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The Unemployment Problem in Europe: Lessons from Implementing the OECD Jobs Strategy

JØRGEN ELMESKOV

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The Unemployment Problem in Europe: Lessons from Implementing the OECD Jobs Strategy

JØRGEN ELMESKOV*

*Conseillor for Structural Policy, Economics Department, OECD, Paris.

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BADIA FIESOLANA, SAN DOMENICO (FI)

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High and persistent unemployment is a key policy issue in many OECD countries, particularly in Europe. Many initiatives have been taken to reduce this problem. In 1994, the OECD launched the OECD Jobs Study, which contained both a thorough analysis of the issue and a comprehensive set of policy recommendations for dealing with it. This paper[1] reviews the experience countries have had with implementing policies to reduce unemployment. As a background to this, it first presents a brief review of unemployment and wage developments as well as an overview of the OECD Jobs Strategy.

Unemployment, Wages and the OECD Jobs Strategy

There may not be much which is particularly European about the unemployment problem in Europe. That is not to say that cultural backgrounds and norms play no role. But it is probably the case that if European labour market institutions and European macroeconomic and structural policies had been in place in other corners of the world, then unemployment would have been a problem there as well[2]. That also means that it is important to look beyond Europe both to identify the mechanisms that have created high European unemployment and to look for policies which may help to bring European unemployment down. In what follows, this paper therefore draws on experience in European as well as non-European OECD countries.

Much research has been made on unemployment and a lot of statistics are available. Presenting a brief review of unemployment is therefore a selection process, which in this case has led to a focus on six features.

---

1) The views expressed in this paper are those of the author and do not necessarily represent those of the OECD or its Member governments. This paper draws heavily on Elmeskov (1998).

2) In a comprehensive cross-country/time series study of unemployment and its determinants, Scarpetta (1996) tried to identify outlying observations which did not fit the estimated general pattern of links between unemployment rates and determinants. Both this analysis and a look at the estimated country-specific unemployment components indicated little systematic difference between European and non-European countries.

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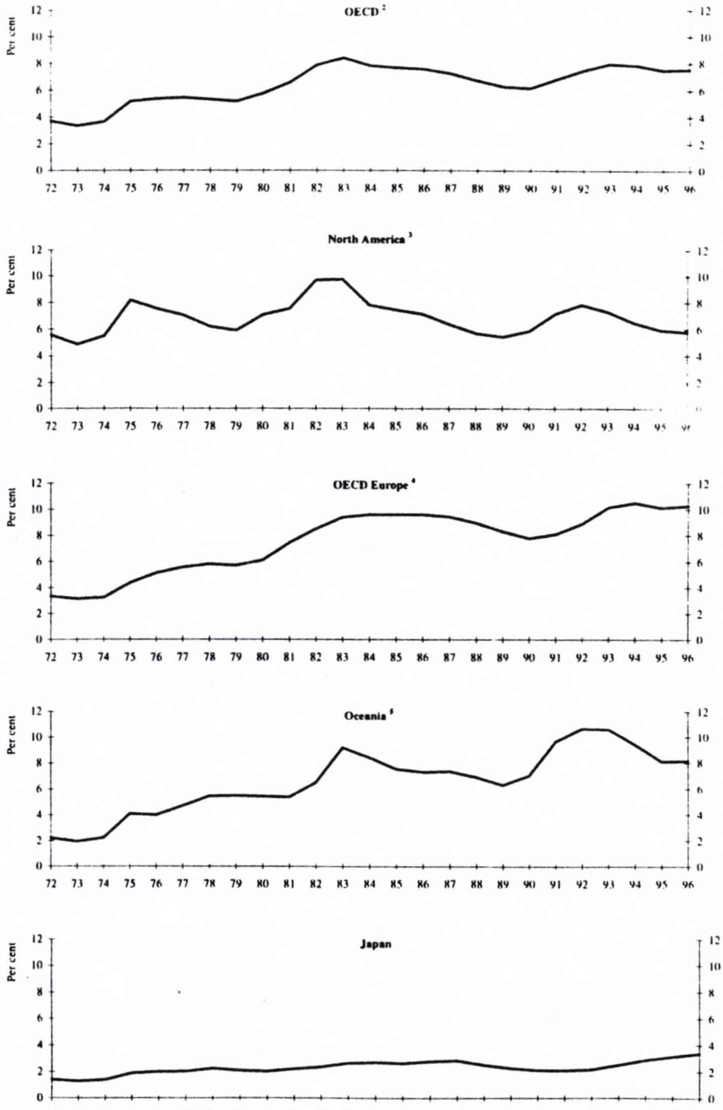
Figure 1. **Standardised unemployment rates in OECD regions, 1972-96**[1]



Notes

1. Standardised unemployment rates for all countries except for Austria, Denmark, Greece, Iceland, Luxembourg and Turkey. Data for 1996 are OECD estimates.
2. Excluding Czech Republic, Hungary, Korea, Mexico and Poland.
3. United States and Canada.
4. EU15, Iceland, Norway, Switzerland, and Turkey.
5. Australia and New Zealand.

Source: OECD Labour Force Statistics

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First, high and rising unemployment has been a particular problem in Europe (Figure 1). Some of the non-European OECD countries have managed to preserve low and/or unchanged unemployment over the last two to three decades. This is notably the case for the two large ones, United States and Japan. However, there are also European countries, such as Norway, where unemployment has remained relatively low for many years. Noteworthy is also the tendency for unemployment to rise rapidly in downturns but to fall back only slowly thereafter -- a time series feature which is common across most regions but most pronounced in Europe, where some recoveries made hardly any impact on unemployment.

Second, unemployment is predominantly structural even if there are significant cyclical components in some countries (Figure 2). By their nature, estimates of structural unemployment are subject to both numerical and conceptual uncertainties, and the OECD indicator is only one among many (its derivation is described in Box 1). Nevertheless, it is noticeable that changes in estimated structural unemployment rates have generally gone together with corresponding movements in a range of other labour market indicators such as long-term unemployment, the number of discouraged workers and employment rates (Figure 3). Moreover, comparison with other time-varying indicators of structural unemployment in most cases show relatively high correlations (Elmeskov, 1993)[3].

3) Holm and Somervuori (1997) argue that in the case of Finland the short-term NAWRU estimate deviates significantly from their estimate of a time-varying long-term equilibrium rate of unemployment. For countries such as Finland and Sweden, which experienced very abrupt increases in actual unemployment in the beginning of the 1990s, uncertainties about the level of structural unemployment are particularly large.

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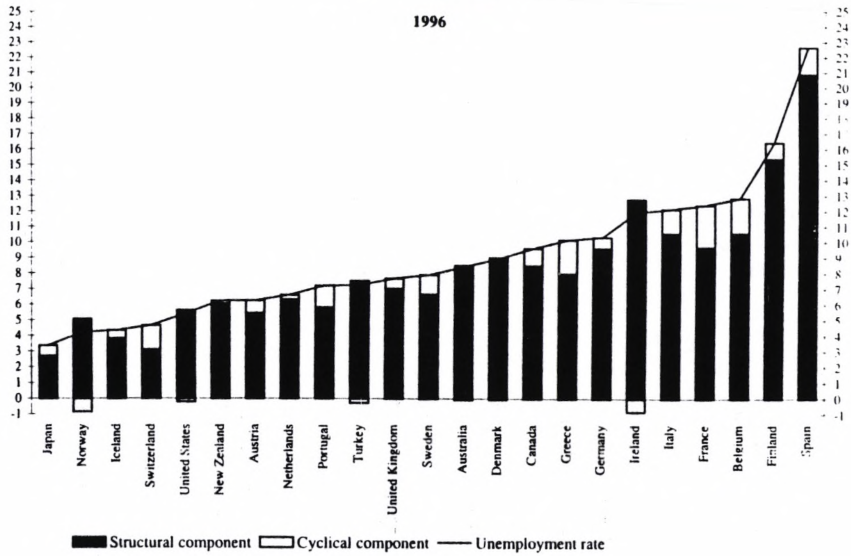
Figure 2. **Structural and cyclical components of unemployment rates**[1]

Per cent of total labour force



Note:

1. Based on national unemployment definitions. Structural unemployment data are based on Secretariat estimates of the non-accelerating wage rate of unemployment (NAWRU) made for the *OECD Economic Outlook*, 60, 1996.

Source: OECD Secretariat.

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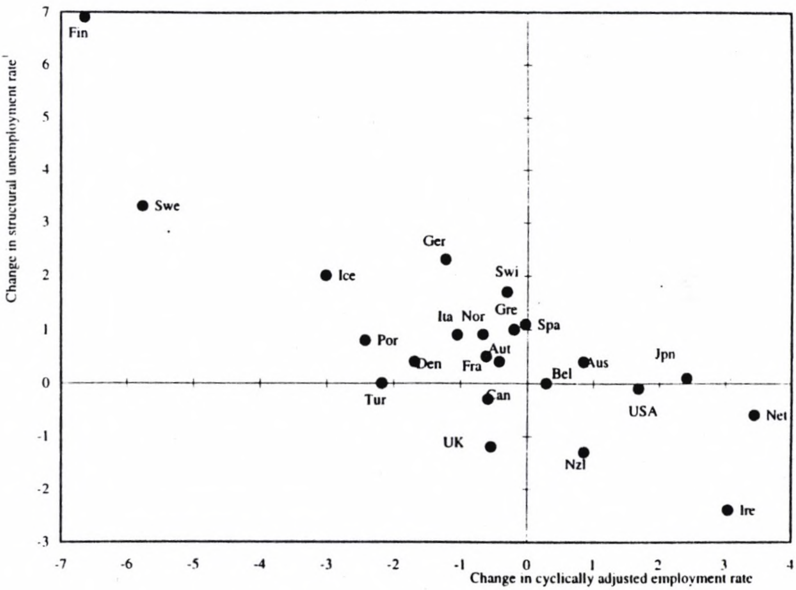
Figure 3. **Change in structural unemployment and employment rate, 1990-95**
(percentage points)



Note:

1. Structural unemployment data are based on Secretariat estimates of the non-accelerating wage rate of unemployment (NAWRU) made for the *OECD Economic Outlook*, 60, 1996.

Source: OECD Secretariat.

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Box 1. The OECD indicator of structural unemployment

The OECD indicator of structural unemployment is based on the notion of a non-accelerating wage rate of unemployment (NAWRU). Estimates are derived under the assumption that changes in wage inflation are proportional to the gap between actual unemployment and the NAWRU:

$$D^2 \log W = -\alpha \cdot (U\text{-NAWRU}); \alpha > o$$

where D is the first-difference operator, and W and U are levels of wages and the unemployment rate, respectively. Using consecutive observations, and assuming the NAWRU to be constant between two consecutive years, an estimate of α can be calculated as:

$$\alpha = -D^3 \log W/DU$$

which yields an estimate of the NAWRU as

$$NAWRU = U - (DU/D^3 \log W) \cdot D^2 \log W.$$

Conceptually, the NAWRU estimated in this way is a short-run concept, i.e. it indicates the rate of unemployment which, in a given year and based on the actual history of unemployment, would be associated with a constant rate of nominal wage increases[1]. In practice, the OECD indicator of structural unemployment takes into account not only the (suitably smoothed) "mechanical" estimates based on the above method but also the views of country experts (Giorno et al., 1995).

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1) In the presence of speed-limit effects or slow adjustment, a lower (or higher) rate of unemployment may be associated with stable wage inflation in the long run, but this rate of unemployment cannot be reached in the short term without setting off changes in inflation.

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Third, high unemployment is usually accompanied by a high share of long-term unemployment (Figure 4). This suggests that high unemployment is associated with marginalisation of the unemployed. There is evidence to suggest that the long-term unemployed exert less downward pressure on wages than people who have recently become unemployed (Elmeskov and MacFarlan, 1993). It is also noticeable that the risk of becoming unemployed is actually higher in the United States, with relatively low unemployment, than it is in Europe with relatively high unemployment. This reflects that once people become unemployed in Europe there is a much bigger risk of becoming stuck in that situation.

Fourth, in much of Europe high unemployment also goes together with weak employment for marginal groups on the labour market. For example, employment rates for young workers and for older adults are comparatively low. In the latter case, this reflects inter alia the proliferance of early retirement and similar schemes. By contrast, employment rates for men between 25 and 54 years of age, which are often taken to be a core group on the labour market, vary much less across countries and regions.

Fifth, unemployment rates are disproportionately high for low-skilled workers. This is the result of a long-term trend away from the use of low-skilled labour which, however, has been partly offset by a relative decline in supply (see e.g. OECD, 1997a). The trend towards declining demand for low-skilled workers has sometimes been linked with trends towards globalisation and technological change[4].

Sixth, there seems to be a link across countries between unemployment and participation rates: where unemployment is high, participation is low (Figure 4). Thus, the unemployment rate shows only part of the employment problem -- the rest is hidden both in various schemes such as early retirement, invalidity etc., but also in people being discouraged from entering the labour force. At present, some countries, including the United States, Japan, Iceland, Norway and Switzerland combine low unemployment with high rates of labour force participation. By contrast, France, Italy, Belgium, Spain and, despite strong recent improvements, Ireland share with some of the transition economies the combination of high unemployment and low labour force participation. Other countries are in intermediate positions.

---

4) This is particularly so because relative wage developments appear unable to explain the shift in labour demand. Evidence on the influence of globalisation and technological change mostly suggests that the former played a relatively limited role compared to the latter, but a great deal of uncertainty remains in this area (see e.g. OECD, 1997a; Lawrence, 1996).

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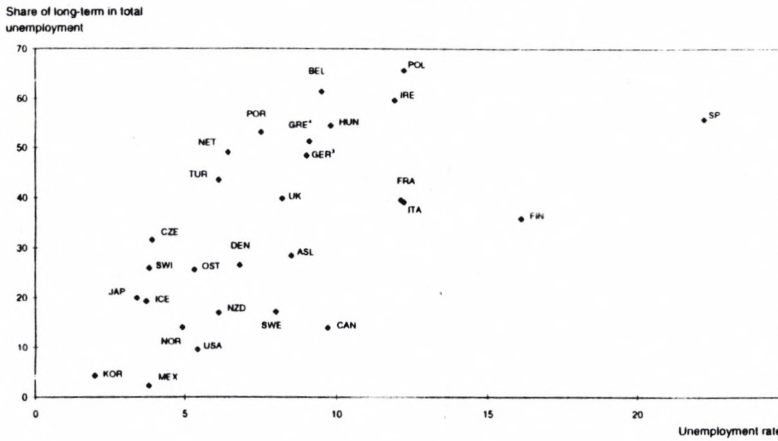
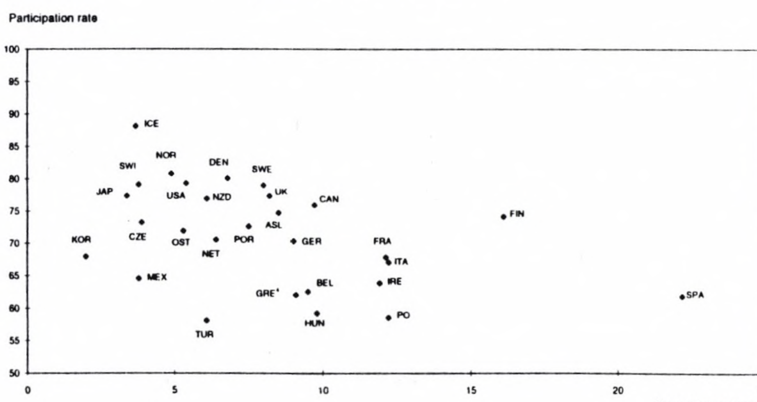
Figure 4. **Unemployment, long-term unemployment [1] and labour force participation [2] 1996**

Per cent

A. Unemployment and the incidence of long-term unemployment



B. Unemployment and labour force participation



1. Long-term unemployment is defined as 12 months and over.
2. Labour force as a share of total population 15-64 years.
3. Data for long-term unemployment in Germany refer to 1995.
4. Data for Greece refer to 1995.

Source: OECD *Employment Outlook*, 1997

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These six main features of unemployment do not permit any simple diagnosis of the problem. Nevertheless, they are not inconsistent with the view that insider-outsider distinctions play a significant role together with influences on demand and supply of low-skilled labour.

Wage developments in the United States and Europe have also differed significantly. As concerns aggregate wages, real compensation rose rapidly in Europe over the last couple of decades while it broadly stagnated in the United States. To some extent this difference reflected higher productivity growth in Europe. But the reverse causality was probably also important. That is, higher real wage growth forced firms to rationalise and forced low-productive firms and workers out of production[5]. As concerns relative wages, there has been broad stability of wage dispersions in continental Europe but significant widening in the United States, the United Kingdom and some other countries (see e.g. OECD, 1997b). In the United States, widening wage dispersion in a context of broad stagnation of average real wages implied that those at the bottom suffered real cuts in pay. This development gave rise to the discussion about the 'working poor', even if poverty in all countries is linked predominantly to people not being employed[6].

Against this background, the Jobs Study proposed a balanced and wide-ranging set of policy recommendations to reduce unemployment, raise employment and increase prosperity (see Box 2). These recommendations aim, on the one hand, to raise the ability of economies to adjust and to adapt to new developments, including cyclical variations as well as trends towards globalisation and technological change, and, on the other hand, to increase their knowledge base and innovative capacity.

Box 2. The OECD Jobs Strategy

1. Set macroeconomic policy such that it will both encourage growth and, in conjunction with good structural policies, make it sustainable, i.e. non-inflationary.
2. Enhance the creation and diffusion of technological know-how by improving frameworks for its development.

5) See e.g. the discussion in International Monetary Fund (1996).

6) Poverty rates after taxes and transfers for individuals living in households without employed adults vastly exceed those for individuals in households with at least one employed adult (OECD, 1997c).

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3. Increase flexibility of working-time (both short-term and lifetime) voluntarily sought by workers and employers.
4. Nurture an entrepreneurial climate by eliminating impediments to, and restrictions on, the creation and expansion of enterprises.
5. Make wage and labour costs more flexible by removing restrictions that prevent wages from reflecting local conditions and individual skill levels, in particular of younger workers.
6. Reform employment security provisions that inhibit the expansion of employment in the private sector.
7. Strengthen the emphasis on active labour market policies and reinforce their effectiveness.
8. Improve labour force skills and competences through wide-ranging changes in education and training systems.
9. Reform unemployment and related benefit systems -- and their interactions with the tax system -- such that societies' fundamental equity goals are achieved in ways that impinge far less on the efficient functioning of the labour markets.
10. Enhance product market competition so as to reduce monopolistic tendencies and weaken insider-outsider mechanisms while also contributing to a more innovative and dynamic economy.

Since the publication of the Jobs Study, work at the OECD has continued on two tracks. First, a number of thematic reviews by the OECD Secretariat have further explored appropriate policy orientations in specific fields[7]. Second, the Economic and Development Review Committee (EDRC) has been mandated by OECD Ministers to examine the implementation of the OECD Jobs Study recommendations in individual Member countries[8]. Based on the EDRC review process, but drawing also on thematic reviews and recent work by the OECD Secretariat, the remainder of this paper presents the key lessons learned from the country-specific work.

7) The OECD Secretariat reports on four thematic reviews were presented to the OECD Ministerial Council Meeting in May 1996. They are: **Enhancing the effectiveness of active labour market policies**; **Making work pay: A thematic review of taxes, benefits, employment and unemployment**; **Interactions between structural reform, macroeconomic policy and economic performance**; and **Technology, Productivity and Job Creation**. A fifth thematic review is under way on policies to enhance **entrepreneurship**.

8) The results of this work have been published in **OECD Country Surveys**.

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Main Lessons from Implementing the Jobs Strategy

Overall, the EDRC reviews of Member countries' experience with implementation of the OECD Jobs Strategy give rise to both hope and caution. A clear message from the review process is that comprehensive reforms along the lines of the recommendations in the OECD Jobs Study are capable of expanding employment opportunities and reducing structural unemployment. However, only a few countries have introduced and sustained policy reforms in a sufficiently wide-ranging and consistent way to achieve such an improvement in labour market performance. This is partly because implementing the OECD Jobs Strategy sometimes involves difficult trade-offs between different policy concerns. Moreover, special interest groups often put up strong resistance to needed reforms. In what follows, the discussion of the main lessons learned from the EDRC country review process has been organised under the six broad headings identified by the OECD Secretariat in OECD (1997b).

1. High and persistent unemployment has been the result of both conjunctural and structural forces, and it can be durably reduced

As shown previously, unemployment in the OECD area as a whole rose over the period 1990-96 from its already high level at the end of the previous decade. Based on OECD Secretariat estimates, most of this increase was cyclical, but structural unemployment may also have gone up. Area-wide developments mask considerable differences across individual Member countries (Figure 5). In part, this reflects different cyclical positions. But structural unemployment rates have also shown diverse trends (Table 1), often moving in the same direction as actual unemployment rates.

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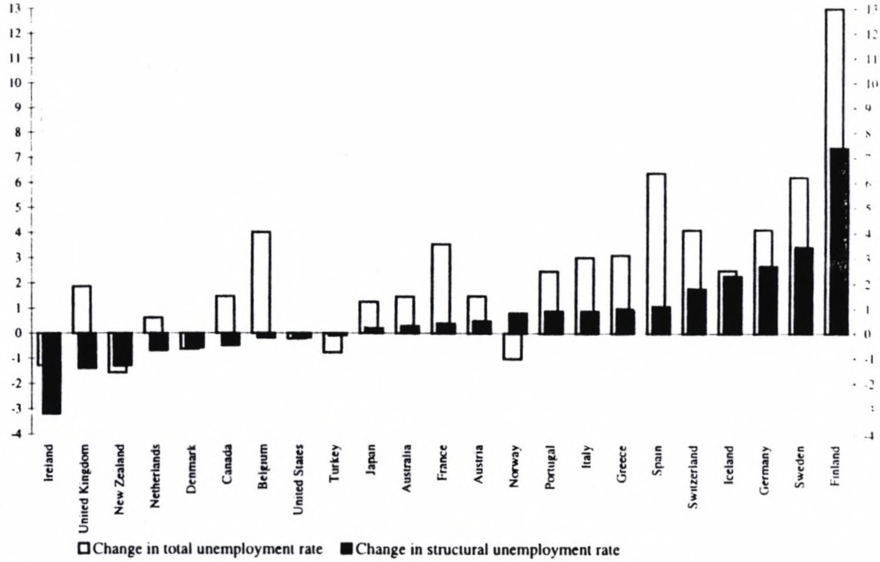
Figure 5. Changes in **structural and cyclical components of unemployment rates**[1]

Per cent of total labour force



Note:

1. Based on national unemployment definitions. Structural unemployment data are based on Secretariat estimates of the non-accelerating wage rate of unemployment (NAWRU) made for the *OECD Economic Outlook*, 60, 1996.

Source: OECD Secretariat.

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Table 1. **Structural unemployment in the OECD countries, 1986-96**[1]

As a per cent of total labour force

In the nineties the structural unemployment rate has ...		1986	1990	1996
... increased:	Finland	5,5	8,0	15,4
	Sweden	2,1	3,2	6,7
	Germany	7,3	6,9	9,6
	Iceland	0,8	1,5	3,8
	Switzerland	0,7	1,3	3,1
	Spain	19,1	19,8	20,9
	Greece	6,7	7,0	8,0
	Italy	8,4	9,7	10,6
	Portugal	6,1	4,9	5,8
	Austria	4,1	4,9	5,4
	France	8,9	9,3	9,7
... remained fairly stable:	Norway[2]	3,1	4,2	5,1
	Australia	8,1	8,2	8,5
	Japan	2,5	2,5	2,7
	Turkey	7,5	7,6	7,5
	United States	6,2	5,8	5,6
	Belgium[3]	11,7	10,8	10,6
	Canada[2]	8,3	9,0	8,5
	Denmark[2]	8,6	9,6	9,0
... decreased:	Netherlands	8,0	7,0	6,3
	New Zealand	4,7	7,3	6,0
	United Kingdom	10,2	8,4	7,0
	Ireland	15,3	16,0	12,8
	OECD structural unemployment rate[4]	7,0	6,8	7,1
	OECD actual unemployment rate[4]	7,7	6,1	7,7

Notes:

1. Based on national definitions of unemployment. Structural unemployment data are based on Secretariat estimates of the non-accelerating wage rate of unemployment (NAWRU) made for the OECD *Economic Outlook*, 60, 1996. A change is considered significant (in absolute terms) if it exceeds one standard-deviation. The latter was calculated for each series and country over the 1986-96 period.
2. Canada, Denmark and Norway had an increasing structural unemployment rate in the late 1980s up to the beginning of the 1990s.
3. Belgium had a decreasing structural unemployment rate in the second half of the 1980s.
4. Weighted averages of the countries reported in the table.

Source: OECD Secretariat.

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Among individual countries, already high structural unemployment appears to have risen further over the 1990s in Spain, Italy and, to a minor extent, France. In Finland and Sweden, structural unemployment has risen abruptly from previous low levels. A number of other small European countries with traditionally low unemployment rates also recorded increases in structural unemployment. Some countries, including the United States, Japan and Norway, have managed to keep structural unemployment steady at a relatively low level. The most encouraging new developments were registered in the United Kingdom, Ireland, Netherlands and New Zealand, where falls in structural unemployment rates either began or continued in the course of the 1990s[9], [10]. In a context of worries about European unemployment, it is notable that three of these four countries are European.

2. Many countries have made progress in implementing the Jobs Strategy, but progress has been uneven both between countries and between different areas of policy

Developments in structural unemployment over the 1990s to a large extent reflect the progress made in implementing the OECD Jobs Strategy. Some OECD countries had introduced a number of main recommendations of the OECD Jobs Study well before the completion of the study. Indeed, the United Kingdom and New Zealand have pursued both wide-ranging and deep structural reforms, beginning already in the early to mid-1980s. These are also among the countries where the estimated rate of structural unemployment has fallen significantly -- since the second half of the 1980s in the United Kingdom, which began earlier to introduce structural reform, and since the early 1990s in New Zealand. Based on a more gradualist approach, the Netherlands has also pursued a comprehensive reform programme starting in the first half of the 1980s, with

9) Statistical tests reported in OECD (1997b) suggest that the decline in structural unemployment over the period 1990–96 in these four countries is significant and tests based on trends in actual unemployment tend to confirm this impression. Falls in Danish and Canadian structural unemployment rates of about ½ percentage point were not statistically significant but may become so if, as seems likely, trends towards decline continue beyond the observation period.

10) Recently, there has been some discussion as to whether the Netherlands should be regarded as an example of successful policy adjustment given, not least, its relatively high level of non-participation in the labour force (e.g. McKinsey Global Institute, 1997). However, as discussed in OECD (1997b) there seems to have been a notable improvement in the labour market situation, even if levels of inactivity, and in particular levels of invalidity, remain high. The assessment, thus, depends in part on whether the focus is put on levels or first differences of indicators such as unemployment and employment rates.

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positive results in the form of falling structural unemployment since the second half of that decade. In Ireland, macroeconomic stabilisation began in the first half of the 1980s, while structural changes commenced in the second half of the 1980s; structural unemployment has declined during the 1990s. These experiences suggest that, even where policies are reformed over a broad range, lags may be considerable between the introduction of reform and the subsequent improvement of labour market performance.

The reform processes in these four countries share a number of common features[11]. One is that they were all initiated at a time when serious economic disequilibria had made it clear that existing policies could no longer be sustained. Another is that all four countries put in place macroeconomic frameworks focused on sound public finances and effective control of inflation. Even though the countries were not always successful in implementing these frameworks, by 1996 Ireland, the Netherlands and New Zealand combined inflation below 2 per cent (measured by the GDP deflator) with general government balances which were either in surplus (New Zealand) or had deficits of less than 3 per cent of GDP. Nevertheless, reform processes also differed between these countries, reflecting different starting positions, not least as regards structural policies. Examples include:

- The Netherlands where high labour costs, including very high payroll taxes, were perceived as a problem, focused on achieving general wage moderation through centralised bargaining and tax reductions, restrictions on social transfers, lowering minimum wages, including in particular for young workers, and scaling back payroll taxes, especially on low-wage groups.

- The United Kingdom had a heritage of nationalised industries and troubled labour relations and gave priority to product market reform, including privatisation, and reform of industrial relations.

- New Zealand, which was arguably among the most protectionist OECD countries at the beginning of the 1980s, gave early priority to trade liberalisation and reduced government intervention in its comprehensive reform programme[12].

- Ireland, which was faced with a dependency problem, in the presence of unemployment and poverty traps due to interaction between the tax and transfer systems, and had a tradition of weak education effort, has taken

11) Main elements of reforms are described in the relevant **OECD Economic Surveys**.

12) An overview of the New Zealand reform process is presented in Atkinson (1997).

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action to lower the generosity of unemployment benefits, reduce marginal effective tax rates and improve human capital formation.

More recently, Canada and Australia have carried out significant and wide-ranging reforms, but the results are yet to be seen. In other countries, reforms have typically been less wide-ranging though individual reforms have sometimes been significant. In some countries, including Germany, France, Italy and Belgium, political constraints prevented greater breadth and/or depth of reform (see below).

In the United States, Japan and Norway, policy settings prevented a significant rise in structural unemployment from occurring in the first place. Arguably, the three countries managed to maintain low unemployment because policies in important respects followed the main thrust of the OECD Jobs Strategy, though with clear differences of emphasis between the countries. Thus, the United States has traditionally operated and adapted its structural policies so as to be consistent with flexible labour and product markets while also placing emphasis on macroeconomic policies geared towards sustainable high employment. In Japan, institutional features have allowed high flexibility of wages and working hours at the same time as favouring geographical mobility and functional versatility of labour within enterprises. And in Norway, macroeconomic stability has been given priority, against the background of the flexibility provided by oil and gas revenues, and emphasis has been given to human capital formation. Nonetheless, even in these three cases, areas in which policy can be improved were identified by the EDRC.

At the same time as initial, and different, starting positions of countries have conditioned progress in the 1990s in implementing the Jobs Study recommendations, reform efforts in different areas have met with varying degrees of political resistance across countries. Partly as a result, progress within specific structural policy areas has differed considerably from country to country (Box 3). Hence, it is difficult to draw strong, OECD-wide conclusions about reforms in specific areas in the 1990s.

Box 3. Prominent structural policy reforms in the 1990s[1]

For each of the main structural policy fields comprised under the OECD Jobs Strategy, this box presents some of the most significant policy developments so far in the 1990s:

- **Transfers and taxes.** Unemployment benefit support levels or effective durations have been cut back in the United Kingdom, Austria, Denmark, Ireland, the Netherlands, Spain and Sweden, whereas the generosity of unemployment and related welfare benefits was increased in Italy, Greece, Iceland and, to some extent, Switzerland. No other countries

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made significant changes to these parameters but many countries tightened eligibility, availability or willingness-to-work requirements, as well as rules concerning temporary layoffs. Invalidity schemes have been tightened in Italy, the Netherlands and Norway. Possibilities for retirement before the statutory retirement age have been tightened in France, Italy and Greece, while in a number of countries decisions have been taken or are under implementation to raise standard retirement ages (Germany, Italy, United Kingdom, Australia, Belgium, New Zealand, Portugal, Switzerland). Action has been taken to reduce high marginal effective tax rates on low incomes in France, the United Kingdom, Canada, Australia, Denmark, Ireland, the Netherlands, New Zealand and Sweden, while measures to reduce unemployment traps through the use of employment-conditional benefits were introduced or expanded in the United States, the United Kingdom, Canada, Australia, Ireland and New Zealand. The average tax wedge on production workers was reduced in the Netherlands, Turkey and, to a smaller extent, Norway but significantly increased in Australia, Finland and Greece. Within an overall unchanged tax wedge, there was a shift away from payroll taxes in France and Sweden, but in the opposite direction in Denmark.

- **Employment protection legislation.** The United Kingdom, Portugal and Spain significantly eased employment protection for permanent workers, with further, future easing agreed between the social partners in the latter country. In contrast, the legislation became tighter in France and Luxembourg. Germany and Australia first tightened and then relaxed these policies. Italy, Spain and Sweden allowed the use of temporary work agencies, while restrictions on fixed-term contracts were eased in Belgium and tightened in Spain.

- **Wage formation.** The most comprehensive liberalisation of the industrial relations framework resulted from implementing the Employment Contracts Act in New Zealand in 1991. In contrast, wage formation in Belgium has become increasingly influenced by government intervention. Most countries have made little change to industrial relations frameworks though Australia is in the process of implementing significant reforms with the aim of making wage formation more decentralised. A number of European countries have pursued tripartite agreements. Significant relative reductions in legal minimum wages have taken place in the Netherlands and New Zealand. France, Belgium and the Netherlands have significantly reduced non-wage labour costs for low-wage workers. Some countries have taken action towards establishing identical industrial relations frameworks in the public and private sectors (Italy, United Kingdom, Australia and New Zealand) and to ensure similar patterns of wage formation (Italy, New Zealand, Sweden).

- **Working-time flexibility.** Regulations restricting unusual working hours were eased in France, Italy, Finland, Greece and Spain, but measures to discourage overtime were introduced in France and Finland. At the same time an overall maximum on weekly work hours was enacted at the EU level and, by extension, in the non-EU members of the EEA. Regulation concerning part-time work was eased in France, Italy, Austria, Greece and Spain and tax incentives for part-time work have been given in France, Italy and Spain.

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- **Active labour market policy.** Emphasis on job-search assistance has generally gained in importance in English-speaking countries, Austria, Belgium and Switzerland but increased caseloads have made it difficult to maintain traditionally high ambitions in this area in some Nordic countries. In a major innovation, the market for mployment services has been made fully contestable in Australia and public monopolies on job placement services have been eliminated in Germany, Austria, Denmark and Finland.

- **Education and training.** The length of compulsory education has been extended in Belgium, Iceland, Mexico, New Zealand and Norway, while national testing at key stages has been introduced in France, England, New Zealand, Sweden and Spain. Curricula and school governance have been reformed in several countries, while the United Kingdom and New Zealand have introduced greater freedom in choice of school. Various steps to strengthen vocational education have been taken in English-speaking countries, Japan, France, Italy, Austria, Finland, Netherlands, Norway, Portugal, Spain and Switzerland. In recognition of the investment aspect of higher education, tuition fees in public universities have been raised in the United States, Australia and New Zealand, but they have been abolished in Ireland. Denmark, Spain and Sweden have strengthened adult education.

- **Product market competition.** The creation and deepening of regional trade blocks, including NAFTA, the EU Single Market and the customs union between the EU and Turkey, together with further trade liberalisation as a result of the Uruguay Round, increased competition from imports in almost all OECD countries, and unilateral reductions of trade barriers took place in Australia, New Zealand and Switzerland. Various aspects of competition law were strengthened in a large number of countries. Measures to ease general licensing requirements have been taken in the Netherlands and barriers to inter-regional competition are being lowered in Canada, Australia and Switzerland. Retail competition has been strengthened by less restrictive shop-opening hours (Germany, Italy, Austria, Denmark, Greece, Netherlands) and an easing of restrictions on large-scale stores (Japan), though France has tightened the latter type of regulation. Competition in the financial sector is due to increase in Japan, Mexico and EU countries, while some liberalisation of professional services has taken place in Australia and Ireland. Early liberalisation steps have been taken in telecommunications (United States, United Kingdom, Australia, Finland, Sweden), electricity (United Kingdom, Australia, Finland, Norway, Sweden) and railways (Germany, United Kingdom, Denmark, Mexico, Sweden), and EU-wide liberalisation is taking place in telecommunications, airlines and electricity sectors.

- **Innovation and technology.** Japan, Denmark, Finland and the Netherlands have taken steps to increase public R&D spending, whereas measures to increase the efficiency of spending have been taken in the same countries and in the United States, the United Kingdom, Austria, Norway and Sweden. Tax incentives for private R&D activity have recently been increased or amended to increase their efficiency in Canada, Australia and the Netherlands. A number of countries have taken initiatives to improve the provision of finance for innovation through development of venture capital markets. Japan has strengthened its system of intellectual property rights, and the GATT agreement in 1994

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included a significant step towards the establishment of international minimum standards of patent protection.

- **Entrepreneurship.** Germany, Mexico and the Netherlands have taken measures to reduce "red tape" for business start-ups and Germany has also extended exemptions for very small companies from employment protection requirements. Measures to ease financing constraints for small and medium-sized companies have been taken in Japan, Germany, France, Italy, the United Kingdom, Canada, Australia, Austria, Belgium, Finland, the Netherlands, New Zealand, Norway and Sweden. In Germany, France and Austria, steps have been taken to strengthen links between SMEs and research centres.

1) Only reforms introduced or decided until summer 1996 are considered. A much more extensive overview of policy reforms in the 1990s is presented in OECD (1997b).

Nevertheless, in a number of policy areas, most countries have shied away from pursuing policy reforms which would directly and negatively affect core groups on the labour market and have instead relied on other adjustments:

- Few countries have cut replacement rates or maximum durations of unemployment benefits more than marginally whereas many have tightened benefit administration and eligibility rules, which are more likely to affect marginal groups on the labour market (Table 2).
- Though some action has been taken to weaken general employment protection legislation, countries have generally shown greater willingness to introduce and liberalise fixed-term contracts and job protection for part-time workers and workers in small firms, which also affect mainly marginal groups.
- Some governments have focused on increasing product market competition in order to increase market pressures for more flexible labour market regulations and practices rather than aiming to reform the latter directly.

To some extent, the countries which have seen significant reductions in structural unemployment are the ones which have managed to introduce reforms that affected also labour market insiders[13].

13) For example, among the countries which experienced falling structural unemployment, both the Netherlands and the United Kingdom cut maximum benefit duration whereas Ireland abolished earnings-related benefit schemes.

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Table 2. Evolution of unemployment benefit systems over the 1990s

	Summary measure of gross replacement rates[1] 1991	1995	Tighter work availability requirements and enforcement[2]	Tighter eligibility requirements[2]
United States	11.1	11.8	=	=
Japan	9.9	9.9	=	=
Germany	28.1	26.4	X	=
France	37.2	37.5	=	X
Italy	2.5	19.7	X	=
United Kingdom	17.5	18.1	X	X
Canada	27.8	27.3	X	X
Australia	26.5	27.3	X	X
Austria	31.0	25.8	X	=
Belgium	42.3	41.6	X	X
Denmark	51.9	70.3	X	X
Finland	38.8	43.2	=	X
Greece	17.1	22.1	=	=
Ireland	29.3	26.1	X	=
Netherlands	51.3	45.9	X	X
New Zealand	30.4	29.8	X	X
Norway	38.8	38.8	=	X
Portugal	34.4	35.2	=	=
Spain	33.5	31.7	X	X
Sweden	29.4	27.3	X	=
Switzerland	21.9	29.5	X	X

Note:

1. Benefit entitlements before tax as a percentage of previous earnings before tax. Data shown are averages over different earnings levels, length of unemployment spells, and family situations. The index does not take into account social assistance at the regional or local level. For further information and comparison with other indicators of generosity, see Martin (1996).
2. X denotes that the country has taken action; = means no action

Source: OECD Database on Unemployment Benefit Entitlements and Replacement Rates; *OECD Economic Surveys*.

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3. The central issue dividing the more comprehensive reformers from the less comprehensive is differences in judgement about potential conflicts between better labour market performance and concerns for equity and social cohesion

A key reason cited for slow and sporadic implementation of the OECD Jobs Strategy is the perception that undertaking reform involves conflict with policy objectives concerning equity and social cohesion. In particular, concern has been expressed in some quarters that the Jobs Strategy recommendations to enhance wage flexibility and to reform social transfer systems would be at odds with the policy objectives of ensuring some degree of equity across members of the labour force or the population at large. The follow-up work to the Jobs Study has not provided conclusive evidence as to the nature and magnitudes of any potential trade-offs. Nevertheless, it has been suggested that these objectives do not necessarily conflict, or at least that the terms of the trade-off change, when they are seen in a dynamic perspective. Three reasons have been quoted for this:

- First, increased employment as a result of policy reform will tend to offset at least partly the impact of increased wage-rate dispersion and restricted social transfers on income distribution. Thus, a wider distribution of wage rates is likely to enhance the employment prospects of workers at the bottom of the qualification scale. Such effects may lie behind the negative cross-country correlation between widening of the bottom part of the wage-rate distribution and the change in unemployment and the positive, albeit weak, correlation between a wider distribution at the bottom of the pay scale and the rise in employment (see Figure 6). Nevertheless, this evidence is far from conclusive and there is little agreement about the magnitude of such employment effects, with econometric estimates of elasticities between relative wage-rates and demand for different categories of labour being both highly uncertain and variable across studies[14].

14) For example, estimates of elasticities of substitution between different categories of labour substantially above 1 have been found by Bound and Johnson (1992) and Katz and Murphy (1992) for the United States, and Risager (1992) for Denmark. In contrast, Machin et al. (1996) find an elasticity of around 1 for the United States and less than ½ for the United Kingdom, Denmark and Sweden. OECD (1996a) presented a number of simple cross-country correlations between wage distributions and indicators of labour-market performance without finding any strong relationships, though that result may reflect the focus on static correlations and the fact that different distributions of qualifications across countries could not be taken into account.

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- Second, there is evidence of considerable mobility of individuals over time within the wage scale, implying that in some cases low-paid employment may be a stepping-stone to better pay. Across countries, with large differences in the static distribution of earnings, the degree of mobility appears to be remarkably similar[15]. As a rule of thumb, it seems that after a period of five years only about a third of those full-time workers initially receiving low earnings (belonging to the lowest earnings quintile) do so at the end of the period (Table 3). And among full-time workers continuously employed over the 1986–91 period only 3 to 5 per cent remained in the lowest quintile throughout the period. A large part of the workers who left low-paid employment had moved up in the earnings distribution, though in some countries a significant fraction had also moved out of employment. Young persons in particular have a high likelihood of moving up in the earnings distribution. However, older and less educated workers run a higher risk of becoming trapped in low-paid jobs. Moreover, there are indications that "cycling" may take place, with those moving upwards in the earnings distribution subsequently falling back again. As a result, among workers with continuous employment those who started out as low-paid in 1986 on average spent some 3½ to 4 years in the low-paid group.

15) This is based on the comparative data on earnings mobility in a number of countries presented in OECD (1996a and 1997a). The finding of broadly similar mobility patterns across countries is also supported by Aaberge et al. (1996).

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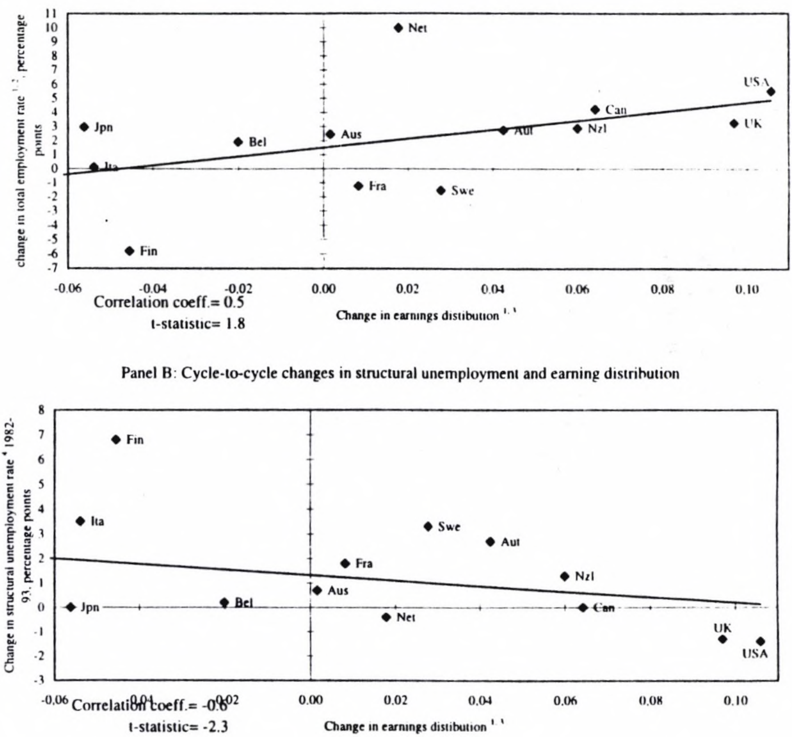
Figure 6. **Earnings distribution and labour market performance**

Panel A: Cycle-to-cycle changes in employment rates and earning distribution

Panel B: Cycle-to-cycle changes in structural unemployment and earning distribution



1. Changes between recession periods:
   For United States, United Kingdom, Canada, Australia changes are between averages of 1980-82 and 1990-91.
   For Japan, France, Italy, Austria, Belgium, Finland, Netherlands, New Zealand, Sweden and Switzerland changes are between averages of 1981-84 and 1990-93.
   West Germany was not included because of lack of data for the 1990s.
2. Data are from *Labour Force Statistics.*
3. Average annual absolute change in the ratio between median and first decile earnings of full-time workers, based on the *Employment Outlook* 1996, Table 3.1.
4. Structural unemployment data are based on Secretariat estimates of the non-accelerating wage rate of unemployment (NAWRU) made for the *OECD Economic Outlook*, 60, 1996.

Source: OECD Analytical database; OECD, *Employment Outlook*, 1996; OECD Secretariat estimates.

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Table 3. Retention rates in low earnings after five years[1]

	Low earnings defined as bottom quintile among:		Low earnings defined as below 0.65 median earnings of full-time wage and salary workers
	Full-time wage and salary workers	All employed wage and salary workers	
United States			
Male	29.4	28.2	31.2
Female	31.2	57.9	35.4
Germany			
Male	14.4	20.1	10.7
Female	34.6	48.3	18.2
France			
Male	28.5	21.3	17.5
Female	42.4	32.9	28.0
Italy			
Male	37.2	29.8	15.3
Female	49.8	41.2	23.0
Denmark			
Male	19.6	40.6	4.8
Female	37.6	44.0	6.7
Finland			
Male	30.1	45.3	30.0
Female	28.0	40.4	24.5
Sweden			
Male	22.7	25.8	-
Female	40.7	42.9	-
United Kingdom			
Male	30.7	-	28.1
Female	38.7	-	37.0

Note:

1. Share of the low-wage population in 1986 that received low earnings also in 1991.

Source: OECD (1996a) and further calculations based on the longitudinal data sets used in that publication.

- Third, lower relative incomes at the bottom of the scale may raise incentives for investment in human capital by groups who would otherwise have made little such investment; the existence of this kind of linkage is supported by evidence that, across countries, university graduation rates tend to be higher

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where the financial rewards to such education is higher (Figure 7)[16]. Such an effect in turn could reduce income dispersion over the longer run and assist the adaptation of the workforce to changing skills requirements.

In spite of these arguments, representatives from a number of countries at the EDRC considered that there was a trade-off between horizontal equity and employment objectives, but at the same time argued that its strength was susceptible to policy influence. However, for two very different sets of reasons, representatives from other countries rejected the notion of a trade-off. Thus, representatives from some English-speaking countries saw low unemployment as an essential condition for, or element of, horizontal equity. And those from some continental European countries saw equity as a more fundamental goal than low unemployment.

In addition to the traditional arguments stressing market failure as a reason for government involvement in education, training and active labour market policies, many countries see these policies as a way of supporting horizontal equity without having to pay a price in terms of lower economic efficiency, or vice versa. Some, most notably France, Belgium and the Nordic countries, resist a wider distribution of wage rates as a means to reduce unemployment and instead rely on these policies to bring the dispersion of individual productivity levels into line with the prevailing wage distribution. However, a compressed wage structure and generous social transfers limit the financial returns to private investment in human capital, and it is not clear to what extent public expenditure can compensate for weaker incentives for private investment in this area. There is also a question mark over the effectiveness of much public spending on active labour market policies, suggesting a need for further efforts to raise their efficiency if they are to play a substantial role in affecting the distribution of individual earnings capacities[17].

16) It should be noted that the rates of return shown in Figure 7 do not take into account the effects of tax-transfer systems, including support for students, or different unemployment risks across education categories. Freeman (1986) presents an overview of empirical estimates concerning the link between the return to education and demand for it. More recently, Fredriksson (1997) and Hers (1997) have presented supportive evidence on this link in the cases of, respectively, Sweden and the Netherlands.

17) Scarpetta (1996) in a combined cross-country/time-series approach to identify the influence of policy and institutional factors on unemployment finds an only weakly significant effect from spending on active labour market policies, which contributes very little to explaining cross-country differences in unemployment over the period 1983 to 1993. This limited impact may of course in principle reflect that these measures are reflected more in higher real wages than in lower unemployment. Moreover, when omitting Swedish data from the sample a much stronger effect is found.

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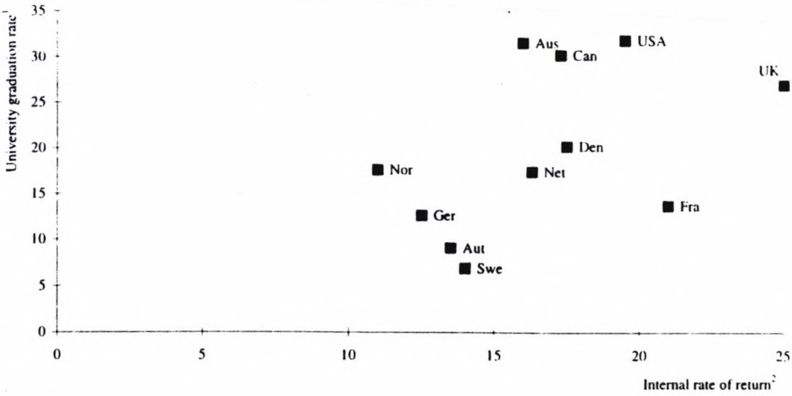
Figure 7. **Internal rate of return and university graduation rates**
Per cent



Notes:

1. Ratio of graduates from short first university degree programmes to population at the typical age of graduation in 1994 (long first university degree programmes where short first degree programmes are not available (Austria, France and Germany)).
2. Based on university wage premia in the early 1990s, theoretical length of study and assumed retirement at age 65 (see table 30).

Source: OECD, *Education at a Glance,* Paris, 1996; OECD, *The OECD Jobs Study*, Vol II, Paris, 1994.

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Thus, it remains an open question whether a policy approach that sees public intervention in post-compulsory education, training and active labour market policies as a substitute for relative wage flexibility is effective, let alone cost-effective, particularly in a world of rapid structural change where shifts in demand for particular skills are likely to exceed the pace at which skill supplies can be adjusted through education and training. At the same time, however, there is also concern about the effectiveness of relative wage signals in influencing human capital investment, not least because increased inequality of income, in a context of imperfect capital markets, may prevent those at the bottom of the income distribution from investing in their own or their children's education[18]. The recommendations given by the EDRC may be seen as favouring a combination of the two policy approaches, relying both on the market mechanism, through relative wage signals, and government support to education and training and active labour market policies in the pursuit of equity and employment objectives.

Delegates to the EDRC from some countries, including France, Austria and Belgium, have cited fear of negative consequences not only for horizontal equity but also for the much wider concept of social cohesion as a reason for adopting a measured and incremental approach to reform along the lines of the OECD Jobs Strategy. Such consequences, were they to occur, would be undesirable in their own right and may also entail high economic costs. Indeed, with social cohesion goes a set of common norms and standards of behaviour without which individual opportunistic behaviour might be difficult, or at least very costly, to constrain. At the same time, however, high and persistent unemployment is itself likely to seriously impair social cohesion.

Beyond a basic level of social cohesion, many, predominantly continental European, countries have gone further to establish institutions with the purpose of seeking social consensus. The aim here is to achieve an alignment of interests and wide-ranging agreements on policy actions comprising also organised, non-governmental groups, most prominently labour market organisations. In countries where this approach is argued to have worked -- including Austria, Ireland, the Nordic countries and the Netherlands -- social consensus is seen not only as a desirable outcome in itself, but the gains are believed also to comprise a better overall economic performance. For example, consensus policy in these countries is argued to increase aggregate wage flexibility, to reduce the risk of and thereby the loss associated with conflict, to provide decision makers with a stable environment for long-term planning, and to enhance the degree of trust and thereby economise on transaction costs.

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18) A model illustrating this point is presented in Benabou (1996).

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In the review process, countries not relying on corporatist institutions have pointed to the risk that such institutions may, over time, become increasingly static in their outlook and gradually come to serve the interests of labour market insiders to the detriment of outsiders. These institutions may also prove less flexible in a dynamically changing environment. For example, it was argued that institutions of consensus and corporatism, which usually go hand-in-hand with a centralised element in wage bargaining, may have increased the flexibility of aggregate wages in the past -- arguably the case in Austria, Norway and Sweden -- but that they may work less efficiently in a low-inflation climate and are much less adapted to deal with economic changes which require changes in relative wages[19]. The risk may also be particularly high in a corporatist set-up that failure to adjust relative wages and associated malfunctioning of labour markets could then spill over into pressures on the government to expand early retirement schemes and other fiscal measures to encourage withdrawal from the labour force.

Partly for these reasons, the role of strong political leadership in introducing structural reform has been stressed in the cases of the United Kingdom and New Zealand. And in these countries, structural reforms seem, as noted above, to have been sufficient to reduce structural unemployment over the 1990s. In the case of the latter country it was argued that since structural reforms imply the destruction of economic rents, undertaking deep structural reforms through a consensual process is difficult. However, the Netherlands and Ireland also experienced falling structural unemployment and are examples of countries where both macroeconomic policies and comprehensive structural reforms were implemented based on processes of decision making involving the social partners directly. Thus, the experience of these four countries suggests that there are different approaches to successfully implementing the Jobs Strategy, depending on national traditions and institutions. This latter lesson is reinforced by the experiences of the United States, Japan and Norway which, as noted above, have maintained relatively low structural rates of unemployment.

19) See e.g. Calmfors (1993) on the relationship between centralisation of wage bargaining, real wages, inflation and relative wage developments. Scarpetta (1996) presents evidence of a hump-shaped relationship between an indicator of centralisation and unemployment, and also shows results to suggest that increased employer coordination is associated with lower unemployment whereas the opposite is the case for worker bargaining strength, as proxied by union density. OECD (1997a), using a somewhat different specification, finds little evidence of systematic links between features of bargaining systems and unemployment. It did, however, find strong evidence that more centralised and/or co-ordinated bargaining systems were associated with more compressed wage distributions.

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There are also similarities between the four countries that managed to significantly reduce structural unemployment. A crucial common feature facilitating the reform processes both in the Netherlands, and, to some extent, Ireland, on the one hand, and in the United Kingdom and New Zealand, on the other hand, may have been the notion that individual reforms were part of a wider programme or strategy. Hence, specific reforms that affected particular groups met with less resistance because they were seen as part of an overall strategy affecting much wider groups and thereby possessing an element of fairness, which is an essential factor working for social cohesion.

4. There are significant synergies between structural reforms in different fields

Seeing structural reforms as part of an overall strategy is also important because reforms in one area produce better results if other areas are also reformed, while sometimes the beneficial effects of reform in one area may be blocked by impediments elsewhere[20]. As a result, broad-based reform is likely to be more effective than reform focused in particular areas[21]. One general channel for such interactions arises from the effects of policy reform on government budgets: many reforms which raise employment and lower unemployment will also result in reduced public expenditure or higher tax revenue, thereby permitting lower tax rates, which, in turn, may set off further improvements in labour market performance. A few more specific examples of such interactions include[22]:

- Increasing incentives for seeking and accepting jobs is likely to be more effective when, on the one hand, product market reforms have ensured that labour demand will react swiftly and significantly to changes in wages and, on the other hand, regulations governing industrial relations, minimum wages and employment protection are reformed in ways which ensure that such a wage response will be forthcoming swiftly.

- Easing employment protection legislation may, by raising turnover in the labour market and the supply of vacancies, enhance the effectiveness of

20) This point was emphasised in Lindbeck (1996). Coe and Snower (1996) illustrate such complementarities in a search model, including taxation, employment protection, bargaining power, unemployment benefits and job creation.

21) In a chapter on 'Interactions between Structural Reform, Macroeconomic Policy and Economic Performance', OECD (1996b) discusses a number of issues related to the political economy of structural reform.

22) Further examples are outlined in OECD (1997b).

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active labour market policies as well as the enforcement of availability for and willingness to work criteria in unemployment benefit systems.

- Where other transfer schemes such as invalidity, early retirement, social assistance etc. are comparable in generosity to unemployment benefits, tightening of the latter scheme is likely to be more effective in terms of reducing overall under-utilisation of labour, as opposed to measured unemployment, if accompanied by tightening of the former schemes. Conversely, reducing the generosity of other transfer programmes may be ineffectual without tightening of unemployment benefits.

- Where wage rigidities, caused, for example, by legislated minimum wages or administrative extension of wage agreements, prevent wages from falling in response to higher employer social security contributions, the effects of increases in payroll tax rates may be particularly onerous.

Interactions between structural policies may also be political in nature. This may sometimes lead to cases of substitutability, rather than complementarity, between structural reforms in different fields. For example, the absence of an adequate social safety net has in some cases been seen as strengthening the political case for various types of employment protection, including severance pay (Greece, Mexico, Turkey) or, conversely, its existence has been seen as a political pre-condition for a liberal job protection regime (Denmark).

5. Macroeconomic conditions and their interactions with structural forces are important for labour market outcomes

Macroeconomic conditions are very important for labour market outcomes and this has been reflected in the recommendations given to individual countries by the EDRC. There are two dimensions here: establishing an appropriate medium- and long-term framework for policies and preventing excessive short-run fluctuations in output and employment.

The OECD Jobs Study emphasised the role of macroeconomic policy in reducing unemployment by providing a stable framework, based on sound public finances and price stability. A main channel through which budget consolidation may affect unemployment over the longer term is via its impact on real interest rates[23]:

23) Orr et al. (1996) estimate that a rise in the government deficit of 1 per cent of GDP will lead to an increase in domestic real interest rates of between 1/6 and 1/3 percentage points dependent on the extent to which it affects the external balance of a country. Much larger

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- First, a fall of real interest rates may lower production costs in much the same way that lower payroll taxes or energy prices would do and it may raise capital accumulation and thereby labour productivity. Where wage earners do not receive a corresponding increase in real wages, unemployment is likely to fall[24].

- Second, lower real interest rates may in some cases affect the bargaining attitudes of workers and the labour demand behaviour of enterprises with the end result of lower unemployment[25].

- Third, lower real interest rates could favourably affect productivity growth, either temporarily, while the capital-intensity of production responds, or more long-lasting if the rate of innovation and its diffusion are affected. Increased productivity growth again might cause unemployment to fall. This would be the case to the extent it reduced the incidence of downward wage stickiness or facilitated wage bargaining by increasing the scope for real wage gains[26].

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effects have been found by authors focusing on the effects of government debt. Thus, estimates suggesting that a 1 percentage point rise in debt/GDP ratios may increase real interest rates by 14 to 24 basis points have been reported by Helbling and Wescott (1995) and Ford and Laxton (1995).

24) This line of reasoning has been emphasised by Cotis et al. (1996) to suggest that higher real interest rates have been a factor behind the rise in French unemployment since the early 1970s. However, while wage rigidities are likely to prevent full wage adjustment to an increase in real interest rates, for example because of institutional hindrances such as minimum wages, there is a question as to whether the same incomplete adjustment can be assumed when real interest rates fall, since, for example, minimum wages do not prevent wages from rising.

25) Manning (1992) has argued that, in a context where current employment raises the chances of future employment, higher real interest rates will harden the bargaining stance of wage earners because the present value of future earnings is diminished, reducing also the value of current jobs and thereby the expected loss from pressing for higher wages. Phelps (1992) emphasises that higher real interest rates will reduce the asset value to firms of their customer base and their stock of employees familiarised with the firm, and thereby reduce labour demand at a given level of real wages. The links between real interest rates and unemployment are discussed further in Mellis and Webb (1997).

26) There is some empirical evidence suggestive of a link between productivity growth and unemployment. Manning (1992) argues that a substantial part of the rise in unemployment until the early part of the 1980s can be explained by lower productivity growth. Turner et al. (1993) present results suggesting that such effects are large in the case of Germany but insignificant in the cases of the United States and Japan.

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Empirical estimates of the effects of real interest rates on unemployment have given results which are variable but suggestive of significant impacts in some countries[27].

Price stability has now been recognised as the primary goal of monetary policy in virtually all OECD countries. However, there is some disagreement as regards the long-term impact on unemployment of moving to price stability as compared with accepting stable but moderate rates of inflation:

- On the one hand, moves to, and the maintenance of, price stability may have favourable effects on labour markets to the extent they reduce risk premia in real interest rates associated with inflation variability[28] or lead to improved resource allocation and higher productivity. Both cross-country evidence and time-series evidence from individual countries is suggestive of a link between lower inflation and higher output growth, though it remains an open question whether this link holds also for moves from already low inflation to price stability[29].

- On the other hand, the presence of nominal wage floors may prevent wages from falling in absolute terms and such effects could impede relative and, indeed, aggregate real wage adjustment at price stability, putting upward pressure on unemployment. Such nominal floors would obviously tend to be less constraining in conditions of high productivity growth which would explain why it was possible to combine low inflation and low unemployment in the 1960s but not now. There is some empirical evidence suggesting that nominal wage floors are indeed present and that the importance of downward

27) Scarpetta (1996) finds that across 17 OECD countries the rise in real interest rates accounted for between 1 and 3 percentage points of the rise in the unemployment rate over the period 1971-93. Manning (1992), in a study of 19 OECD countries, finds effects suggesting that a 1 percentage point increase in real interest rates may increase unemployment by between zero and 1 percentage point. Phelps (1992) in a study of 17 OECD countries finds an impact of 0.1 to 0.4 percentage points. Cotis et al. (1996) report estimates suggesting that rising real interest rates accounted for about half of the rise in the French equilibrium unemployment rate between 1974 and the mid-1990s.

28) Orr et al. (1995) present evidence that, across countries, real interest rates are correlated with the extent of exchange-rate depreciation and inflation and estimate an impact on real interest rates from errors in inflation expectations which may be interpreted as an inflation-risk adjustment.

29) For an overview, see Edey (1995). More recently, Feldstein (1996) has argued that because tax distortions of household saving and investment decisions are large even at price stability, the added effect of even fairly low inflation is also likely to be large.

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sticky wages increases with declining inflation[30],[31]. However, the argument has been made that this evidence relates to periods when inflation was non-negligible and, thus, may not be representative of the importance of nominal floors at price stability when expectations have adjusted to that situation. Nevertheless, to the extent expectations are slow to adjust, this may argue in favour of slow movement towards price stability, when this has not already been attained.

As noted, the second main orientation for macroeconomic policies is to minimise macroeconomic fluctuations as far as is realistically possible within the scope given by other policy targets and constraints. Countries with the room for manoeuvre to counteract prolonged slumps in macroeconomic conditions have avoided strong increases in actual unemployment and estimated structural unemployment. In contrast, countries with relatively large fluctuations in unemployment have usually also seen stronger rises in structural unemployment because increases in unemployment which were initially cyclical in origin have often tended, over time, to become structural. Indeed, the countries where structural unemployment rose the most in the 1990s were largely the ones where the cyclical volatility of unemployment increased significantly (Figure 8), with Finland and Sweden as extreme cases where strong economic downturns led to a persistent ratcheting up of unemployment. Correspondingly, the United Kingdom and New Zealand may not have experienced a fall in structural unemployment commensurate with their structural reforms because cyclical fluctuations in unemployment became more pronounced in the past decade. Spain is a somewhat similar case where a further increase in the variability of unemployment since the mid-1980s led to a rise in structural unemployment despite a number of structural reform initiatives over the past decade. The substantial increase in the German structural unemployment-rate despite a slight fall in cyclical variability, is related, not least, to the re-unification of the

30) Looking at distributions of wage changes, several authors have found a spike at zero (for an overview of these results, see Braun and Chen (1996) or Chapple (1996). Concerning the relation between stickiness and inflation, Chapple (1996) estimated a significantly negative effect from expected inflation on the incidence of sticky wages in New Zealand, and Fortin (1996) argues that at inflation rates below 4 per cent, wage stickiness exerts significant upward pressure on unemployment in Canada. Using state-level data for the United States, Card and Hyslop (1996) found that the incidence of sticky wages in the United States did not depend very strongly on the rate of inflation. In contrast, Akerlof et al. (1996) criticise as spurious the evidence of nominal wage reductions based on panel data and set up a model showing large unfavourable unemployment effects as a result of a fall in inflation.

31) The literature on wage bargaining has in some cases argued that multi-layered bargaining entails a need for each level of bargaining to produce positive wage increases which may conflict with the goal of price stability at low rates of unemployment (e.g. Calmfors, 1993).

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country and the rapid convergence in labour market institutions and policies as well as wages between the two parts of the country.

The extent to which cyclical unemployment increases are transformed into higher structural unemployment depends on structural policy settings[32]. The policy implications of these relationships include:

- For countries with very rigid labour markets, macroeconomic instability carries a particularly high price in terms of structural unemployment whereas countries with flexible labour markets, most notably the United States, have experienced large cyclical fluctuations in unemployment around a rather stable trend.

- Moves towards medium-term macroeconomic targets will often be less costly in terms of unemployment if the appropriate structural policies have been implemented first. Conversely, a sequencing which involves moving towards macroeconomic targets before implementing structural reform may be expensive in terms of unemployment. For example, countries which both disinflated significantly and did so with unemployment benefit systems which were very generous in terms of benefit duration, tended to experience large increases in their structural unemployment rates over the 1980s (Figure 9).

---

32) Scarpetta (1996) links slow adjustment of unemployment to strict employment protection, generous unemployment benefits and aspects of wage bargaining systems. Barro (1988) reports evidence that the existence of corporatist institutions and, where these are not present, the degree of unionisation slows down unemployment adjustment. Finally, Layard (1989) finds that long benefit durations slow down adjustment whereas centralised bargaining and expenditure on active labour market policies speed it up.

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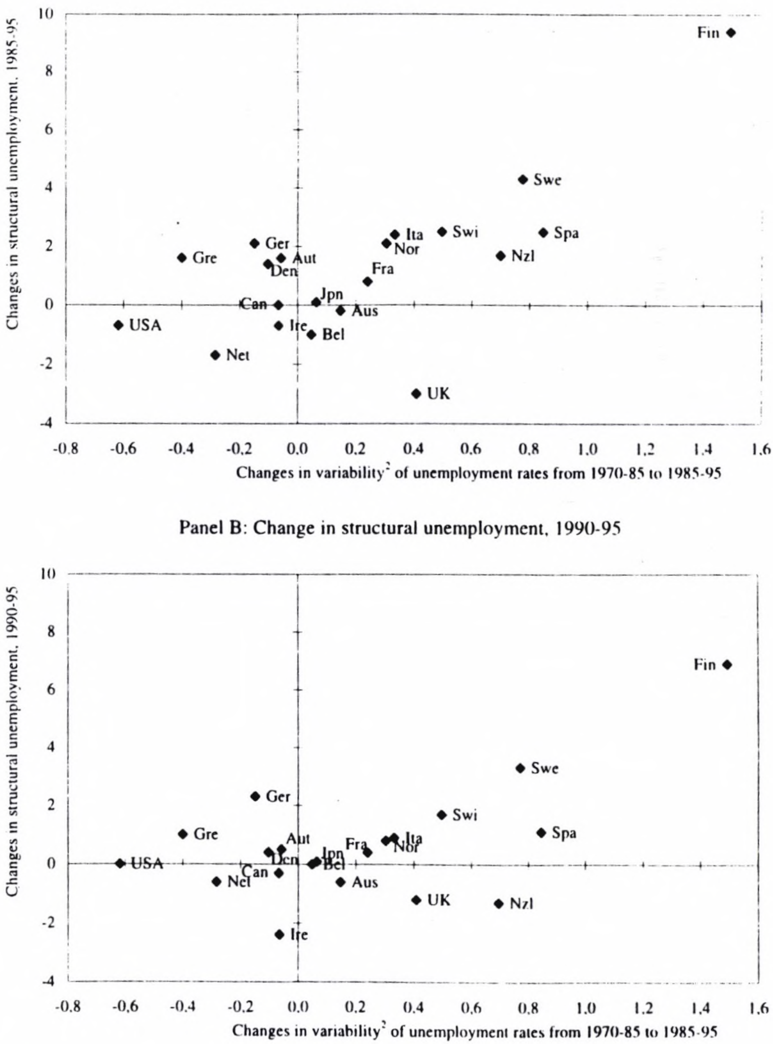
Figure 8. **Cyclical variability and structural unemployment**[1]

Percentage points

Panel A: Change in structural unemployment, 1985-95



Notes:

1. Structural unemployment data are based on Secretariat estimates of the non-accelerating wage rate of unemployment (NAWRU) made for the *OECD Economic Outlook*, 60, 1996.
2. Measured by the standard deviation of yearly changes in unemployment rates.

Source: OECD Secretariat.

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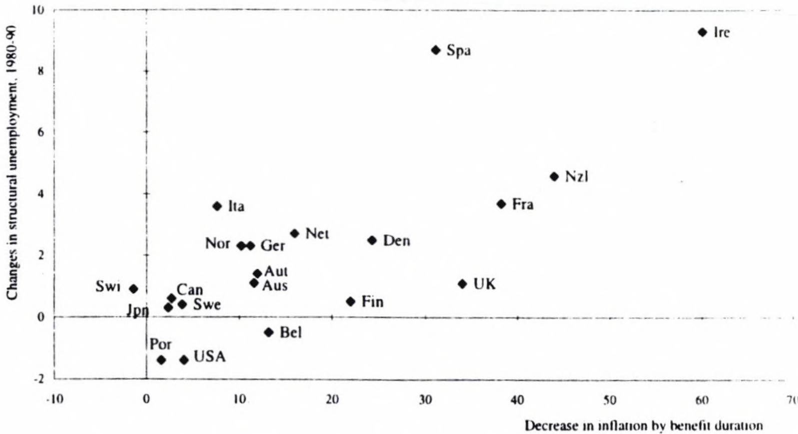
Figure 9. **Disinflation, benefit duration and structural unemployment**[1]



Note:

1. Structural unemployment data are based on Secretariat estimates of the non-accelerating wage rate of unemployment (NAWRU) made for the *OECD Economic Outlook*, 60, 1996. The variable on the horizontal axis is the decrease in inflation over the period 1980-90 as measured by the consumer price deflator multiplied by the maximum duration of unemployment benefits in the mid-1980s (see Layard et al., 1991). The rational for this specification is that increases in unemployment associated with disinflation may be more persistent in countries with long maximum duration of unemployment benefits.

Source: Ball (1996).

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- Structural rigidities may sometimes be associated with asymmetric responses of the economy to unemployment being, respectively, above and below structural levels[33]. Thus, where inflation reacts more strongly when unemployment is below its structural rate than when it is above, a policy which prevents strong fluctuations will also be associated with a lower average rate of unemployment than one which results in stronger fluctuations. Where hysteresis effects are asymmetric in the sense that increases, but not decreases, in actual unemployment are followed by hysteresis, avoiding large cyclical fluctuations is evidently also important. Since fluctuations are inevitable even under the best macroeconomic management, these observations underscore the need to implement structural reforms to eliminate the asymmetries themselves.

The upshot is that structural policy setting consistent with the recommendations of the Jobs Strategy is likely not only to reduce unemployment directly but also to reduce the risk that unemployment persists following a cyclical downturn.

Other synergies also exist between structural reforms and an appropriate setting of macroeconomic policies. For example, progress in structural reform leading to lower unemployment rates may increase the credibility of macroeconomic policies, with the end-result of reducing risk premia in interest rates and diminishing speculative pressures against currencies[34].

Conversely, structural reform will be more effective when introduced in stable macroeconomic conditions. For example, policies to increase work incentives through curbs on welfare provisions work best when the economy is generating a reasonable number of job vacancies. Similarly, when activity is high, relaxation of employment protection legislation may predominantly act to remove a disincentive for hiring, whereas such deregulation is more likely to be followed by labour shedding when undertaken in a weak business climate (as seems to have been the case recently in Italy). More generally, structural reform is usually aimed at giving greater scope for market forces. Improved functioning of markets and structural policy settings which are more sustainable should in themselves tend to raise confidence, but where structural reform leads to the destruction of economic rents -- in the shape of excessive prices, wages or job security, or low work intensity -- confidence could suffer. Macroeconomic

33) Turner (1995) presents evidence on asymmetric inflation effects and Giorno et al. (1996) present evidence suggestive of asymmetric hysteresis in some countries.

34) Funke (1996) presents evidence that an increase in unemployment increases the probability of devaluation for countries operating fixed exchange rate regimes.

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policy setting should, as far as possible, take this into account. It is noticeable that the countries where structural unemployment has fallen have all had rapid enough growth for actual unemployment to fall. However, at the same time there is a risk, which judged by past policy developments is non-negligible, that when conjunctural conditions are relatively buoyant, the motivation could be weakened for undertaking necessary structural reforms.

6. Overall, the Jobs Strategy remains an effective response to labour market problems in Member countries, and the EDRC has encouraged countries to press on with its implementation

Perhaps it is difficult to imagine the OECD reaching any other conclusion than the one just stated. But, as illustrated above, there is indeed some evidence to suggest that the Jobs Strategy works. Nevertheless, there are still areas where knowledge is weak. The linkages and potential conflicts between reforms to enhance economic efficiency and the policy concerns for equity and social cohesion are a prominent example. Work is also ongoing to enhance our understanding concerning the roles for labour-market performance of entrepreneurship and technology -- two of the main areas of policy recommendations in the OECD Jobs Study. Moreover, continued monitoring of the effectiveness of policies pursued in individual countries is also likely to generate further insights. Thus, the Jobs Strategy is set to evolve further in the light of experience gained and in view of developments in OECD economies.

Summing up, developments in recent years have provided evidence that high and persistent unemployment can be cut on a durable basis by adopting the right policies. There is no reason for countries to become resigned to high and persistent unemployment: a comprehensive approach along the lines of the Jobs Strategy holds out promise of improved labour market performance. General policy recommendations for implementing the Jobs Strategy have been available for some time, but so far they have been acted upon only partially and insufficiently in most countries. Country-specific recommendations in line with the Strategy, but taking into account the specificity of each country, have now been derived. What remains is to proceed with the practical implementation of these recommendations.

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