-\to NS$	$+$	$-$	$+$	$+$
	EPL/PMR	subst.	subst.	subst.	subst.	subst.	subst.
Unemployment	EPL	$NS\to-$	$-\to NS$	$-\to NS$	$+\to-$	$-\to NS$	$NS\to-$
	PMR	$+$	$+$	$+\to NS$	$+$	$+$	$+\to NS$
	EPL/PMR	compl.	?/subst.	?/subst.	compl.	subst.	compl.
Inactivity	EPL	$-\to+$	$-\to+$	NS	$-\to NS$	$NS\to+$	$NS\to+$
	PMR	$-\to+$	$-\to NS$	$+$	$+$	$-\to NS$	$+$
	EPL/PMR	subst.	subst.	compl.	subst.	subst.	subst.

Table3. Effects of employment protection legislation and product market regulation on joblessness, unemployment and inactivity for different working age population groups.

5   Is Flexicurity the answer?

The results presented in the preceding section lead to conclude that deregulation of both product and labour markets may not be the ultimate solution for improved employment performance. This finding would question both the liberal structural reforms policy and the 'flexicurity' strategy (Wilthagen, 1998; Madsen, 2002), which is sometimes presented as the solution to the problems of the European model (European Commission, 2007). It would preserve the social cohesion characteristic of Europe's models of capitalism while still enjoying the flexibility and adaptability of market-based models. There are of course several dimensions to labour market flexibility (Boyer, 1988), but the recent debate has for the most part focused on numerical flexibility of employment, i.e. the possibility for firms to fire (and hire) with greater ease, i.e. diminishing the level of EPL. Labour market flexibility's social consequences would be mitigated by a generous and 'active' welfare state. The detrimental effects of employment insecurity, even in terms of an increased wage premium compensating job insecurity (Amable and Gatti, 2006), would be avoided since employment security could be provided by society, not by the firm. This corresponds to the idea that the individual rather than the job should be protected (OECD, 2006).

There is an alluring aspect to this idea, but two elements may lead one to be more cautious. First, the employment effects of labour market flexibilisation may not be as expected, as illustrated above. A decrease in the level of employment protection may even lead to a worsening of the employment performance, even if some population groups may see their situation improve. If 'flexibility' brings little or no benefit in terms of labour market participation or employment, there is no point in associating flexibility with security. Second, even if one believes that labour market flexibilisation will bring improvements, if not in employment levels maybe in other dimensions, political economy considerations may prevent the emergence or stability of such an institutional arrangement (Amable and Gatti, 2007).

5.1   The employment effect of flexicurity

The impact of a flexicurity strategy on employment may be assessed by using the same type of estimations as the ones in Amable, Demmou and Gatti (2007) mentioned in the previous section. The focus will this time be on the interaction between the generosity of the unemployment benefit scheme, measured by the net benefit replacement rate ($RR_{i,t}$) and employment protection (EPL).

$$y_{i,t} = \alpha_i + \phi \cdot y_{i,t-1} + \gamma \cdot RR_{i,t} + \delta \cdot EPL_{i,t} + \zeta \cdot RR_{i,t} \times EPL_{i,t} + \beta \cdot x_{i,t} + \epsilon_{i,t} \quad (1)$$

$y_{i,t}$, $x_{i,t}$ correspond respectively to the annual observation of the dependent variable and the vector of independent variables (for country i at year t). Regressions include time and country dummies.

According the flexicurity view, the employment performance should improve with a combination of generous employment benefits and weak employment protection legislation. Therefore, EPL should be all the more detrimental to employment that the level of unemployment benefits is low and the latter should increase joblessness more when EPL is higher. Table 4 gives the results of the estimation for joblessness, with the marginal effects of employment protection legislation and unemployment benefits. As can be seen from the values of the marginal effects, an increase in unemployment benefits raises the magnitude of the effect of EPL, but not in the expected direction. In fact EPL would decrease joblessness all the more that the generosity of unemployment benefits is high. Therefore, a decrease in joblessness would be obtained by combining generous unemployment benefits and a high level of EPL. Likewise, an increase in EPL would gradually neutralise the detrimental effects of unemployment benefits, as can be seen from the marginal effects of these benefits. To sum up, there is no evidence of the type of interdependence between unemployment benefits and employment protection on which the flexicurity strategy is based on. Estimations for unemployment and inactivity give the same type of results (see Appendix).

	Joblessness	
lagged dep. Var.	0.797***	0.776***
	(0.033)	(0.038)
Empl. protect.	-0.084	-0.023
	(0.906)	(0.949)
Unemp. benef. x empl. prot.	-2.565**	-2.027*
	(1.193)	(1.222)
Unemp. Benef.	4.081**	4.052*
	(1.960)	(2.074)
union density	0.072***	0.052**
	(0.023)	(0.025)
tax wedge	0.019	0.018
	(0.022)	(0.029)
financialisation		0.012***
		(0.004)
real exchange rate	-1.911**	-2.718**
	(0.935)	(1.128)
lag productivity	-0.589	-0.657
	(1.994)	(2.489)
credit to economy	-0.071***	-0.075***
	(0.011)	(0.011)
trend trade balance	-0.088*	0.062
	(0.045)	(0.093)
product market regulation	4.104***	5.478***
	(0.110)	(0.130)
coordination	-0.402***	-1.450***
	(0.093)	(0.106)
central bank dependance	-0.625***	-0.828***
	(0.071)	(0.074)
year dummies	Yes	Yes
Number of Obs	266	227

marginal effect of employment protection legislation		
Unemp. Benef.		
min	-0.345	-0.342
	(0.805)	(0.804)
mean less 1 sd	-1.374***	-1.100*
	(0.511)	(0.579)
mean	-1.733***	-1.359**
	(0.484)	(0.570)
mean plus 1 sd	-2.092***	-1.618***
	(0.513)	(0.603)
max	-2.419***	-1.869***
	(0.581)	(0.669)

marginal effect of unemployment benefits (repl. rate)		
Empl. prot.		
min	3.824**	3.850*
	(1.856)	(1.981)
mean less 1 sd	2.717*	2.927*
	(1.435)	(1.611)
mean	1.338	1.844
	(1.039)	(1.352)
mean plus 1 sd	-0.042	0.761
	(0.959)	(1.382)
max	-1.148	0.037
	(1.178)	(1.563)

Note: Standard errors in parentheses
* p<0.10, ** p<0.05, *** p<0.01

Table 4. The interaction of
unemployment benefits and EPL and
the impact on joblessness.

Other results are more favourable to some aspects of the flexicurity strategy. Interacting the share of active labour market policies expenditure in GDP with the unemployment benefit replacement rate allows to assess a possible complementarity between welfare state generosity and activation policies. Table 5 reports the marginal effects of the two variables with estimations similar to the ones presented above. Active labour market policies are increasing joblessness except when unemployment benefits are very generous. The effects on inactivity and unemployment are contrasted. On the other hand, the interaction of unemployment benefits with active labour market policy expenditure are unambiguous. The former have no employment decreasing effects when the latter is very large. Therefore, active labour market programs and generous unemployment benefits could be combined without having negative effects on employment.

marginal effect of active labour market policies

unemp. ben.	joblessness	inactivity	unemploymen
min	2.375***	0.451	1.846***
	(0.789)	(0.531)	(0.653)
mean less 1 sd	1.748***	0.456	1.342***
	(0.494)	(0.302)	(0.42)
mean	1.415***	0.459**	1.075***
	(0.389)	(0.213)	(0.321)
mean plus 1 sd	1.082***	0.462**	0.807***
	(0.366)	(0.198)	(0.268)
max	0.7	0.466	0.499*
	(0.456)	(0.287)	(0.295)

marginal effect of unemployment benefits

act. lab. pol.	joblessness	inactivity	unemploymen
min	7.366***	3.308**	4.151***
	(2.196)	(1.351)	(1.576)
mean less 1 sd	6.496***	3.315***	3.451**
	(1.875)	(1.138)	(1.397)
mean	4.680***	3.331***	1.992
	(1.565)	(0.955)	(1.325)
mean plus 1 sd	2.865	3.347**	0.532
	(1.906)	(1.293)	(1.671)
max	-1.433	3.387	-2.923
	(-3.923)	(2.914)	(-3.19)

Note: Standard errors in parentheses
* p<0.10, ** p<0.05, *** p<0.01

Table 5 Marginal effects of active labour market
policies and unemployment benefits.

5.2 Flexicurity and political economy

There may exist political economy obstacles to the implementation of a strategy associating labour market flexibilisation with an increase in the generosity of the welfare state. Labour market flexibilisation may set off a dynamics of political weakening of labour's collective representation, thus decreasing labour's bargaining power in the design of public policies. Such an evolution would probably not favour the emergence of a political equilibrium favourable to the extension of social protection, i.e. the counterpart to increased labour market flexibility in the 'flexicurity' scheme. Besides, the general movement of liberal structural reforms may affect the institutional complementarities favourable to a generous welfare state, reinforcing a dynamics of institutional change in the direction of a mere 'flexibility' model instead of 'flexicurity'

Table 6 presents the results of simple regressions of an indicator of generosity of the welfare state on a certain number of institutional variables, using the same panel of countries as in the previous section. The dependent variable is the index of generosity designed by Allan and Scruggs [2005]. This indicator is built with the help of net benefit replacement rates for unemployment, retirement and unemployment as well as indicators on the extent of protection and entitlement conditions. This index is regressed on various other institutions' indices, for employment protection, product market regulation end financialisation. A variable representing the partisan position of the government is included; this variable is all the more negative that the governing parties are left-wing, and all the more positive that governing parties are right wing.[4]

One can see from Table 6 that, as expected, left-wing coalitions are associated with more generous welfare states. Besides, the generosity of the welfare state is positively correlated with employment protection, most certainly because the political and social influences on these variables are very similar. Agents demanding social protection are likely to demand employment protection as well in a search for social security in general. The possibility for the emergence of a trade-off between a generous welfare state and employment protection is therefore not guaranteed. Besides, other types of institutional change do not seem to be favourable to the welfare state either. As documented In Table 6, financialisation is negatively correlated with the welfare state's generosity. The correlation with product market regulation seems to be somewhat looser but a significant positive correlation between regulation and welfare state is sometimes found.

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[4]The partisan position of the government is constructed on the basis of the 2002 version of the PGL File Collection by Thomas R. Cusack and Lutz Engelhardt of the Wissenschaftszentrum Berlin für Sozialforschung. Their dataset provides variables for numerous political parties reflecting the relative frequency of statements in party manifestos on characteristic economic and non-economic political topics. It is possible to construct a continuous variable expressing the position of a party on a left-right axis. The position of the government is the weighted average of the positions of governing coalition parties (Amable, Gatti and Schumacher, 2006).

index of generosity of the welfare state

lagged variable	0.697***	0.728***	0.728***
	(0.043)	(0.047)	(0.04)
EPL	1.313***	0.903*	1.352***
	(0.258)	(0.477)	(0.466)
partisan position	-0.006*	-0.004	-0.006**
	(-0.003)	(-0.003)	(-0.003)
inactivity rate		-0.070**	
		(-0.027)	
financialisation	-0.013***	-0.010***	-0.012***
	(-0.002)	(-0.004)	(-0.003)
PMR	-0.183	1.821***	-0.1
	(-0.225)	(0.668)	(-0.095)
eta	1.000***		
	(0.152)		
Number of Obs	272	267	272
	FEVD	PCSE	PCSE
Country dummies	yes	yes	yes
Time dummies	yes	yes	yes

* $p<0.10$, ** $p<0.05$, *** $p<0.01$

Table 6. Institutions and the generosity of the welfare state.

6 Conclusion

Because institutions in developed political economies are interrelated through a complex network of complementarities, institutional change has consequences beyond the area concerned by a reform. This also implies that there are complementarity effects in reforms themselves. A challenge of reform programs is therefore to achieve a new type of complementarities between reformed institutions. The general orientation of structural reforms has been a move toward liberalisation and deregulation of markets. A complementarity between deregulated product markets and flexibilised labour markets is supposed to lead to an improvement in the employment performance. However, empirical tests do not support the existence of such a complementarity. This does not imply the general non existence of liberalised market-based complementarities, but could be the consequence of the diversity of capitalism within OECD countries. The implementation of some market-based structural reforms, even in conjunction with one another, may not be enough to transform political economies based on different principles into liberal market economies.

Another reform strategy attempts to combine flexibility in labour markets with

security through social protection. Empirical tests performed in this article lead to question the economic efficiency of such an arrangement. Active labour market programs rather than diminished employment protection would seem to be the crucial element to combine with a generous welfare state in the search for labour market efficiency. Other tests raise the question of the political conditions for the stability of a flexicurity strategy. Generous welfare states have been possible in countries where the organised labour movement has been strong enough. Welfare state institutions are therefore generally associated with institutions that protect workers, such as employment protection legislation. While not ruling out the possibility for a future emergence of a political trade-off between employment protection and social security, the results presented above emphasize the sociopolitical compromise upon which the institutional architecture of the modern economies are built.

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	Unemployment	
	b/se	b/se
lagged dep. Var.	0.671***	0.655***
	(0.063)	(0.054)
Empl. protect.	-0.054	0.194
	(0.924)	(0.656)
Unemp. benef. x empl. prot.	-1.285	-0.932*
	(1.055)	(0.546)
Unemp. Benef.	2.545*	1.882*
	(1.539)	(1.009)
union density	0.037**	0.050***
	(0.016)	(0.015)
tax wedge	0.039*	0.053***
	(0.022)	(0.019)
financialisation	0.001	0.005
	(0.003)	(0.005)
real exchange rate	-1.339	-1.466**
	(0.853)	(0.591)
lag productivity	-1.243	-1.128
	(1.436)	(1.860)
credit to economy	-0.040***	-0.049***
	(0.009)	(0.007)
trend trade balance	0.065	0.069
	(0.068)	(0.067)
product market regulation	2.236***	2.265***
	(0.141)	(0.140)
coordination	-1.302***	-1.700***
	(0.080)	(0.061)
central bank dependance	-0.305***	-0.378***
	(0.042)	(0.057)
education		0.004
		(0.026)
year dummies	Yes	Yes
Number of Obs	227	178

marginal effect of employment protection legislation		
Unemp. Benef.		
min	-0.256	0.047
	(0.783)	(0.631)
mean less 1 sd	-0.736	-0.285
	(0.516)	(0.616)
mean	-0.900*	-0.411
	(0.467)	(0.627)
mean plus 1 sd	-1.065**	-0.536
	(0.455)	(0.645)
max	-1.224**	-0.655
	(0.481)	(0.670)

marginal effect of unemployment benefits (repl. rate)		
Empl. prot.	b/se	b/se
min	2.416	1.788*
	(1.472)	(0.962)
mean less 1 sd	1.831	1.403*
	(1.236)	(0.777)
mean	1.145	0.907
	(1.169)	(0.584)
mean plus 1 sd	0.458	0.411
	(1.357)	(0.497)
max	-0.001	0.035
	(1.586)	(0.538)

Note: Standard errors in parentheses
* p<0.10, ** p<0.05, *** p<0.01

Table A1. The effect of flexicurity on unemployment.

	Inactivity	
lagged dep. Var.	0.895***	0.863***
	(0.024)	(0.046)
Empl. protect.	-0.355	-0.324
	(0.512)	(0.628)
Unemp. benef. x empl. prot.	-0.780	-0.836
	(0.734)	(0.688)
Unemp. Benef.	2.345*	0.870
	(1.226)	(1.095)
union density	0.034**	0.003
	(0.015)	(0.016)
tax wedge	0.014	0.040**
	(0.014)	(0.017)
financialisation	0.004*	0.008***
	(0.002)	(0.003)
real exchange rate	-1.649***	-1.186***
	(0.543)	(0.423)
lag productivity	-0.939	-7.469***
	(1.096)	(2.156)
credit to economy	-0.034***	-0.030***
	(0.007)	(0.008)
trend trade balance	-0.085*	-0.050
	(0.049)	(0.070)
product market regulation	2.770***	3.068***
	(0.066)	(0.079)
coordination	-0.497***	-0.246***
	(0.063)	(0.093)
central bank dependance	-0.376***	-0.032
	(0.060)	(0.066)
education		-0.074***
		(0.021)
year dummies	Yes	Yes
Number of Obs	247	196

marginal effect of employment protection legislation

Unemp. Benef.		
min	-0.478	-0.455
	(0.449)	(0.552)
mean less 1 sd	-0.766*	-0.753*
	(0.407)	(0.434)
mean	-0.868**	-0.867**
	(0.433)	(0.419)
mean plus 1 sd	-0.969**	-0.981**
	(0.478)	(0.424)
max	-1.065**	-1.085**
	(0.533)	(0.447)

marginal effect of unemployment benefits (repl. rate)

Empl. prot.		
min	2.267*	0.786
	(1.160)	(1.036)
mean less 1 sd	1.914**	0.435
	(0.877)	(0.805)
mean	1.495**	-0.011
	(0.609)	(0.590)
mean plus 1 sd	1.075**	-0.458
	(0.533)	(0.564)
max	0.769	-0.821
	(0.647)	(0.701)

Note: Standard errors in parentheses
* p<0.10, ** p<0.05, *** p<0.01

Table A2. The effect of flexicurity on inactivity.