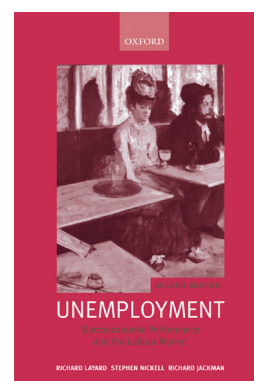


Why has unemployment fallen in some European countries but not in others? To answer this question, **Richard Layard**, **Stephen Nickell** and **Richard Jackman** revisit their landmark analysis of macroeconomic performance and the labour market.



Tackling unemployment: Europe's successes and failures

In 2002, average unemployment in Europe was relatively high compared with OECD countries outside Europe. Yet the majority of countries in Europe in 2002 had lower unemployment than any OECD country outside Europe, including the United States. These two facts are consistent because the four largest countries in continental Western Europe – namely, France, Germany, Italy and Spain – have very

high unemployment and most of the rest have comparatively low unemployment.

This variability is highly informative because despite 'free' movement of labour, European countries have more or less independent labour markets in practice. Using this information, we see how changes in the structure of the various labour markets explain a substantial proportion of the secular fluctuations in unemployment in the various countries.

In particular, we can pin down some of the particular factors that enable us to understand why some European countries have been able fully to recover from the unemployment disasters of the early 1980s whereas some have not.

Changing labour market institutions

Table 1 presents a picture of unemployment in the OECD since the

Table 1
Unemployment (standardised percentage rate)

	1960-64	1965-72	1973-79	1980-87	1988-95	1996-99	2000-1	2002
Australia	2.5	1.9	4.6	7.7	8.7	7.9	6.5	6.3
Austria	1.6	1.4	1.4	3.1	3.6	4.3	3.7	4.3
Belgium	2.3	2.3	5.8	11.2	8.4	9.2	6.8	7.3
Canada	5.5	4.7	6.9	9.7	9.5	8.7	7.0	7.7
Denmark	2.2	1.7	4.1	7.0	8.1	5.3	4.4	4.5
Finland	1.4	2.4	4.1	5.1	9.9	12.2	9.4	9.1
France	1.5	2.3	4.3	8.9	10.5	11.5	9.0	8.7
Germany (W)	0.8	0.8	2.9	6.1	5.6	7.4	6.4	6.8
Ireland	5.1	5.3	7.3	13.8	14.7	8.7	4.0	4.4
Italy	3.5	4.2	4.5	6.7	8.1	9.9	8.4	7.4
Japan	1.4	1.3	1.8	2.5	2.5	3.9	4.9	5.4
Netherlands	0.9	1.7	4.7	10.0	7.2	4.5	2.6	2.8
Norway	2.2	1.7	1.8	2.4	5.2	3.8	3.6	3.9
New Zealand	0.0	0.3	0.7	4.7	8.1	6.8	5.7	5.2
Portugal	2.3	2.5	5.5	7.8	5.4	6.0	4.1	5.1
Spain	2.4	2.7	4.9	17.6	19.6	19.4	13.5	11.4
Sweden	1.2	1.6	1.6	2.3	5.1	8.6	5.5	4.9
Switzerland	0.2	0.0	0.8	1.8	2.8	3.5	2.6	2.6
UK	2.6	3.1	4.8	10.5	8.8	6.8	5.2	5.1
United States	5.5	4.3	6.4	7.6	6.1	4.8	4.4	5.8

1960s. Our analysis suggests that a large part of the dramatic rise in unemployment in the big continental European countries over this period can be explained by changes in the key labour market institutions – changes in unemployment benefit systems, increases in labour taxes, increased power of trade unions and changes in employment protection law.

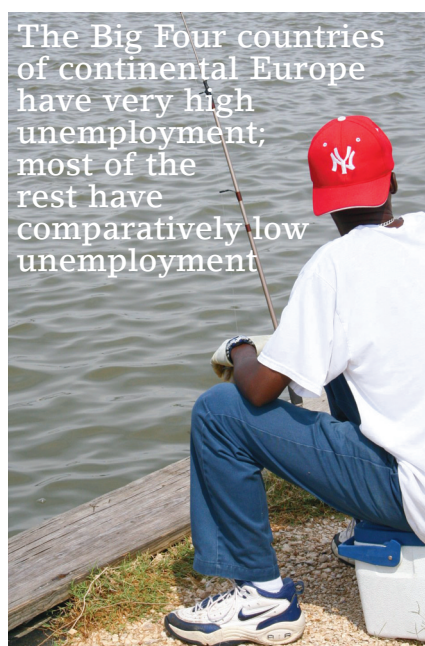
It is widely accepted that labour market rigidities are an important part of the explanation for the high levels of unemployment that are still to be found in a number of OECD countries. But acceptance is not universal. One often cited argument is that labour market rigidities cannot explain why European unemployment is so much higher than US unemployment because the institutions generating these rigidities were much the same in the 1960s as they are today and in the 1960s, unemployment was much higher in the United States than in Europe.

What are the facts? It is indeed correct that US unemployment was much higher than European unemployment in the 1960s, but as we have seen, the picture today is less clear-cut than is commonly thought. And what of the argument that the European institutions generating labour market rigidities have been more or less unchanged since the 1960s? In fact, the evidence makes clear that this is simply not true.

Unemployment benefits

There are four aspects of the unemployment benefit system for which there are good theoretical and empirical reasons to believe that they will influence the long-run, equilibrium, level of unemployment: the level of benefits; the duration of entitlement; the coverage of the system; and the strictness with which the system is operated.

Of these, data are only available for the first two for the OECD countries. The OECD has collected systematic data on the



unemployment benefit replacement ratio for three different family types – single, with dependent spouse and with spouse at work – in three different duration categories from 1961 to 1999.

The key feature of these data is that in nearly all countries, benefit replacement ratios tended to become more generous from the 1960s to the late 1970s, the exceptions being Germany, Japan and New Zealand. Italy had no effective benefit system over this period for the vast majority of the unemployed.

After the late 1970s, countries moved in different directions. Italy introduced a benefit system and those in Finland, Portugal and Switzerland became markedly more generous. By contrast, benefit replacement ratios in Belgium, Ireland and the UK have fallen steadily since the late 1970s or early 1980s.

It is unfortunate that we have no comprehensive data on the coverage of the system or on the strictness with which it is administered. This is particularly true in the case of the latter because the evidence we possess appears to indicate that this is of crucial importance in determining the extent to which a generous level of benefit will actually influence unemployment.

For example, Denmark, which has very generous unemployment benefits, totally reformed the operation of its benefit

Table 2

Union density (union members as a percentage of employees)

	1960-64	1965-72	1973-79	1980-87	1988-95	1996-98	Extension laws in place
Australia	48	45	49	49	43	35	✓
Austria	59	57	52	51	45	39	✓
Belgium	40	42	52	52	52	-	✓
Canada	27	29	35	37	36	36	✗
Denmark	60	61	71	79	76	76	✗
Finland	35	47	66	69	76	80	✓
France	20	21	21	16	10	10	✓
Germany (W)	34	32	35	34	31	27	✓
Ireland	47	51	56	56	51	43	✗
Italy		32	48	45	40	37	✓
Japan	33	33	30	27	24	22	✗
Netherlands	41	38	37	30	24	24	✓
Norway	52	51	52	55	56	55	✗
New Zealand	36	35	38	37	35	21	✗
Portugal	61	61	61	57	34		✓
Spain	9	9	9	11	16	18	✓
Sweden	64	66	76	83	84	87	✗
Switzerland	35	32	32	29		23	✓
UK	44	47	55	53	42	35	✗
United States	27	26		20	16	14	✗

system through the 1990s with a view to tightening the criteria for benefit receipt and the enforcement of these criteria via a comprehensive system of sanctions. The Danish Ministry of Labour is convinced that this process has played a major role in allowing Danish unemployment to fall dramatically since the early 1990s without generating inflationary pressure.

A further aspect of the structure of the benefit system for which we do not have detailed data back to the 1960s are those policies grouped under the heading of active labour market policies (ALMPs), the purpose of which is to provide active assistance to the unemployed that will improve their chances of obtaining work.

We do, however, have data from 1985, which shows that, by and large, the countries of Northern Europe and Scandinavia devote most resources to ALMPs. It might be hypothesised that they do this because high expenditure on ALMPs is required to offset their rather generous unemployment benefit systems and to push unemployed individuals into work. Such additional pressure on the unemployed is less important if benefits are very low relative to potential earnings in work.

Systems of wage determination

In most countries in the OECD, the majority of workers have their wages set



by collective bargaining between employers and trade unions at the plant, firm, industry or aggregate level. The available data on collective bargaining coverage – the proportion of employees covered by collective agreements – show that across most of continental Europe, including Scandinavia but excluding Switzerland, coverage is both high and stable. This is either because most people belong to trade unions or because union agreements are extended by law to cover non-members in the same sector.

In Switzerland and the OECD countries outside continental Europe and Scandinavia, coverage is generally much lower, with the exception of Australia. In New Zealand, the UK and the United States, coverage has declined with the fall in union density, there being no extension laws.

Table 2 shows the percentage of employees who are union members. Across most of Scandinavia, membership tends to be high. By contrast, in much of continental Europe and in Australia, union density tends to be less than 50% and is gradually declining. In these countries, there is, consequently, a wide and widening gap between density and coverage, which it is the job of the extension laws to fill. This situation is at its most stark in France, which has the lowest union density in the OECD at around 10%, but one of the highest levels of coverage at around 95%.

Outside these regions, both density and coverage tend to be relatively low and both are declining at greater or lesser rates. The absence of complete coverage data means that we have to use density measures to capture the impact of unionisation on unemployment. As should be clear, this is only half the story, so we must treat any results we find in this area with some caution.

The other aspect of wage bargaining that appears to have a significant impact on wages and unemployment is the extent to which bargaining is co-ordinated. Co-ordination refers to mechanisms whereby the aggregate employment implications of wage determination are taken into account when wage bargains are struck.

This may be achieved if wage bargaining is highly centralised, as in Austria, or if there are institutions, such as employers' federations, which can assist bargainers to act in concert even when

bargaining itself ostensibly occurs at the level of the firm or industry, as in Germany or Japan. It is worth noting that co-ordination is not, therefore, the same as centralisation, which refers simply to the level at which bargaining takes place: plant, firm, industry or economy-wide.

Notable changes in co-ordination since the 1960s are the increases in Ireland and the Netherlands towards the end of the period and the declines in Australia, New Zealand and Sweden. Co-ordination also declined in the UK over the same period but this simply reflects the sharp decline of unionism overall.

Employment protection

Employment protection laws may tend to make firms more cautious about filling vacancies, which slows the speed at which the unemployed move into work. But the mechanism here is not clear-cut. For example, the introduction of employment protection laws often leads to an increased professionalisation of the personnel function within firms, as was the case in the UK in the 1970s. This can increase the efficiency of job matching.

So in terms of outflows from unemployment, the impact of employment protection laws can go either way. By contrast, such laws will clearly reduce involuntary separations and hence lower inflows into unemployment. So the overall impact on unemployment is an empirical question. Furthermore, employment law may also have a direct impact on pay since it raises the job security of existing employees, encouraging them to demand higher pay increases.

Labour taxes

The important taxes here are those that form part of the wedge between the real product wage (labour costs per employee normalised on the output price) and the real consumption wage (after tax pay normalised on the consumer price index). These are payroll taxes, income taxes and consumption taxes. Their combined impact on unemployment remains a subject of some debate despite the large number of empirical investigations.

All countries exhibit a substantial increase in the total tax rate on labour over the period from the 1960s to the 1990s although there are wide variations across countries. These mainly reflect the

Table 3
 'Policy' changes from the early 1980s to the late 1990s

	Replacement rate	Benefit duration	Benefit strictness	ALMP	Union coverage	Union density	Co-ordination
Europe							
Austria	×	-	-	-	-	✓	×
Belgium	✓	-	-	-	-	-	×
Denmark	-	×	✓	✓✓	-	-	×
Finland	×	-	-	-	-	×	✓
France	-	×	-	✓	×	-	×
Germany (W)	-	×	-	✓	-	-	-
Ireland	✓	×	-	-	?	✓	✓
Italy	×	-	-	-	-	-	✓
Netherlands	-	-	✓	✓	-	-	✓
Norway	×	×	✓	✓	-	-	×
Portugal	×	×	-	✓	-	✓✓	-
Spain	✓	-	-	-	×	-	-
Sweden	×	-	-	-	-	-	×
Switzerland	××	×	-	✓	-	-	×
UK	✓	×	✓	×	✓✓	✓	-
Non-Europe							
Australia	-	-	✓	✓	-	✓	×
Canada	✓	×	-	-	-	-	-
Japan	×	-	-	-	-	-	-
New Zealand	-	-	-	×	✓✓	✓	××
United States	-	-	✓	-	-	-	-

extent to which health, higher education and pensions are publicly provided along with the all-round generosity of the social security system. Some countries have made significant attempts to reduce labour taxes in recent years, notably the Netherlands and the UK.

Labour market institutions and the successes and failures of the 1990s

Having looked at some of the key factors that the evidence suggests have some impact on equilibrium unemployment, let us see how changes in these variables over the last two decades can contribute to our

understanding of unemployment changes over the same period.

Table 3 provides a picture of changes in the relevant variables with a tick referring to a significant move that will tend to reduce unemployment and a cross for the reverse. Double ticks and crosses reflect really big moves. A dash implies no significant change. Of course, this is a pretty crude business and a proper panel data analysis is arguably preferable. But here we are able to take account of variables where we are unable to obtain long time series data.

So we can ask the question: do the ticks and crosses bear any relationship to

the unemployment changes reported in the final columns of the table? Our analysis indicates that the number of ticks and crosses explains about half the cross-country variation in unemployment changes from the early 1980s to the present. We may reasonably conclude that the countries that had very high unemployment in the early 1980s and still have high unemployment today simply have too few ticks and/or too many crosses.

Four strategies for tackling unemployment

The experience of the last 15 years shows that given sensible macroeconomic policies, it is possible to ensure that unemployment remains fairly close to the full employment level. Four strategies seem particularly relevant.

- To prevent people drifting into long-term unemployment, there should be active policies to ensure that everyone gets offers of work or training within a year of becoming unemployed. The work should where possible be with regular employers, and secured if necessary by a recruitment subsidy. A modernised Public Employment Service is a key instrument in the business of



Table 3
– cont'd

	Employment protection	Labour taxes	Total		Unemployment		Unemployment change
			✓	×	1980-87	2000-1	
Europe							
Austria	-	×	1	3	3.1	3.7	0.6
Belgium	✓	-	2	1	11.2	6.8	-4.4
Denmark	✓	-	4	2	7.0	4.4	-2.6
Finland	✓	-	2	2	5.1	9.4	4.3
France	×	-	1	4	8.9	9.0	0.1
Germany (W)	✓	-	2	1	6.1	6.4	0.3
Ireland	-	✓	4	1	13.8	4.0	-9.8
Italy	✓	×	2	2	6.7	8.4	1.7
Netherlands	✓	✓	5	0	10.0	2.6	-7.4
Norway	✓	-	3	3	2.4	3.6	1.2
Portugal	✓	-	4	2	7.8	4.1	-3.7
Spain	✓	-	2	1	17.6	13.5	-4.1
Sweden	✓	-	1	2	2.3	5.5	3.2
Switzerland	-	-	1	4	1.8	2.6	0.8
UK	-	✓	6	2	10.5	5.2	-5.3
Non-Europe							
Australia	-	?	3	1	7.7	6.5	-1.2
Canada	-	X	1	2	9.7	7.0	-2.7
Japan	-	-	0	1	2.5	4.9	2.4
New Zealand	-	?	3	3	4.7	5.7	1.0
United States	-	-	1	0	7.6	4.4	-3.2

channelling job offers to workers. It should be properly staffed and funded, with private agencies free to compete with it.

- The welfare-to-work approach will not prevent long-term unemployment if individuals who receive offers from employers can instead choose to continue living on benefit. A system of complementary rights and responsibilities is needed where the citizen can expect high-quality help in finding work, but in return must take advantage of it or cease to draw benefits. Provided the state is channelling offers of work or work-related activity to everyone within the first year of unemployment, that should be the maximum period for which benefits are paid to people who are not working or engaged in some work-related activity.
- Further policies are needed to deal with regional unemployment. In particular, the decentralisation of wage setting and measures aimed at improving the external environment where firms operate (for example, the efficiency of public administration, the enforcement of the rule of law, etc.) are also essential. The decentralisation of collective bargaining can be accompanied with measures



There should be a maximum period for which benefits are paid to people who are not working

encouraging regional labour mobility and encouraging take-up of relatively low-paid jobs, for example, by providing in-work benefits to low-wage earners.

- Labour supply reducing policies such as early retirement, as well as uncontrolled access to invalidity pensions, should be phased out as the welfare-to-work approach makes it possible to deal with redundancies without having to implement (high cost) early retirement for older workers. Reforms of pension systems should also remove from public pension arrangements those features that discourage the participation of older workers.

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