HIGHLIGHTS

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Is There a Trade-off between Unemployment and Inequality?

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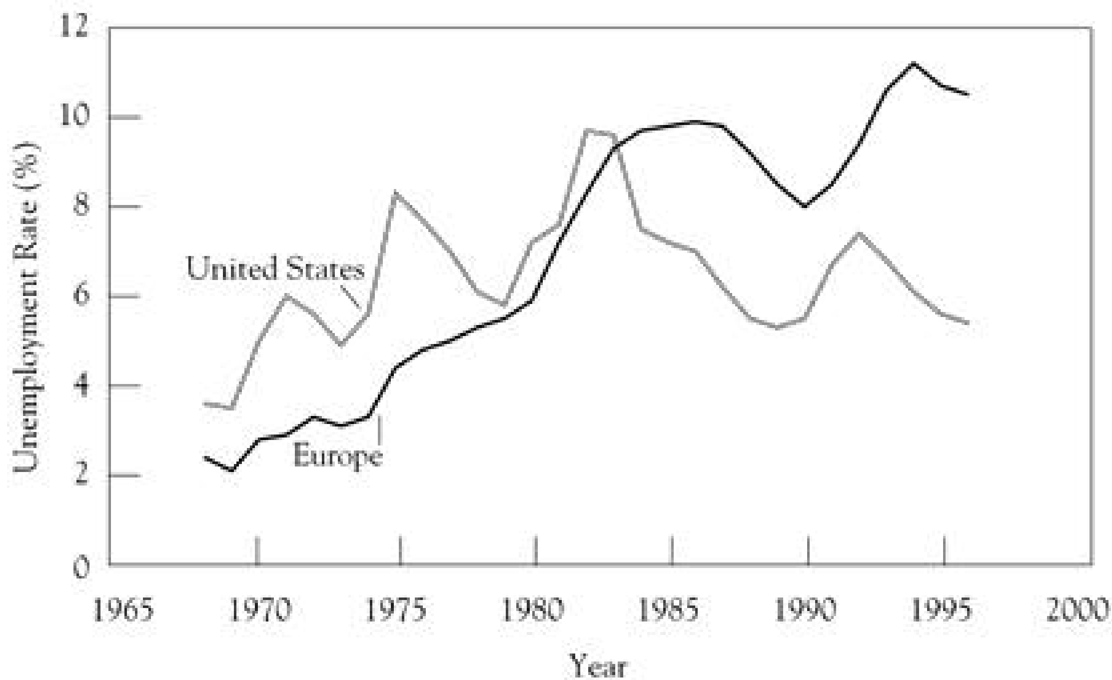
Over the last two decades virtually every western European nation has faced high and persistent unemployment. In frustration, many European nations have looked to the United States, with its lower unemployment rates, as a model of labor market flexibility. The U.S. model has become less attractive, however, as analysts have come to recognize the extent of rising wage inequality in the United States over the same period, including sharp declines in wages among the less skilled. In short, *both* Europe and the United States have faced serious labor market problems in recent years.

The U.S. and the European experiences demonstrate that there are no easy answers about how to operate a labor market that will generate plenty of jobs for younger and less-skilled workers and also offer workers the opportunity to earn enough to support a family. Good policy choices will require mixing some of the best aspects of labor market flexibility with well-run activist labor market and social protection policies.

The Story in Europe

European nations experienced a sharp rise in unemployment and a slowdown in growth in the mid 1970s, which became worse in many nations in the 1980s. High rates of unemployment persist (see Figure 1), with the share of workers out of work for 12 months up 30 to 50 percent in many nations (Blank 1995, Table 2).

Figure 1 Unemployment in Europe and the United States



Source: U.S. rates based on data from *Economic Report of the President* (Washington, D.C.: U.S. Government Printing Office), various years; European rates based on data FROM *OECD Employment Outlook* (Paris: Organization for Economic Cooperation and Development), various years.

Initial explanations of high unemployment focused on the lack of labor market flexibility in Europe resulting from extensive labor market regulation and generous social assistance programs. Despite the uncertain economy, it was argued, wages stayed high because of protective legislation and rigid union rules. Employers refused to hire high-cost workers because severance protection made it costly or impossible to lay them off, and workers were content to remain out of the work force because they received generous and long-term unemployment compensation and other assistance (Bean, Layard, and Nickell 1987; Lawrence and Schultze 1987).[1]

Throughout the 1980s many nations tried to create greater flexibility in their labor markets by weakening protective legislation. For instance, Germany, France, the United Kingdom, and Belgium weakened their dismissal laws; Spain, the United Kingdom, and the Netherlands decentralized wage bargaining; and Italy eliminated automatic wage indexation (Organization for Economic Cooperation and Development 1990). Researchers found these policies had surprisingly few effects on labor market flexibility and employment. For instance, aggregate unemployment rates did not fall and there were no bursts of job growth or worker mobility (Blank 1994; Blanchflower and Freeman 1993; Atkinson and Mogensen 1993; and Buechtemann 1993). Although the changes enacted in the 1980s might have been too minor to make a difference, the small effect of efforts by European countries to create more flexibility suggests that the problems facing Europe's labor markets go beyond these countries' institutional structures and rules.

The Story in the United States

Through the mid 1980s the much less regulated labor markets and low unemployment rates in the United States appeared to provide a successful alternative model. By the late 1980s, however, a number of economic observers recognized that wage inequality had risen rapidly and real wages of less-skilled workers had fallen steadily since the early 1970s (Levy and Murnane 1992; Danziger and Gottschalk 1995). Between 1979 and 1993 real wages (wages adjusted for inflation) of full-time, male workers fell 22 percent for those without a high school degree, fell 12 percent for those with a high school degree, but rose 10 percent for those with a college degree (Blank 1997a). Female workers also saw dramatic increases in wage inequality, although the actual declines among the least skilled were not as extreme.

A "Unified Theory" of Links between U.S. and European Labor Market Problems

Increasingly, researchers are looking for possible links between rising inequality in the United States and high unemployment in Europe. For instance, changing patterns of international trade and changing technology will increase the demand for some groups of workers (especially the more skilled), while decreasing the demand for other groups (especially the less skilled). In the more open U.S. labor markets, these changes produce shifts in wages, leading to increasing inequality. In the more regulated European labor markets, employers adjust by changing their hiring and firing behavior, leading to increased unemployment. *A priori,* it is not clear whether the United States or the European model is preferable; they are simply different.

Let us call this story the "unified theory," since it suggests that both European and U.S. labor market problems are the result of the same fundamental changes in global economic forces. The best evidence in support of this theory is simply the timing of events, that is, European and U.S. labor market problems occurred at the same time. Other empirical evidence for the unified theory is admittedly mixed. The unified theory implies a trade-off between wage inequality and high unemployment: Countries with the most inflexible labor markets should experience the highest unemployment rates but the lowest rise in wage inequality and vice versa. The United States has experienced the greatest increase in wage inequality but little long-term increase in unemployment rates over the past 15 years, while some European countries have had high unemployment but no change in wage inequality. However, this reverse correlation between the two problems appears at best mild, and some European countries, most notably the United Kingdom, have experienced both problems (Freeman and Katz 1995).

Further evidence might be found by determining which group of workers is experiencing the biggest decline in relative wages in the United States and asking whether this same group is most affected by rising unemployment in European countries. In the United States it is clearly the less skilled who have seen the biggest wage declines, although wage inequality is rising within skill categories as well. In Europe unemployment rates are highest among the less skilled, but it is not clear that the relative unemployment rate of less-skilled workers has risen over time. In fact, only France, Italy, and Norway show big rises in unemployment among the least-skilled relative to more-skilled workers (Nickell and Bell 1995). In other countries unemployment among all groups has risen, so relative unemployment rates by skill remain largely constant. In general, European unemployment seems more focused by age than by skill level, with younger workers having experienced the biggest increases in unemployment. But this does not necessarily contradict the unified theory. Labor market protections that make it hard to fire older workers in Europe may have pushed an undue burden of unemployment onto younger workers of all skill levels as companies try to cope with changing competition and changing demand.

Researchers also have tried to test directly the extent to which direct changes in trade and technology feed through to the labor market (Allen 1996; Berman, Bound, and Griliches 1994). The evidence seems to suggest that changing technology has played a larger role than changing trade, although there remain serious problems in correctly characterizing technological change and in developing a fully satisfactory model of how trade changes flow through the entire labor market.

While there is much we still do not understand about the extent to which U.S. and European labor market changes are linked, it appears that a series of demand shifts have affected many of the most industrialized nations. Differences in how U.S. and European labor markets have responded to such shifts depend on each nation's institutional structure. Less regulated labor markets experienced greater changes in relative wages (Freeman and Katz 1994) than countries with centralized labor bargaining; [2] those with centralized bargaining maintained their relative wage structures, but many experienced high and sustained unemployment. Some of the labor market differences across countries can be explained by demographics (such as different age structure in the population) and by different patterns of labor force entry and exit among younger, older, and female workers.

Social protection programs have played a key role in offsetting the effect of labor market changes on workers' income and well-being. Countries with more redistributive programs have spread the economic costs of these changes more broadly within the economy. In fact, some evidence indicates that countries with more extensive social assistance programs experienced increases in unemployment that were spread more broadly across skill

levels, which suggests that countries may have distributional norms that affect corporate and public behavior beyond the explicit transfer systems that are in place. Within the United States the costs of these economic changes have been much more highly concentrated on a particular group of workers, with less relief provided by public transfer programs.

The unified theory approach clearly has limits in its ability to explain the unemployment or wage situation in any one country. Every industrialized country has faced its own unique set of economic and social forces over the past two decades, and those forces in combination with the country's response to them have shaped the economic reality of its workers. For instance, some countries' pursuit of strong macroeconomic and monetary policies to fight inflation has affected their unemployment and wage rates; significant immigration issues in other countries have affected unemployment and the distribution of jobs and wages. However, despite these limits, the theory still has relevance. It remains a useful exercise to stop asking what is different about the U.S. and the various European experiences and instead to ask what is similar about them.

Policy Implications

Changing labor markets have presented major challenges to policymakers in all countries, including increasing demands on public assistance programs. The initial approach taken by many nations to combat both labor market and public budget problems was simply to hope that they would go away and things would return to "normal." Unfortunately, but not surprisingly, this approach failed. The fundamental economic changes underlying these problems--changing technology and patterns of international trade--are unlikely to reverse themselves and may even accelerate in the foreseeable future.

Another possible approach is to try to insulate a country from these economic changes--for example, by imposing higher trade barriers or slowing down the adoption of new technologies--in an attempt to regulate labor market changes. Fortunately, few countries have chosen this route, although a vocal political minority in all industrialized countries continues to advocate it. As economists are famous for pointing out (often with annoying frequency), creating barriers to trade and economic change can produce negative long-run effects, such as limiting economic growth and job creation, and create long-run costs that are much greater than any short-run benefits such programs might produce.

To respond effectively to these problems, governments must confront them head-on, recognize that the problems have no quick and easy solution, and make long-run plans to offset and reduce their labor market effects. There is no "magic bullet" to do this, and no single remedy will work for all countries; each country must find a solution that works within its own set of political and economic institutions. The best approach is utilizing a mix of ideas from both the U.S. and the European experiences.

On the one hand, those who admire the flexibility of the U.S. labor market have some good arguments in their favor. Restrictions on employee hiring and firing can seriously limit an economy's ability to adapt to changing economic forces. In economies with historically extensive labor regulation, easing severance restrictions and increasing the ability of firms to hire part-time or temporary labor are almost surely necessary changes. On the other hand, along with flexibility must come the greater regulation and social assistance that has characterized the European labor market. There must be a greater willingness to redistribute the costs of that flexibility throughout the economy, rather than forcing it to be borne by particular groups of workers facing extended unemployment or falling wages. U.S. policymakers have been far too ready to shrug and say "That's just the result of the market" in the face of massive loss of earning power among less-skilled workers.

Countries should offset the costs of ongoing labor market changes through two types of policies: active labor market policies to raise wages and to find jobs for the unemployed and income redistribution policies to provide a social safety net. Many countries have experimented with a variety of active labor market policies such as job placement and training programs; subsidies and tax incentives for hiring disadvantaged workers; and public sector job creation, particularly for the long-term unemployed and younger workers who may have dropped out of the labor market entirely. These programs directly address some of the problems of low skills and inadequate access to jobs and also operate to redistribute some of the gains by the "winners" to the "losers."

There is plenty of evidence that these programs can have positive effects (U.S. Department of Labor 1995), but it is important to recognize that such effects are typically small. Traditionally, such programs have worked best when run on a small scale for targeted groups, but, according to most evaluations, training and job placement programs rarely lead to large increases in future income, and they make significant demands (in terms of participant cost and management expertise) on the public sector. Many such programs may be best operated by government in conjunction with the private sector (where management expertise is often greater).

Given the limits on the effects of active labor market policies, a reasonable social safety net also needs to remain in place. Without one, countries will face serious long-term consequences, such as increased underground economic activity, crime, drug use, family fragmentation, civic disconnection, and civic disorder--frequent outcomes when a share of the population is excluded from mainstream labor markets. Income supplementation can occur through traditional unemployment and public assistance subsidies or in more novel ways, such as the earned income tax credit, which has been shown to increase labor market participation among those initially out of the labor market (Eissa and Lehman 1995); public sector job programs to supplement income while still encouraging labor market activity; and partial unemployment payments, used in some European countries, to subsidize involuntary part-time workers. The appropriate level of such subsidies is always a contentious issue. The United States has been in the midst of a debate about whether its social assistance programs are too generous, while European countries have made major changes in some of their programs and in their unemployment benefit systems. Setting limits on access to cash support may be a fiscal necessity, but if at all possible, setting such limits should coincide with active labor market policies.

There is no reason to believe that the problems of wage inequality and unemployment in U.S. and European labor markets will reverse soon. There are no obvious solutions to the problems of unemployment and wage declines in the short-run, only ways to soften their effects. Europe has found no effective ways to lower youth unemployment rates, just as the United States has found no effective ways to prevent wage declines among the less skilled. Those who favor enough labor market flexibility to give workers incentives to invest in new skills, change jobs, or relocate must also indicate how to deal with the substantial portion of the population facing permanently lower wages and reduced incentives to participate in mainstream labor markets. Those who favor labor market regulation and redistribution to provide more job protection and greater wage equality must indicate how to deal with the large number of long-term unemployed. A better response is not to view policy as a choice between two opposing models, but to try to meld the best parts of a flexible private labor market with an effective set of active labor market and social protection policies.

Notes

1. For other related explanations of high European unemployment, see Blank (1997b).

2. It is worth noting that only in the United States have there been actual declines in real wages among workers. In other countries where inequality has grown, it is because the wages of more-skilled workers have risen faster than the wages of those at the bottom of the wage distribution.

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