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THE EUROPEAN UNEMPLOYMENT PROBLEM

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UNEMPLOYMENT IN THE UNITED STATES AND IN EUROPE

A CONTRAST AND THE REASONS

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I hope it will be understood from the beginning that I am not one of those Americans who think that the Celestial Economist smiles with special favor on the U.S.A., or that American businessmen are more entrepreneurial, American workers more ingenious, and American policies more appropriate than their European counterparts. Not at all. Nevertheless, the remarks which follow are implicitly critical of European thinking about macroeconomics, and also about the policies that follow from that thinking. I ask you, please to keep it in mind that I am really trying to make a few general remarks about macroeconomic principles and macroeconomic policies.

The basic facts we have to understand are easy to describe and well known to most of us. In 1970 the unemployment rate in the U.S. was 5%, that in (West) Germany was 1%, and in the rest of the European Union the unemployment rate stood at 3%. In those days, American economists, myself included, used to wonder what the U.S. would have to do in order to reproduce the European experience. In 1997 the unemployment rate was still 5% in the U.S. (4.9% to be exact) and in 1998 it was a full half-point lower. Meanwhile the (Unified) German unemployment rate was at 10% and the rest of the European Union was between 11 and 12%.

The contrast is certainly striking. Europe used to have consistently lower unemployment than the U.S.; now it has higher. Since 1970, there has been no trend in U.S. unemployment; it is actually a bit lower than it was then. But there have been marked business-cycle fluctuations, with the unemployment rate peaking in 1975, 1982 and 1992, and reaching low points before and after the peaks. Today we have the lowest unemployment rate in 30 years. When you look at the European experience, the clear impression is that there has been a strong upward trend that dominates the business cycle.

That contrast poses an inevitable question: What explains the difference between the current levels of unemployment in Europe and the U.S.? There is a tendency in matters like this to assume that there must be one single answer to this question, one secret ingredient that explains why the U.S. has kept its unemployment rate moderately low while Europe has seen its rate rise to high levels and get stuck there. That would make for drama; but economic life is not necessarily like a detective story. It is more likely that the difference between American and European unemployment arises from the cumulation of several differences in institutions and policies.

Labour market rigidities are the major explanation in Europe

Furthermore, the talk of "Europe" is not always appropriate. There are big differences within Europe; for instance, Austria, Norway and, more recently, the Netherlands and Denmark have avoided the high unemployment that has continued to characterise France and Germany. The most I can hope to do is to pick out a few useful lessons that bear on the main issue.

The conventional understanding of this contrast, especially among Europeans, seems to rest entirely

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on *labour-market rigidities.* As evidence I can cite the title of a recent and exhaustive article by Horst Siebert, "Labour Market Rigidities: At the Root of Unemployment in Europe". Beyond doubt there are plenty of labour-market rigidities to rest an argument on. The main ones to attract attention seem to have been: (a) the relatively low replacement rate embodied in the U.S. unemployment insurance system compared with most European countries, as well as the relatively short duration of benefits allowed in the U.S., the natural consequence being more active search by unemployed workers and more willing acceptance of inferior job offers; (b) the broad scope of legal restrictions on discharging workers in Europe which, though perhaps working against unemployment in the short run, has the long-run effect of discouraging job creation and strengthening the power of incumbent workers to protect wages at the expense of outsiders seeking employment; (c) the relatively low minimum wage in the U.S., which allows higher employment of low-productivity workers at the expense of greater wage inequality; (d) Siebert points out that the U.S. labour market generally allows greater wage differentiation between classes of workers than in Europe, but I think this may be a more complicated matter than just a difference in labour-market institutions; (e) the greater density and power of trade unions in Europe; (f) the wider wedge of payroll taxes and social charges in Europe that surely pushes some low-wage workers below the margin of employability; even if the long-run incidence of such charges is generally on workers' wages, this tax-shifting may not be possible at or near the minimum wage.

Two empirical reasons for rejecting the exclusive focus on labour market rigidities

That is an impressive array of labour-market rigidities. So perhaps it is understandable that this is the *only* explanation of high unemployment that is ever discussed seriously by civil servants and central bankers in much of Europe, especially Germany. Consequently the only potential cure for high and persistent unemployment that is ever seriously discussed is labour-market reform and wage moderation, though that process is inevitably slow and sure to be socially divisive.

I do not think one can deny the significance of labour-market rigidities in Europe, and the likelihood that greater flexibility in the U.S. contributes to its much more favourable performance in terms of employment. But I believe that the almost exclusive focus on this aspect of the problem is a major mistake. It hides other, very important, lines of causality, and steers Europe away from possible policy strategies that could have substantial results in much less time, and with a fairer distribution of the burden.

There are good empirical reasons for rejecting this convenient belief that the labour market *by itself* provides an adequate account of the sad story of European unemployment. At the crudest level, the timing is wrong. One of the two big increases in unemployment took place in the early 1980s, although there was no change in labour-market regulation to account for it.

The argument was sometimes made that European wage determination (unlike the U.S.) exhibited "real-wage resistance" or effective indexing of the nominal wage. This stickiness of the real wage could certainly be a source of unemployment in principle and in fact. But real-wage resistance must eventually have worn off. The profit share has risen to very high levels in Europe, meaning that real wages have not kept pace with productivity. But unemployment did not wither away, so this story is inadequate. And the further rise in unemployment after 1990 came during a period when labour markets were being deregulated in the major nations of Europe. Some other forces must have been at work.

The second empirical reason for rejecting an exclusive focus on the labour market is less obvious and more indirect. A useful summary indicator of many kinds of labour-market rigidity is the position of the so-called *Beveridge curve,* named after Sir William Beveridge's famous wartime report *Full Employment in a Free Society.* Beveridge chose to define "full employment" as a situation in which there are as many unfilled jobs as there are unemployed workers. The definition was not generally acceptable, but it suggested studying the relation between the number of unemployed workers and the number of unfilled jobs, both expressed as a fraction of the labour force.

In any country at any moment, the Beveridge curve is a downward-sloping relation between the vacancy rate and the unemployment rate. It has a negative slope for the common-sense reason that jobs are easier to fill, and the vacancy rate therefore is lower, the more unemployed workers there are for employers to choose among. A perfectly flexible or efficient labour market would interpose no obsta-

cle to the frictionless matching of an unfilled job and an unemployed worker with the appropriate skills. Flexible wages would adjust so that every part of the labour market had, within reason, adequate employment opportunities. In that case, vacant jobs and unemployed workers could not coexist. The Beveridge curve would coincide with the axes of the diagram: there could be vacancies with no unemployment or there could be unemployment with no vacancies. One would expect pressure on wages in either case.

Of course no real-world labour market could be perfectly flexible in that sense. Labour-market rigidities (including skill mismatches as a special form of rigidity) are precisely what allows vacancies and unemployment to coexist, and the more rigidities there are, the more the Beveridge curve diverges from the hypothetical limiting case, the further from the zero-zero point it is located. In the U.S., for instance, there appears to be a well-defined Beveridge curve for 1958–71 that shifted adversely in the early 1970s and then returned to its initial position in 1987–88, and has stayed there since.

It is more interesting and relevant to look at France and Germany, where the story is quite different. The main message transmitted by the Beveridge curves for France and Germany goes squarely against the cliché that high and persistent unemployment is entirely or mainly a matter of worsening functioning of the labour market. It is precisely in France and Germany that there is no sign of a major unfavourable shift of the Beveridge curve during the period of rising unemployment.

To the extent that the location of the Beveridge curve is a reasonable summary of the degree of labour-market rigidity, the large continental economies do not seem to have suffered from noticeably more rigid labour markets during the high-unemployment 1980s than they did in the low-unemployment 1970s. In fact, what stands out from the data for France and Germany is precisely the depressed level of the vacancy variable, i.e., the weakness of the demand for labour.

Careful studies in the U.S. have demonstrated the importance of analysing net changes in employment and unemployment as the resultant of *gross flows* of job creation and job destruction. As I hinted earlier, much of the European failure to reduce unemployment arises from low exit rates from unemployment during limited business-cycle upswings. This in turn suggests that an important part of the problem is an inadequate rate of job creation. Here may be the source of the shocking difference between Europe and the U.S. in the incidence of long-term unemployment. In the U.S. in 1997, 8.7% of all the unemployed had been out of work for more than 12 months. The corresponding figure for Germany (1996) was 47.8%, for France 41.2%, for the U.K. 38.6%, and for the E.U. as a whole 50.2%. This contrast would still be apparent if we used U.S. figures for periods of relatively high unemployment. It is even possible that the tolerant character of the European unemployment insurance system is as much a response to as it is a cause of the low exit probability from unemployment.

A weakness in job creation could have several sources; one of them might be those legal restrictions on firing workers. But I suggest that product-market deregulation (of opening hours, land use, banking practices) and increased competition might help to reduce unemployment by improving employment prospects. Finally, I suggest that American fiscal and monetary policy has been more successful than Europe has been in supporting aggregate demand, and above all more aggressive in taking advantage of opportunities to expand whenever inflationary pressure has been weak, whatever the cause of that weakness. This could be important for two reasons. The first reason is the direct effect of excessively tight fiscal and monetary policy on an economy with limited wage and price flexibility. The second reason why demand-side policy could be very important has to do with its interaction with the supply side. Any gain in labour-market flexibility or in product-market deregulation will be both more effective and more easily accepted if it occurs at a time when aggregate demand is strong and market prospects are favourable. There is likely to be considerable payoff to coordination of supply-side and demand-side policies within the large European countries and among members of the European Union.

An important part of the problem is an inadequate rate of job creation

More flexibility in labour markets is a good idea, but it is not the only good idea.