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European Unemployment: Contending Theories and Institutional Complexities



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European Unemployment:
Contending Theories and Institutional Complexities

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^(**) European Commission, Forward Studies Unit. The opinions here expressed are only those of the authors and do not involve the European Commission. The authors would like to thank Carlos Martinez Mongay, Madr Kieler, Lucy Sioli and several colleagues in the European Commission for useful comments. Karin Granevi and Carlos Nicolas provided excellent research assistance and Tracy Keble helped in the editorial phase.

Abstract

Unemployment is the current European nightmare. The paper briefly reviews its main features and recalls the debate on its causes. While most existing works have focussed on individual aspects of the labour market institutions as sources of the rise in unemployment, the paper presents a number of reflections on the way the various building blocks of (largely national) employment systems interact with each other and how different institutional combinations may be more or less suitable to the changing economic environment facing industrial countries.

The main points are the following:

- different labour market institutions (such as job-protection legislation and unemployment compensation or unemployment benefits and invalidity benefits) often pursue analogous objectives – typically workers protection – and, as such, are *de facto* “institutional substitutes”. However, functional equivalence does not imply economic equivalence in terms of employment performance and ability to respond to shocks.
- the internal structure of the welfare system may be relevant for employment outcomes. An important aspect which may explain why both the US and the Nordic models, while not without problems of their own, produce high employment, is that both are conducive to development of the social services sector.
- super-imposing a largely uniform institutional set-up onto heterogeneous situations has negative consequences for employment. The importance of the (infra-national) regional component of unemployment in Europe points to a lack of “institutional variety” within EU countries.
- while strong trade unions are more likely to feel entrusted with representing the national interest, thereby willing to co-ordinate their action and set employment-compatible wages, “artificial” (legally-supported) trade unions power is bad for employment. The latter is found in a number of EU continental countries.

The paper ends with some tentative policy conclusions.

1. Introduction

European unemployment is one of the most hotly debated topics in current economics.

The present paper does not attempt an assessment of the relevance of the numerous factors put forward to explain European unemployment. More modestly, in the next sections a number of reflections covering the possible role that the various building blocks of "national employment systems" may play in the size and persistence of the unemployment problem are presented. All these reflections are organised around the theme of institutional choice and economic environment¹, with particular regard to the employment/unemployment outcomes.

Institutions are collective rules and routines of behaviour developed to cope with an uncertain environment. They are changeable, but institutional choice differs from rational choice in the sense that it is difficult to ascertain a conscious decision (and a well defined decision-maker) behind it. Moreover, once established, institutions acquire they own momentum and exhibit unanticipated effects. As institutions are a means to cope with an uncertain environment, 'good' institutions differ from 'bad' institutions in their ability to reflect the amount and nature of variety in their environment, including changes over time. A mismatch between institutions and environment will result in efficiency losses. The European unemployment problem can be read, at least in part, in terms of mismatching between the institutions, not only those of the labour market, and a new economic environment.

Institutions within the same socio-economic system tend to be interconnected, often in ways that are not immediately evident. This tendency is sometimes referred to under the notion of "embeddedness" or "large system". Freeman (1995), who employed it in discussing the Swedish case, argued that in a large welfare state, such as those found in a number of European countries, economic agents are more tightly linked through institutions than in a more decentralised type of economy. Changes in one part of the system may lead to consequences in other parts that are unexpected on the basis of standard economic theory, which tends to overlook institutional correspondences within a system.

Embeddedness and the related potential mismatching between institutions and the economic environment pose special difficulties for the identification of the effect of any given institution on economic outcomes, including unemployment. These problems are beyond those deriving from the well known empirical

¹ The notion of institutional choice is discussed in Schmid (1995).

difficulties of measuring the relevant aspects of the several institutions. Such measurement difficulties have been bravely faced by the OECD, whose work constitutes the basis for most of the subsequent exercises trying to link institutions and unemployment performance².

The problem is multifaceted. First, the fact that the institutions are intertwined makes it difficult to disentangle their individual effects because rarely one part comes without the others. Moreover, across systems one can often find examples of "functional equivalence" in that comparable functions are performed by different institutional mechanisms. Finally, it will be argued that the impact of a given institution on equilibrium unemployment may differ on the basis of the overall economic scenario³. Further technical difficulties derive from the likely non-linearity of their impact. This derives from the combined effect of institutional arrangements on the microeconomic behaviour and from the uncertain timing of the impact on labour market performance of institutions which change discretely but whose change is not an exogenous event.

The rest of the paper is organised as follows:

Section 2 provides a bird's-eye view on the debate on European unemployment, with particular reference to the role of labour market functioning, which is the most commonly cited factor in explaining European unemployment.

Sections 3 analyses the role of the welfare system. After a brief discussion of the interconnections between several transfer programmes, the different typologies of welfare system existing in Europe are explored.

Section 4 considers labour market institutions. In particular, we discuss the scope similarities between the rules protecting the individual workers in their current job position, welfare programmes aiming at protecting them in case of unemployment, and the action of unions.

Section 5 analyses the close relationship existing between the rigidities in product and labour markets.

Section 6 is dedicated to the issue of regional unemployment, which is

² For recent examples see Jackman, Layard and Nickell (1996), Scarpetta (1996) and Nickell (1997).

³ Put simply, one should explain why the European rigidities were not a problem in the 1950s and -60s, when Europe was catching up and the fastest growing industries were the ones producing homogeneous consumer goods using the "Fordist" organisational paradigm.

interpreted in terms of institutional mismatch between nationally homogeneous rules and practices and heterogeneous regions, in terms of productivity levels and degree of economic development.

The final section summarises the main messages of the analysis and offers some policy remarks.

2. The “state of the art” regarding EU unemployment

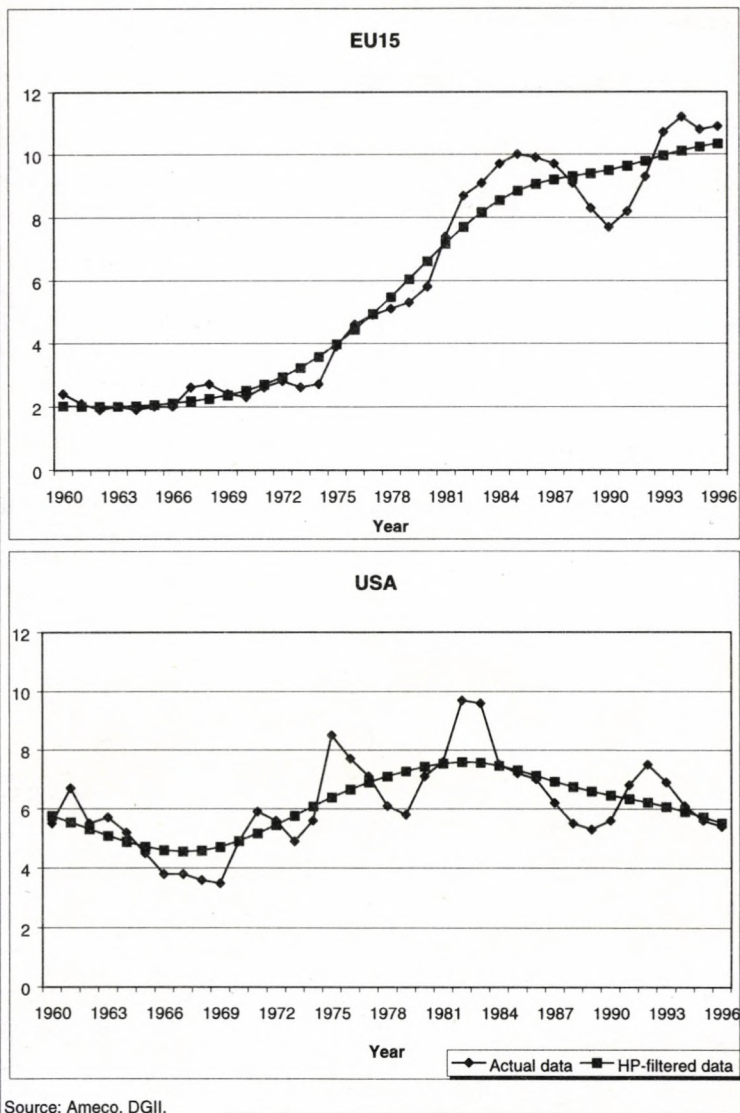
2.1. A snapshot on the debate

The starting point of the debate is the rise in EU unemployment from cyclical peak to peak vis-à-vis a remarkable long run stability in the US (Graph 1). The picture for the employment to working age population ratio is similar (Graph 2)⁴.

The stylised fact of a long run rise in EU unemployment is confirmed when one looks at more economically-based definitions of the trends in unemployment, for instance the short run trade-off between unemployment and inflation, along the lines suggested by Elmeskov (1993) (Graph 3).

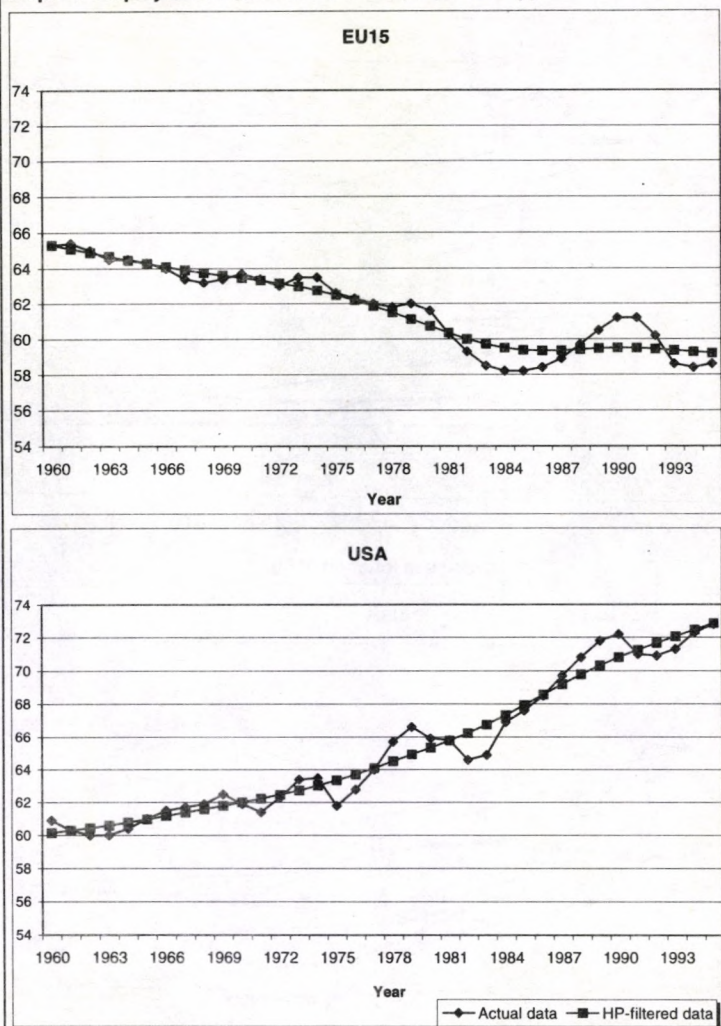
⁴ The employment rate has risen in the US, mostly because of the large inflow of females into the labour market, while it has been declining in the EU as a whole (the decline for males more than offsetting the rise for females). Even more divergent would be the trends for private sector employment.

Graph 1. Unemployment in the EU15 and USA, 1960-1996.



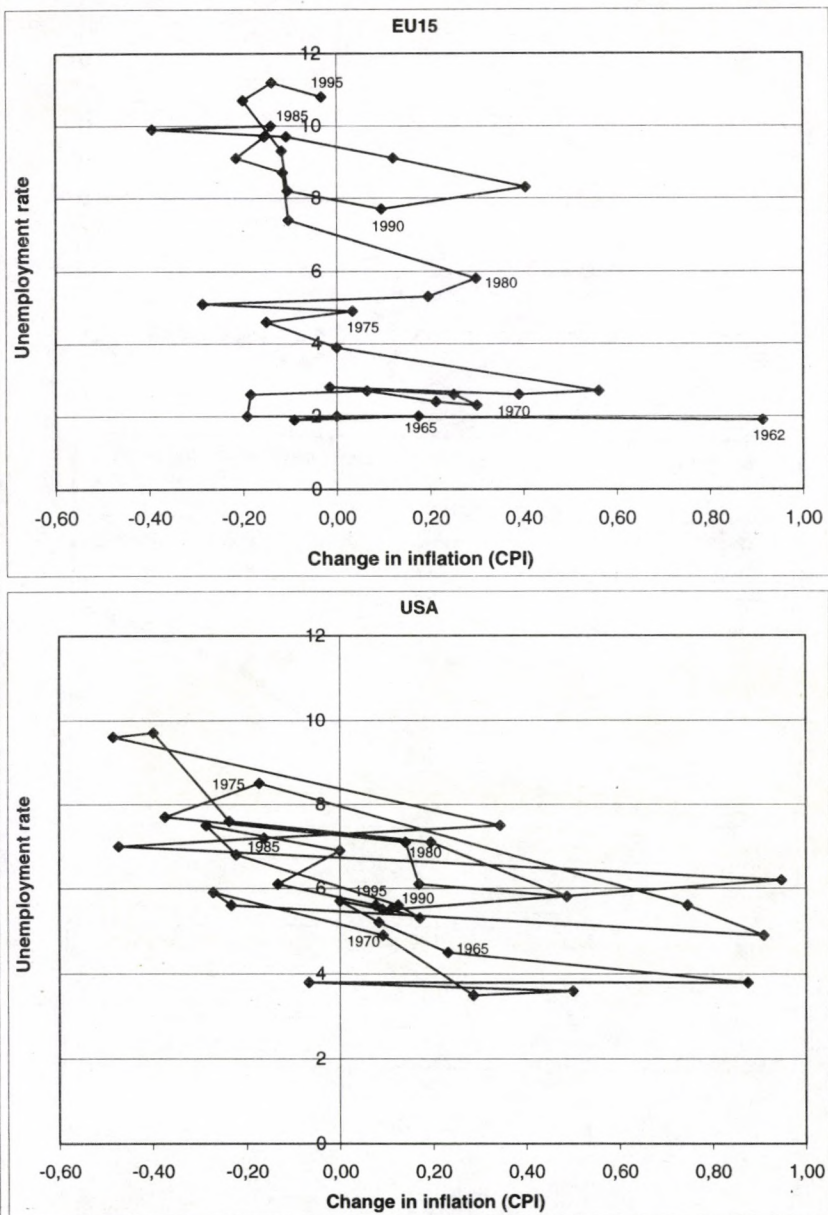
Source: Ameco, DGII.

Graph 2. Employment in the EU15 and USA, 1960-1995. (1)



(1) Employment to working-age population ratio.
Source: Ameco, DGII.

Graph 3. Change in inflation (CPI) and unemployment, EU15 and USA, 1962-1995.



Source: Ameco, DGII

The different evolution across the Atlantic seems to hint at structural factors, i.e. factors not related to the stance of the macroeconomic policy, which may be relevant for some sub-periods and as a factor triggering unemployment, but cannot explain the longer run divergence.

A further element which precludes the interpretation of the rise in EU unemployment as a simple effect of an inappropriate aggregate demand management is in the vast array of differences across countries, in both the level and composition of unemployment and employment (Tables 1 and 2). This fact is in stark contrast with the increasing homogeneity in the business cycle conditions across Europe⁵. For instance, a frequently overlooked aspect of the comparison between the US and Europe is that a number of EU countries have achieved a performance that is broadly comparable to that of the US, in terms of both unemployment and employment rate.

The supply side has therefore been analysed, looking at the possible shifts in the wage and price fixing behaviour. The most popular scheme is that of Layard *et al.* (1991), where a natural rate of unemployment is defined at the intersection of a wage setting curve and a price fixing curve in the wage/employment space when price and wage expectations are both fulfilled⁶. Suitable assumptions on the technology and/or the underlying labour supply behaviour are added so as to guarantee that the long run natural rate does not depend on the productivity trend and the capital endowment⁷.

⁵ See European Commission (1997b). Needless to say, there are exceptions to these business cycle synchronisation trends (as an example consider the current UK cyclical misalignment). Moreover, the current cyclical situation helps to explain some of the current discrepancies across European countries (again the UK case may provide an example). However, no current cyclical factor may explain the differences between, for instance, Germany and Austria or Spain and Portugal.

⁶ Other approaches may be rewritten along similar lines, like for instance that of Phelps (1994) or the more traditional Phillips curve adjustment mechanism. Even those approaches refuting the analytical tool of the decomposition of unemployment into a NAIRU and short-run disequilibrium components (see for instance Rogerson, 1997) tend to emphasise the presence of similar long run shift factors in explaining the rise in European unemployment.

⁷ In the short run the natural rate may differ from its long run level because of behavioural lags capturing the presence of persistence (the simplest formulation is that of having a wage equation with both unemployment and changes in unemployment effects)

Table 1. Unemployment rate, 1990s.

Country	Total	Men 25-54	Men 15-24/ Men 25-54	Men 55-64/ Men 25-54	Women 25-54/ Men 25-54
Austria	3,7	3,2	1,6	1,4	1,3
Belgium	8,5	5,4	3,0	0,7	1,9
Denmark	8,6	7,0	1,5	1,0	1,3
Finland	14,0	14,3	1,8	1,4	0,8
France	11,1	8,1	2,5	0,9	1,5
Germany	7,3	5,8	1,2	1,7	1,6
Greece	8,3	4,4	4,3	0,6	2,4
Ireland	14,5	12,9	1,8	0,6	1,0
Italy	10,3	6,5	4,4	0,6	1,9
Luxembourg	2,5	1,6	3,9	0,6	2,1
Netherlands	6,4	4,5	2,3	0,6	1,7
Portugal	5,6	4,1	2,8	1,0	1,5
Spain	20,9	13,9	2,5	0,8	1,8
Sweden	7,5	6,5	2,4	1,0	0,8
UK	9,5	9,1	2,0	1,2	0,7
EU15	10,0	7,9	2,1	1,1	1,4
United States	6,6	5,3	2,6	0,8	1,0

Table 2. Employment rate, 1990s.

Country	Total	Men 25-54	Men 15-24/ Men 25-54	Men 55-64/ Men 25-54	Women 25-54/ Men 25-54
Austria	67,4	87,0	0,7	0,5	0,8
Belgium	54,6	87,2	0,4	0,4	0,7
Denmark	73,4	86,5	0,8	0,7	0,9
Finland	62,5	78,3	0,5	0,5	1,0
France	57,6	87,3	0,3	0,5	0,8
Germany	63,1	88,2	0,6	0,5	0,7
Greece	53,4	90,0	0,4	0,6	0,5
Ireland	51,7	79,5	0,5	0,7	0,6
Italy	52,6	84,2	0,4	0,5	0,6
Luxembourg	74,7	93,0	0,5	0,4	0,6
Netherlands	62,7	88,5	0,6	0,4	0,7
Portugal	66,2	89,9	0,5	0,7	0,8
Spain	45,9	80,0	0,4	0,6	0,5
Sweden	73,5	85,5	0,5	0,8	1,0
UK	67,5	84,8	0,7	0,7	0,8
EU15	59,4	86,1	0,5	0,6	0,7
United States	71,7	87,3	0,7	0,7	0,8

Source: Ameco and OECD

The debate has been mostly focussed on labour market functioning as the source of these shift factors. However, what happens to the product market side (the price fixing equation) may be equally relevant. Lack of competition in the product markets will result in lower employment as firms set higher prices and produce less output, thereby reducing labour demand at any given wage rate. From a macroeconomic point of view, besides having an aggregate demand effect, high real interest rates and/or credit rationing may increase the cost of expanding output and hence shift downward the labour demand schedule⁸. Lack of competition, especially when resulting from regulations and other government policies that favour incumbents, may also result in lower productivity levels and slower productivity growth, as there is less incentive to reduce X-inefficiencies and to innovate. This, in turn, may have a negative effect on employment.

Empirically, the effect of product market barriers in reducing output and employment has been studied essentially on a sectoral basis⁹. Its importance has been stressed in particular for the service sector, for which, as shown by Koedijk and Kremers (1996), there is clear evidence that the overall degree of product market regulation is higher in continental Europe than in the "Anglo-Saxon" countries. At a more detailed level, comparative case studies suggest that product market restrictions play a particularly important role in reducing output and employment of service industries in continental Europe compared to the United States (Lewis *et al.*, 1994)¹⁰. International comparisons of price and productivity in services confirm that the prices of many services in continental Europe relative to the USA are above the prevailing exchange rates and the productivity levels measured at purchasing power parity are often lower in Europe (Van Ark and Monnikhof, 1997), product market regulations being among the reasons for the under-performance of services.

⁸ The role of the interest rate in determining employment outcomes is central in the model proposed the Phelps (1994). Even if, for the sake of precision, one should say that in his class of models assets considerations also have an impact on workers' behaviour, a fair description of the interest rate-employment chain may be that the position of the labour demand schedule depends on the present value of the firm. Empirically, a relevant aspect to be considered in comparing Europe to the US is the underdevelopment of European financial markets (with the exception of the UK) in comparison to the US: for example, European companies do not have access to well capitalised equity markets, the role of venture capital is very limited, 'securitisation' of debt finance is undeveloped. Such underdevelopment can be particularly penalising for SMEs, as they are more confined to their national systems and have specific problems in securing credit.

⁹ For a recent survey on product market competition and its relationship with employment see Geroski *et al.* (1996).

¹⁰ In some cases, notably retailing, high wage minima further contribute to limit employment performance compared to the US, an example of complementarity between labour and product market regulations to which we will come back later.

More difficult to establish is the exact relevance of these different regulation patterns at the aggregate level. Moreover, their relevance as an explanation for the *rise* in unemployment is downplayed by the apparent increase in the degree of competition over time, particularly in connection with the increasing trade-openness of industrial economies. Even in the services sector the absolute level of regulation is also now declining in continental Europe. However, the gap between the two groups of countries has considerably increased over time, reflecting earlier and more systematic deregulation in the 'Anglo-Saxon' countries compared to continental Europe (OECD, 1992), whose positive employment effects might be accruing now¹¹. The importance of regulations in the services sector may have risen because of the growing weight of this sector in employment performance.

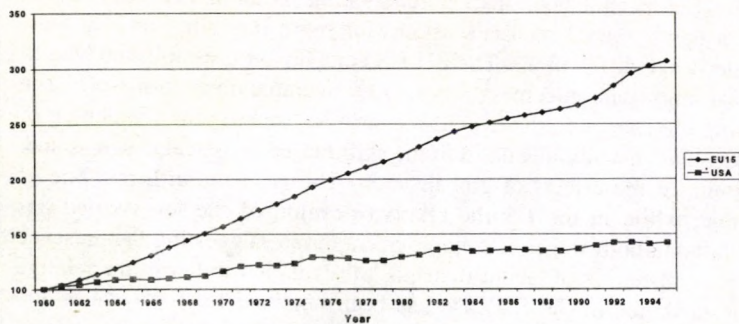
A similar point may be made concerning the "defensive" industrial policies bias characterising continental European countries, which in the longer run may have contributed to delay the exploitation of the new technologies and lowered output and employment growth. It has also been argued that the excess of product market regulation in Europe may have prevented the supply of entrepreneurs from matching the rise in labour supply (Krueger and Pischke, 1997).

Leaving Section 5 to spell out the relationship of complementarity between product and labour market regulations, our brief summary of the debate concentrates on the labour market aspects which are the hallmarks of this debate. As a starting point, a three-way partition is drawn, based on the nature - direct or indirect - of the role of the labour market in counting the rise in unemployment. In the case of an indirect role, a distinction is made according to the micro- or macroeconomic nature of the "environmental" changes to which the labour market would have responded inadequately.

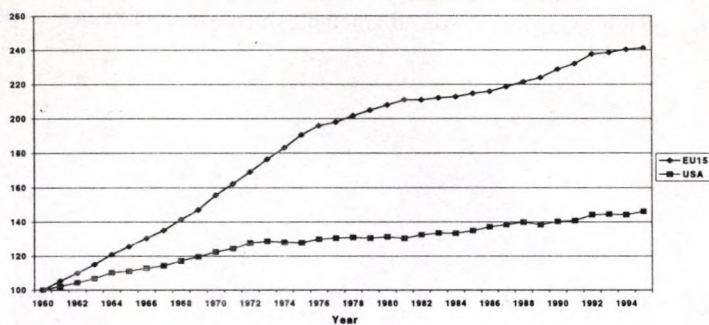
According to a first strand of opinion, the rise in "equilibrium" unemployment is directly caused by some labour market changes leading to a wage push. The relevant EU-US dichotomy is that between the low-employment-high-wage-growth path of the former and the combination of high employment and low-wage-growth in the latter (Graphs 4 and 5). However, many structural differences in the labour market functioning between EU and US predate the upward trend in EU unemployment. Many regulatory changes of the European labour markets and in the generosity of their welfare systems may be located in the sixties, with lagged effects which might have taken a long time to spread over. However, the last fifteen years, although exceptions can be found, can hardly be defined as a wage push period for EU countries (Graph 6).

¹¹ Taking into account the substantial lag presumably existing between the implementation of product market liberalisation and the response of labour demand (in the case of the UK and New Zealand the overall degree of regulation was no lower than in continental Europe in the '70s).

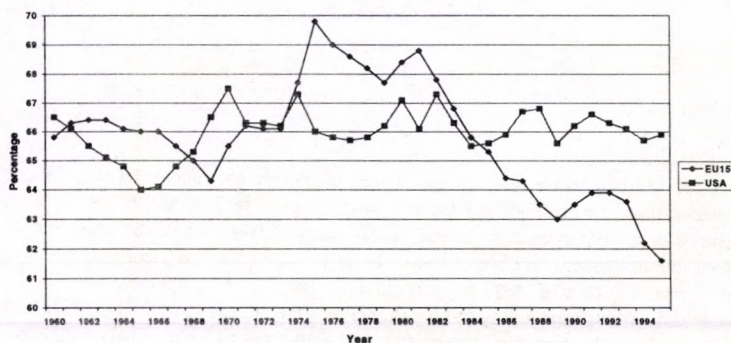
Graph 4. Capital labour ratio, EU15 and USA, 1960-95.
(1960=100)



Graph 5. Growth of real product wage, EU15 and USA.
(1960=100)



Graph 6. Adjusted wage share, total economy, in EU15 and USA.
(Percentage of gross domestic product at market prices.)



Source: Amato, DGI

A second strand of opinion emphasises the role of the (mostly already existing) rigidities in the European labour market functioning as an impediment to the adjustment to a new "micro" scenario, asking for more flexibility and, at least temporary, wider wage differentials. The EU-US comparison is established here in terms of an earnings (and incomes¹²) inequality-unemployment trade-off. The factors triggering the change in the overall scenario, and asking for a widening of wage differentials, are usually identified in the skill-biased technical progress and, to a minor extent, in the effects of globalisation. The problem with this line of reasoning is that, while in the US the relative position of the less skilled has clearly deteriorated in both wages and employment terms, suggesting the presence of a shift in the composition of labour demand¹³, the rough stability in the relative position of the unskilled in the EU case has been obtained for both wages and employment conditions. In other words, the bulk of the rise in EU unemployment cannot be attributed to a disproportionate rise in unemployment of the unskilled, even if the latter are the group more prone to unemployment (in US like in Europe Table 3).

¹² While the possibility of a trade-off between wages inequality and unemployment is quite natural (for instance insofar as a binding minimum wage lets the bottom section of the wages distribution disappear, unemployment rises and wages' inequality shrinks), the presence of a trade-off between unemployment and household incomes inequality is less clear-cut, given that unemployment is itself a source of inequality (for an assessment of the respective contributions of unemployment and earnings inequality to overall incomes inequality, see OECD, 1997a). The trade-off may derive from the fact that income transfers to the poorest may finance their non-employment choices.

¹³ Shift which may have aggregate implications for unemployment if the wage equation is non-linear (see for a simple discussion Nickell and Bell (1995) who however dismiss the importance of such compositional effects as an explanation of the rise in EU unemployment along the lines also presented here).

Table 3. Unemployment differentials by educational level (1994).

	Ratio to secondary level					
	Below upper secondary		Non-univ. tertiary		University	
	25-29	25-64	25-29	25-64	25-29	25-64
Austria	1,9	1,7	0,2	0,5	1,6	0,6
Belgium	1,7	1,8	0,4	0,5	0,8	0,6
Denmark	2,4	1,7	0,8	0,6	0,9	0,5
Finland	1,9	1,4	1,0	0,7	0,6	0,4
France	1,8	1,4	0,7	0,7	0,7	0,6
Germany	2,1	1,6	0,7	0,7	0,7	0,6
Greece	0,8	0,7	1,2	1,1	1,3	0,7
Ireland	2,4	2,0	0,7	0,7	0,5	0,4
Italy	1,0	1,1	na	na	1,7	0,9
Netherlands	1,9	1,7	na	na	1,4	0,9
Portugal	0,9	1,0	0,5	0,4	0,6	0,4
Spain	1,2	1,1	0,9	1,0	1,1	0,7
Sweden	1,5	1,2	0,5	0,5	0,5	0,4
United Kingdom	2,3	1,6	0,3	0,5	0,4	0,5
EU	1,7	1,4	0,5	0,5	0,9	0,6
United States	2,2	2,1	0,6	0,7	0,4	0,5

Source: OECD

In the third view, the role of the European labour market rigidities is also indirect. The basic idea here is the presence of (quasi) hysteresis forces. A leading example may be that of employment protection legislation (EPL), and in particular of the firing restrictions, whose presence in Europe mostly predates the rise in unemployment. While their impact on labour demand, for a given wage rate, is small and indetermined, strict EPL may cause lags in the employment response even after a negative shock has faded away (on top of a possible feedback on wages by supporting insiders' bargaining power). This, and other mechanisms¹⁴, may not have led to changes in the long run natural rate, but they may have contributed to persistence in unemployment after the particularly severe adverse macro-demand shocks, a result which may be empirically difficult to distinguish from a change in the natural rate.

These three different views may be somehow ordered according to the emphasis put on the labour market factors in explaining unemployment and the corresponding differences in the prescription of "painful" reforms in the European labour markets¹⁵.

Starting from a reversed order, the third view recommends avoiding excessively restrictive macro policies so as to prevent the rise in unemployment. Now that unemployment has been created, on top of the list of priorities is a more expansionary macroeconomic policy mix¹⁶. This should be coupled with labour market reforms so as to remove the "speed limits" which otherwise would arise in the case of an aggregate demand push.

The second view looks at "structural" changes in the economic scenario. The debate on unemployment becomes intertwined with that on the ability of the economic system to exploit the potential implicit in technical progress¹⁷. The

¹⁴ For instance the real wage rigidity deriving from unions' bargaining (to be related to the overall structure of unions' bargaining), the shrinking membership of the insiders' group and the disenfranchisement of the long term unemployed gradually becoming outsiders. Persistence effects may also derive from the presence of adjustment costs for capital and the putty-clay nature of investments (for a model along these lines see Caballero and Hammour, 1997). The generosity of unemployment compensation contributes to explain the persistence of unemployment at a high level after the disinflationary shocks of the 1980s in Ball (1996).

¹⁵ A different, even if related issue, is that of the political feasibility of such reforms, an issue emphasised for instance in Alogoskoufis et al. (1995) and which we will only briefly touch upon in the last section.

¹⁶ Just to give an example, one may refer to Modigliani (1995).

¹⁷ The reference here is to that literature (see Freeman and Soete 1994, and OECD, 1996a) which looks at the presence of specific aspects of the present wave of technical progress and/or the mismatch with several institutions, which might have led to difficulties in exploiting the full potential of technical progress. The result would be both a rise in unemployment and a

presence of an inequality-unemployment trade-off suggests policy interventions not limited to dismantling labour market rigidities: human capital formation and schemes for sustaining the demand of the unskilled are often advocated so as to avoid a widening gap between the demand and supply of skills and improve the inequality-unemployment trade-off.

More bluntly, the first view points to the need of an overall reform of the European social system and the overhaul of labour market rigidities.

2.2. The role of labour market institutions

Whatever the differences in the role of the labour market in the literature, the specific institutions analysed tend to be the same.

Our brief summary of the debate will touch upon the aspects which have catalysed most of the attention: the welfare system, the unions' bargaining structure and the employment protection regulation¹⁸. Table 4 presents a number of indicators summarising the institutional features of labour markets in the EU and the US¹⁹.

deceleration in the (measured) rate of growth of labour productivity. An ambitious attempt to link all these issues is in Greenwood and Yorukoglu (1997), where the lags and difficulties in exploiting a major innovation also explain the rise in wages inequality.

¹⁸ For a more detailed survey of the debate, see Sestito (1997).

¹⁹ The data come from OECD (1994), for the EPL, from OECD(1997c), for unions' bargaining characteristics. The data on benefits generosity, which are expressed gross taxes, come from OECD (1997c); the data on non-unemployment benefits come from Blöndal and Pearson (1995). The data on unemployment compensation for Italy and Sweden were adapted by the Authors. For Italy we followed Fabiani et al (1997) in considering the effective overall expenditure, including the Wage Supplements Funds (Cassa Integrazione Guadagni). For Sweden the OECD measure does not appear to take account of the "carousel" effect arising from the possibility of the unemployed to regain access to income support via training (see Martin, 1996); arbitrarily we simply lifted the Swedish figure to the value of the most plausible proximate country (Finland).

Table 4. Labour market features in EU countries and in the US.

	Trade union density		Bargaining coverage		Coordination		EPL ranking (1985-93)	UB summary measure of generosity (avg 1990s)
	mid 1990s	Change since early 1980s	mid 1990s	Change since early 1980s	Union	Employers		
Austria	42	-14	98	0*	3	3	10	28
Belgium	54	-2	90	0*	2	2	11	42
Denmark	76	0	69	0*	3	3	2	61
Finland	81	+11	95	0	2	3	5	41
France	9	-9	95	+10	2	2	8	37
Germany (W)	29	-7	92	+1	2	3	9	27
Greece	-	-	-	-	-	-	12	20
Ireland	50	-	-	-	1	1	6	28
Italy	39	-10	82	-3	2	2	15	(26) ^(o)
Netherlands	26	-9	81	+5	2	2	4	48
Portugal	32	-29	71	+1	2	2	13	35
Spain	19	+10	78	+2*	2	1	14	33
Sweden	91	+11	89	+3*	3	3	7	(41) ^(o)
UK	34	-16	47	-23	1	1	3	18
US	16	-6	18	-8	1	1	1	11

- Coordination: 3, high; 2, medium; 1, low.

- EPL ranking in decreasing order of « strictness ».

- Benefit generosity: benefit entitlements before tax as a percentage of previous gross earnings, average across earning levels, unemployment spells and family situations.

* *change since 1990*

(o) *Adapted by the authors*

Sources: OECD and calculations by the authors

The welfare system

The welfare system has a clear potential in explaining the rise in unemployment. The generosity of its transfer programmes may have labour supply disincentives. Probably the single most debated item has been that of the unemployment benefits (UB), which have been analysed both from a micro and macro perspective. Generous benefits may impact on job search (financing a choosier strategy by the unemployed²⁰), on insiders' bargaining power and on wage differentials. Therefore, they may play a threefold role: sustain aggregate wage push (because of the reduction in effective labour supply or because of their impact on the workers' outside option in wages bargaining); lead to persistence (mostly because of their impact on long term unemployment, particularly where there are lax limits to benefits duration); impede the widening of wage differentials (because their same presence provides for a wage-floor even where no minimum wage legislation applies).

The empirical evidence on their relevance, however, is mixed²¹.

At the microeconomic level, where most of the research has considered their effects on the probability of leaving the unemployment rolls, the effects of the levels of benefits on the length of unemployment spell appear to be relatively modest, the duration of benefits being proportionally more important than their level. The difficulty of obtaining a quantitative assessment is compounded by the presence of several unmeasured aspects of the system, first of all those related to its administration: the tighter the administration of benefits, especially concerning job-search requirements, the lower the labour supply disincentives²².

The macroeconomic literature is more consistent in its finding of a positive correlation between the overall generosity of the UB system and unemployment. However, the exact chain linking them to the unemployment performance remains somewhat unspecified²³.

²⁰ Needless to say that such a strategy may have positive long run effects insofar as it allows better job-matching. Moreover, it is well known that a side effect of the UB system is that new entrants are induced to accept any job so as to gain the right to claim, in the future, for the UB.

²¹ See Atkinson and Micklewright (1991) and Meyer (1995) for surveys of the micro literature, mostly aiming at measuring the direct impact of the UB on job search behaviour.

²² Moreover, the impact of the benefits seems to vary according to the situation of the labour market (see Armlampalan and Stewart, 1995), which by itself would imply a non-linear relationship between benefits generosity and equilibrium unemployment.

²³ Examples are in Layard et al. (1991) and OECD (1994), whose overall measure of UB generosity is the one later used in several econometric exercises (see among others, Nickell, 1997, and Scarpetta, 1996).

Irrespective of the specific nature of the transfer programmes, the size of the welfare state has been considered relevant because of the tax burden implicit in its financing. The idea is that the rise in labour taxes (the tax wedge) may have been detrimental to employment via labour demand, contributing to capital-labour substitution.

Essential for this line of reasoning is the condition that the tax burden is not entirely carried by workers. Until recently, the presence of a low long-run elasticity of labour supply at the individual level has been used for arguing that taxes may have no impact on equilibrium unemployment. Actually, in a competitive labour market, an inelastic supply implies that the burden of taxation is carried entirely by workers, with no effect on quantities. However, it has long been known that changes in taxes, like other shocks such as the oil price hikes of the 1970s, may lead to "real wage resistance"²⁴. Moreover, the elasticity of the individual labour supply is not the relevant parameter when labour markets do not clear, because of union bargaining or efficiency wage mechanisms. Evidence of a significant positive relationship, in (continental) European countries, between the long-run rise of labour taxes and that of unemployment has been linked to the action of unions²⁵.

Whatever their impact on aggregate unemployment, high tax rates can affect the structure of employment, particularly in connection with the development of activities in the informal economy. For countries like Italy, the high weight of self-employment has been often attributed to the relative easiness of avoiding the tax burden implicit in this occupational choice. In the case of the Nordic countries, it has been argued (Angell, 1966) that the level reached in the mid '80s by the marginal tax rates for most of the workers would have implied, even assuming very modest elasticities of supply, large quantitative effects, inducing to substitute home production and informal sector activities to additional hours of work.

Most of the evidence on the role of taxes on unemployment comes from

²⁴ The classical interpretation of the '70s in terms of "real wage resistance" is that by Bruno and Sachs (1985). A across countries comparison of the timing of the adjustment of net wages, showing that in the European countries the process may be quite slow, is in Tyrvainen (1994). According to a comprehensive study (OECD, 1992), on average for sixteen industrial countries a 1 percent rise in the tax wedge induces an immediate rise in labour costs of 0.5 percent, a half of which persists after five years.

²⁵ Daveri and Tabellini (1997) argue that the presence of uncoordinated union bargaining underlies the correlation between the rise in labour taxes and in unemployment they discover for the continental European countries; the absence of such a relationship for the Anglo-Saxon countries is attributed to the fact that the labour market is competitive.

macroeconomic exercises. Apart from the empirical difficulty of disentangling a truly permanent effect of taxes from phenomena of real wage resistance in unionised and less flexible labour markets, an issue still uncovered is that the effects of the tax system should vary according to its specific features. For instance, the possibility of long run employment effects of tax rises in a unions' bargaining model derives from the different tax treatment of the earnings accruing to workers when employed and the pecuniary equivalent of remaining unemployed²⁶: for the specific model used by Daveri and Tabellini (1997), the relevant aspect is that the unemployment benefits are not taxed and are indexed to the gross of taxed wages.

Wage bargaining arrangements

For some time, the Calmfors and Driffill (1988) paper was the basis of a diffused consensus on the presence of a simple, hump-shaped relationship between centralisation of unions' bargaining and equilibrium unemployment. The forces at work were quite simple: unions' power can be restrained where a large and centralised union movement is self-imposing some discipline (internalising the possibly detrimental effects of its own behaviour); alternatively, wage pressure can be contained where many single-firm unions are constrained by competition forces in product markets²⁷.

That consensus has faded away. Calmfors (1993) has recognised that the multiple facets of unions' bargaining cannot be easily summarised in a simple variable like the degree of centralisation. A distinction between the degree of co-ordination²⁸ and unions' strength - respectively having a positive and negative impact on employment - has been stressed in Layard *et al.* (1991). Overall, the empirical results tend to be mixed: the cross-country estimates presented by Scarpetta (1996) and Nickell (1997), seem to confirm a relationship between some aspects of unions' bargaining and unemployment. However, the robustness of the econometric evaluations of the hump-shaped relationship has shown to be weak in OECD (1997b).

Our reading of this literature is that many of the effects of the bargaining

²⁶ The above reasoning applies to changes in average taxation for a given tax structure (progressivity). Changes in tax progressivity for a given average taxation may result in lower wage claims by unions or efficiency premia from employers. For a summary discussion of the implications of different labour market models for the effects of taxation see Sørensen (1997).

²⁷ The labour demand elasticity is larger at the firm level than at the industry level because of the infra-industry competition that the single firm is facing.

²⁸ Co-ordination in the bargaining process, as such depending on the co-ordination existing on both the employers' and the workers' sides.

structure on equilibrium unemployment may depend on the kind of shocks an economic system is subject to. The favourable effects of co-ordination (balancing the negative impact of unions' strength) are likely to materialise in the case of aggregate shocks in which centralised social partners have the right incentives to adjust their behaviour. In such a case, unions' co-ordination may even substitute for other institutions (for instance a stability-oriented and independent central bank) in pursuing macroeconomic stability²⁹. By contrast, in the case of micro economic shocks and/or where other institutions are already guaranteeing macroeconomic stability, unions' centralisation may have detrimental effects insofar as it leads to rigidities impeding the necessary structural adjustment.

Job-security provisions

A shift of the pendulum has also occurred for what concerns the relevance of employment regulation, in particular EPL.

While this was identified as one of the most relevant culprits of the "Euro sclerosis" in the '80s³⁰, a better modelling of labour demand in the presence of adjustment costs has shown that direct (i.e. for given wage rates) employment impact of firing costs may be even dubious as a sign³¹. Therefore the role of EPL is now considered mostly as indirect, i.e. as a factor leading to persistence (after a negative shock has occurred³²) or as a factor whose employment relevance comes

²⁹ This interaction between unions' bargaining structure and central bank independence has been recently emphasised by Cukierman and Lippi (1997).

³⁰ See, for instance, Emerson (1988).

³¹ The hiring costs have an obvious negative impact on both employment variability and its average level. The effects of firing costs on the average level of employment are more dubious. At the same time they will limit layoffs in some firms and will make some other firms more cautious in hiring new staff (which might be terminated in the future). Therefore, a relevant parameter is the degree of persistence in the shocks: in Bentolila and Bertola (1990), the presence of permanent shocks let firms who are contemplating whether or not to hire new staff (those subject to a positive shock) not to worry too much about the risk that in the future the new hired staff might be fired at a cost, so that in the aggregate the firing costs may have a positive impact on employment. Furthermore, Bentolila and Saint-Paul (1994) obtain a non-monotonic relationship between firing costs and aggregate employment, even in the case of temporary shocks (for which the fears of being induced to fire the new staff in the future is more important): when the firing costs are already quite high, a further rise of these costs will still have an effect on those firms who would like to fire their staff, having on the contrary no further effect on the firms which were contemplating whether to hire new staff and which have already refrained from doing so. A further consideration derives from the fact that, at least in theory, it is possible that the costs impinging on firms because of EPL, which represent a mechanism of insurance for the workers, are simply shifted back to workers during the wages' bargaining process (Lazear, 1991).

³² Diaz and Snower (1996) not have been a problem during the '60s when economic cycles were mild and regular. However, strict EPL may hinder employment if a large shake-out of labour

from the support it provides to the insiders' bargaining power.

A further critique to the role of EPL in differentiating across countries in the labour market performance has come from the lack, from an empirical point of view, of a strong correlation between the countries ranking in EPL strictness and job turn-over measures (OECD, 1994, and Contini *et al.*, 1995). Apart from the difficulties in the measurement of the jobs and workers turn-over and in comparing them across countries, it has to be stressed that a rough uniformity in job turnover across countries characterised by different degrees of EPL strictness does not imply that the latter does not matter³³.

More generally, the possibility that each country has its own model of employment adjustment³⁴ does not imply that the formal EPL strictness or any other kind of regulation is irrelevant. For instance, job-security provisions might lead to an increase in the size of the "informal" sector, hence possibly lowering overall productivity and increasing the fiscal burden on the regular and more taxed sector (suffering from the displacement deriving from the informal sector). Moreover, a strict EPL may hinder product innovation, particularly in the service sector, restricting output and employment. This and other developments, in a context of increasing interdependence of national economies, may raise in the future the potential inefficiencies of strict job-security provisions.³⁵

occurs following a severe recession, as those in the '80s and '90s. In such case, the return of demand to its pre-shock state may be insufficient to restore employment to its earlier levels.

³³ Bertola and Rogerson (1997) argue that broadly similar job-turnover rates in Europe and the US may be explained by the combined effect of job-security provisions and relative-wage compression.

³⁴ This being provided by self-employment, sub-contracting to small and medium firms, the black economy, temporary workers or other solutions able to sidestep the strictness of EPL among the standard full-time full-year employees.

³⁵ For a summary of the debate, see Buti *et al.* (1998).

3. The internal articulation of the European welfare system(s)

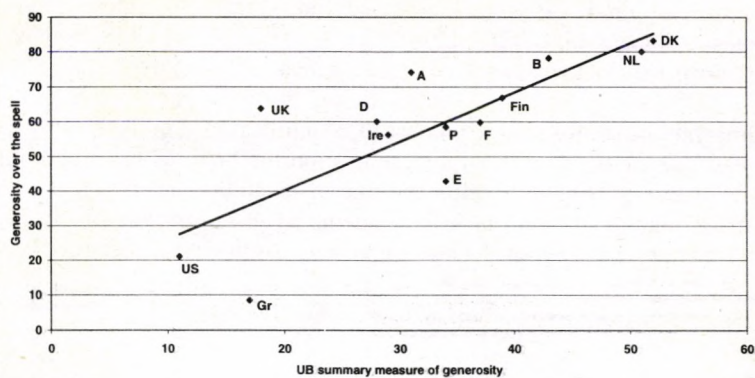
As already pointed out in the previous section, the analysis of the links between the welfare system and unemployment has tended either to focus on the impact of a single transfer programme, the UB system, or to look at the impact of the overall size of the welfare system, via its tax-based financing. We have already discussed strengths and weaknesses of these two explanations. This section will show the richness of aspects of the welfare system which are actually lost in that kind of analysis.

The complexity of the welfare system has been captured in two ways: by introducing a different impact of the UB level and duration; and by considering the role of the so called “active” measures. It is argued here that other aspects are also relevant.

3.1. Unemployment compensation

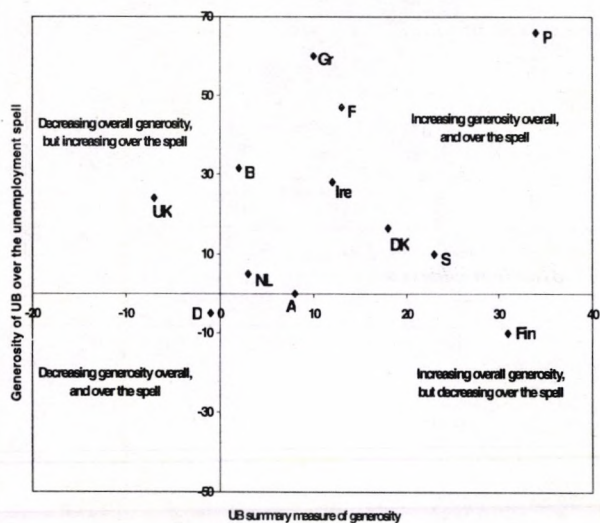
The standard measure of overall UB generosity (Table 4) is an attempt to summarise the two dimensions of benefits: level and the duration. Across countries, the overall generosity of unemployment compensation tends to be correlated with its generosity over the unemployment spell (Graph 7). In other words, where unemployment compensation is relatively generous (in practice most continental European countries), there is little attempt to graduate it over time so as to attenuate the negative effect of benefit duration. As shown in Graph 8, over time, even if in most European countries the overall generosity has shown only a slight increase (the UK decline being rather an exception), the duration aspect of the generosity has clearly increased.

Graph 7. Overall generosity and generosity over the unemployment spell.
(Ratio of 2nd-3d years benefits to 1st years benefits.)



Source: OECD

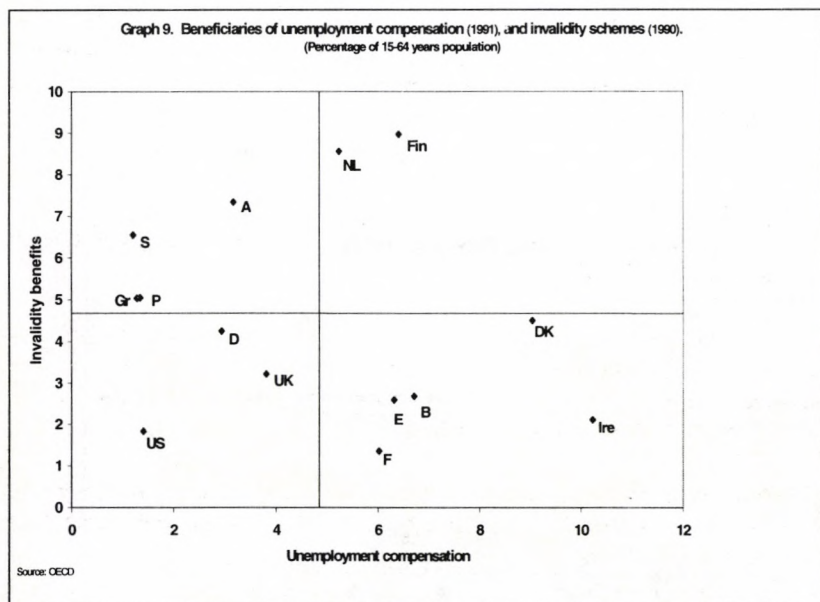
Graph 8. Unemployment compensation: change over time, (1991-75).



Source: OECD

Moreover, the UB system does not work in isolation moreover. Other transfer programmes may be used (or abused) for financing non-employment. For example, invalidity benefits (and early retirement schemes) tend to substitute for unemployment compensation, with the effect of formally excluding from the labour market workers that would otherwise be counted as unemployed³⁶.

Graph 9 shows that, for a large number of countries (those in the north-west and south-east quadrants), there is an inverse relationship between the proportion of recipients of unemployment benefits and that of invalidity benefits. It is well known that for some countries which have attempted to reform one of the two schemes in isolation, massive transfers of recipient across them have occurred³⁷.



³⁶ Comparing countries only on the basis of UB generosity may be misleading. Even if there is some correlation across countries between the generosity of unemployment compensation and that of invalidity benefits, the match is far from being perfect.

3.2. Services versus transfers

The programmes financing non-employment are not the only aspects of the structure of welfare on expenditure having potential labour market implications. The literature has mostly debated the role of active labour market measures. However, whatever their effectiveness, they only cover labour market programmes, which are a tiny fraction of the overall welfare system.

Here we widen the perspective by looking at the relationship between cash transfers and in-kind services. It is argued that this may be relevant for the development of the labour intensive service sector.

The relative weight of services and (cash) transfers provides a fair characterisation of the structure of the welfare system. If one compares countries along two dimensions – represented by total social expenditure as percentage of GDP and the ratio between benefits and services³⁸ – relatively distinct patterns emerge (Graph 10):

- A Nordic pattern (Sweden, Denmark, and, as a borderline case, Finland) characterised by a high level of social expenditure and a relatively high proportion of services relative to benefits;
- A continental European pattern, (the Benelux countries, Germany, France and, as borderline cases, Italy and Austria), in which social expenditure is also relatively high, although distinctly lower than in the Nordic countries, but the weight of services relative to benefits is lower;
- A Mediterranean pattern (mainly Spain and Greece, with Italy and Portugal as borderline cases at the two extremes), characterised by lower social expenditure and a marginal role of services;
- The UK and Ireland, with lower social expenditure than in continental Europe and a comparatively higher weight of services relative to benefits;

³⁸ Benefits include old-age cash benefits, survivor's benefits, unemployment compensation, disability cash benefits, occupational injury and disease benefits, sickness benefits, family cash benefits, and other contingencies (mainly low-income benefits). Services include family services, active labour market programmes and health care. Administration costs (general overheads, registration, collection, inspection) are not included, except for active labour market policies and health care, where they are part of the service being provided to the recipients (OECD, 1997d).

- The USA, where social expenditure is much lower than in continental Europe and the relative weight of services (essentially, health care) in public expenditure much higher.

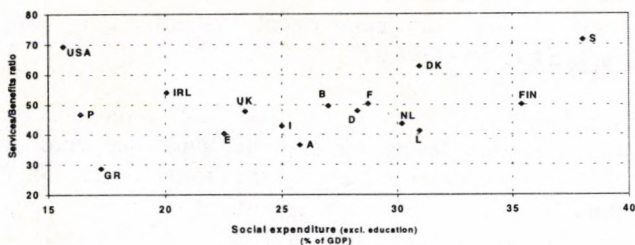
This two dimensional characterisation bears some correspondence with the typologies found in the sociological literature on the welfare state (for example, Esping-Andersen, 1990). It is also largely coincident with classifications based on the description of institutions (European Commission, 1995). Furthermore, the services/benefit dimension tends to overlap with the aged/non-aged dimension, measuring the ratio between old-age and survivor benefits, on the one hand, and other social expenditures (excluding health), on the other hand (OECD, 1996b). This is because everywhere old-age pension expenditure is the largest item in cash benefits.

The level of social expenditure *per se* does not seem to affect the employment performance, as measured by the employment rate. In fact, Nordic countries and the USA – which are at the opposite side of the spectrum in terms of size of social expenditure – score the highest, with the continental European pattern and the Mediterranean pattern doing less well (Graph 11). The employment in services – particularly the community, social and personal services³⁹ – is behind the high levels of employment in both the Nordic countries and the USA.

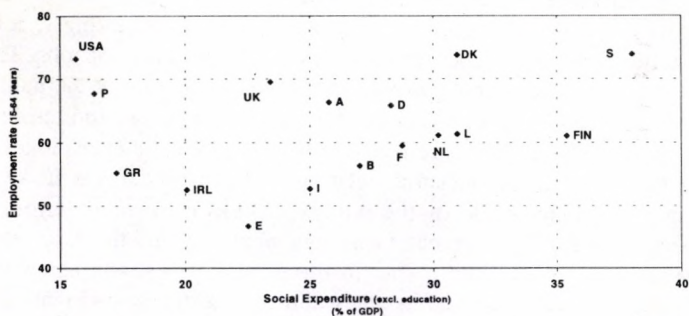
The positive correlation between the relative share of expenditure in in-kind services (Graph 12) suggests that an orientation of social expenditure towards services may offset any potential negative effects of a large welfare state on employment.

³⁹ Community social and personal services include sanitary services, educational services, medical and other health services, recreational and cultural services, personal and household services. The employment data include both public and private employment.

Graph 10. Social expenditure, services and benefits.
 (1993)

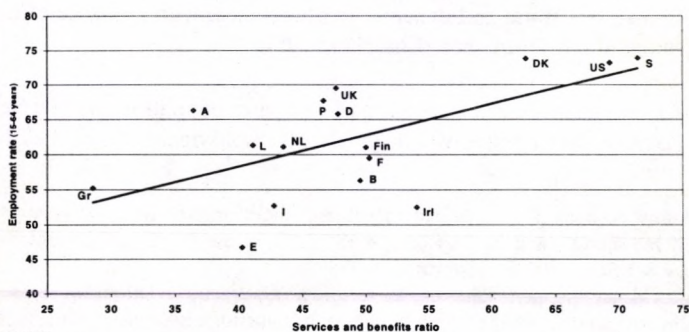


Graph 11. Social expenditure and total employment.
 (1993)



Source: OECD

Graph 12. Services/benefits ratio and total employment.
 (1993)



Source: OECD

Clearly, cross-country comparison along two dimensions, as those presented above, can at best offer a very partial representation of the complex relationship between welfare state systems and employment systems. It is tempting nevertheless to highlight a number of points:

- Levels and structures of welfare state provision differ profoundly across Europe. In terms of expenditure levels, for example, about one third of EU member countries are definitely closer to the USA than to the Nordic countries. Perhaps more importantly, in terms of structures, differences in the weight of services relative to benefits suggest significantly different approaches to the means and the objectives of the welfare state.
- In terms of employment performance, the American model and the Nordic model stand out as two alternative routes to high employment. Interestingly, both result in a high reliance on social and personal services as providers of jobs. The key distinction between the two employment systems lies in the role of the public sector as employer, which is relatively dominant in the Nordic model and residual in the American model. This in turn is reflected in the extreme differences in levels of taxation and the structure of industrial relations⁴⁰. Each model has its own problems. The perceived downside of the American model, especially from a European perspective, is the high degree of earnings inequality and the associated results in terms of social exclusion⁴¹. This in turn raises questions about the "social sustainability" of the model and its applicability in different socio-cultural environments. On the opposite side of the spectrum, the problems of the Nordic model may derive from the pervasiveness of the State role and the associated tax burden. Besides the results in terms of employment/unemployment outcomes⁴², there are indications that the very large weight of the public sector in the Nordic model results in important static and dynamic inefficiencies, with negative effects on the long-run economic performance (Lindbeck, 1997).
- A number of European countries seem to present a combination of relatively high levels of taxation and relatively low levels of employment. There has not

⁴⁰ For a comparisons between the American model and the Swedish model stressing the importance of sheltered services and the respective roles of the private and the public sector see also Appelbaum and Schettkat (1993) and Scharpf (1997).

⁴¹ Cross-country evidence supports the existence of a systematic relationship between institutional features frequently quoted as contributing to the superior employment performance of the US labour market, particularly the low degree of collective bargaining coverage and the low rate of union membership, and the spread of earnings inequality (Freeman, 1996b).

⁴² The recent surge of unemployment in Sweden has been taken by a number of observers as evidence of the long-term unsustainability of the employment performance of the Nordic model, particularly in its reliance on the State as 'employer of last resort' (Alogoskoufis et al. 1995).

been substitution between public and private demand for services in the labour market. Public spending has been primarily geared towards income maintenance and the labour market has played a lesser role in income distribution.

These features of mainly continental countries may be a cause for concern in the medium/long-term, especially if one takes into account concomitant trends in industrial activity and in demography.

In industrial terms, since the 1980s, services have been the only sector with a positive net employment creation in both the USA and in Europe: low levels of employment in services may suggest that institutions are relatively ill adapted to the ongoing shift from the "industrial" to the "tertiary" economy.

In demographic terms, it is arguably not a coincidence that countries with a welfare system geared toward benefits relative to services and, correspondingly, toward the aged relatively to the non-aged (e.g., Germany, Italy and Spain vis-à-vis the Nordic countries), tend to be characterised by particularly low fertility rates and hence, in perspective, particularly pronounced ageing. This risks feeding a vicious circle in which the increasing weight of the elderly further tilts the balance of social expenditure toward pensions, thereby exacerbating the disincentive effects of the welfare state on employment.

4. Interactions between labour market institutions

As stressed earlier, labour market institutions are intertwined in various and complex manners across European countries and result in distinct national employment systems. The present section argues that relations of complementarity or substitutability between these various mechanisms and institutions - often inspired by similar principles - may result in "double" safety nets and excessive rigidity in the face of adjustment to a changing economic environment.

4.1. Social partners behaviour, wage bargaining system and EPL

Bargaining systems, employment regulations, welfare provisions contribute to shape the behaviour of social partners and are themselves affected by such behaviour.

Inspection of Table 4 suggests a number of observations on the relationship between co-ordination, which is generally considered good for employment, and unions' strength, the effect of which is more debated.

Both union density and bargaining coverage are usually considered as measures of union strength. A positive, albeit weak, correlation exists between union density and co-ordination, although the index of co-ordination is very rough (only three values are considered and most of the countries are being assigned a unique intermediate value). A positive correlation also appears to hold between bargaining coverage and co-ordination.

The interplay between coverage and density is complex. In certain countries the former seems to reflect mainly the ability (or lack thereof) of the unions to represent workers' interests (mainly the Nordic countries and, on the opposite side of the spectrum, the UK and US). In some countries, administrative rules appear to have supplemented, if not replaced altogether (typically in France), union representativeness in safeguarding their role in wage negotiations.⁴³

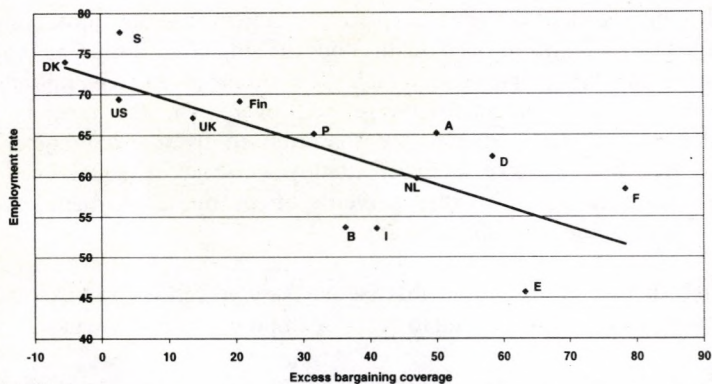
As a first approximation, the difference between coverage and density can be interpreted as an indicator of "artificial" union strength, i.e. a strength not deriving from the unions ability to gain the workers' support. This index, hereafter dubbed "excess bargaining coverage", is supposed to neutralise the possible positive effects of unions' strength (strong unions may more likely feel entrusted with representing the national interest and hence be more willing to co-ordinate).

As shown in Graph 13, the excess coverage is negatively correlated with the employment rate in our sample of countries.⁴⁴

⁴³ However, as pointed out by OECD (1997b, p. 84), a high coverage "insurance" may contribute to a decrease in unionisation as workers feel less motivated to join the unions to benefit from collective agreements (this may be the case in Austria).

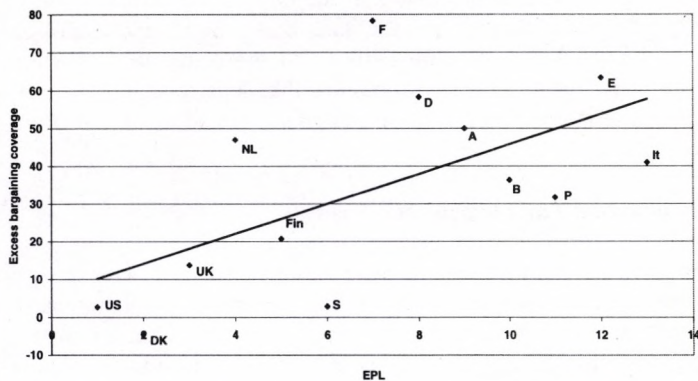
⁴⁴ The negative correlation holds also if we include all OECD countries.

Graph 13. Excess bargaining coverage and employment rate, (av. 1980s and 1990s).



Source: OECD

Graph 14. EPL ranking (av. 1985-1993) and excess bargaining coverage (av. 1980s and 1990s).



Source: OECD

Two sets of countries have distinctively low excess bargaining coverage and a high employment rate: the highly decentralised and uncoordinated Anglo-Saxon economies, with very weak unions, which, in principle, benefit from the allocation efficiency provided by such systems; and, on the opposite side of the spectrum, the Nordic countries with strong unions and highly co-ordinated and centralised bargaining systems, able to internalise wage spill-overs. On the contrary, continental and Mediterranean countries are characterised by a much higher excess coverage and, by and large, a lower employment rate. Although only suggestive, this evidence points to the perverse effect on employment of artificially-blown trade union strength.

Are there labour market institutions that favour the emergence of an excess bargaining coverage, thereby contributing to the poor employment performance?

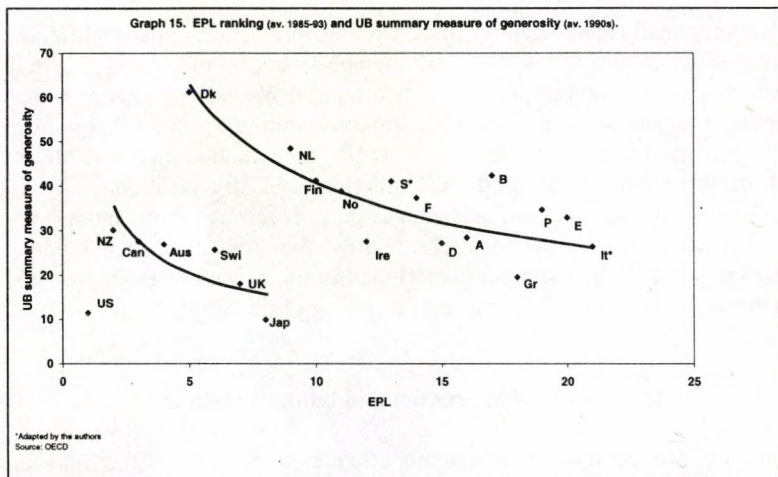
Empirically, it appears that the degree of strictness of job security provisions, rather than the generosity of the welfare system, is associated with excess coverage. As shown in Graph 14, a positive correlation exists between EPL rigidity and the excess coverage indicator. In particular, the correlation is strong between the two groups of countries situated at the ends of the excess coverage ranking (Anglo-Saxon plus Nordic, on the one hand, and continental plus Mediterranean, on the other hand), while France and the Netherlands are clear outliers. Therefore, there is a strong presumption that legally-supported union strength tends to emerge mainly in those countries characterised by interventionist labour market regulations.

4.2. Job-security provisions and benefit generosity

As is well known, some form of EPL can be rationalised as a substitute for insurance that markets cannot provide⁴⁵. To the extent that labour market regulations and welfare provisions respond to similar types of market failure, they are functional equivalents and can be seen as institutional substitutes: "Labour market policy regimes work like communicating pipelines. If one policy is underdeveloped, others will very likely replace or offset it" (Schmid, 1995, p. 57).

The ranking indicator of EPL strictness is represented in Graph 15 against the summary measure of benefit entitlements (UB) for the 1990s, already used in previous sections. Unlike previous graphs, all OECD countries are pictured.

⁴⁵ For a recent account of the debate, see Buti et al. (1998).



Countries present widely different combinations of labour market regulations and income support for the unemployed. As shown in the graph, the various combinations of EPL strictness and benefit generosity can be described in terms of “pseudo-indifference curves” in the “workers protection” space: a given degree of workers protection can be obtained by different combinations of job security provisions and compensation in the event of unemployment⁴⁶. Another message emerging from the graph is that, whatever the combination of instruments, EU Member States (with the exception of the UK) and Norway choose a much higher degree of protection than the other OECD countries, as shown by the outward position of EU countries’ pseudo-indifference curve. As expected, the weakest protection is attained in the USA where low levels of both EPL and UB co-exist.

Within the EU, liberal labour market regulations coupled with generous unemployment compensation are found in Denmark, Netherlands and, to an extent, Finland. On the opposite side of the spectrum, in Italy and Greece, the underdevelopment of the benefit system has been compensated by high job security provisions. EU continental countries have typically an intermediate position.

⁴⁶ Describing institutional equilibrium in the labour market in terms of attaining a certain degree of job security through various combination of EPL and UB is done simply for illustrative purposes. As the indicator of EPL strictness is a ranking, the curves in the graph cannot be interpreted literally as indifference curves. Furthermore, we are fully aware that different combinations of the two elements along the same curve may not result in equivalent levels of workers’ protection.

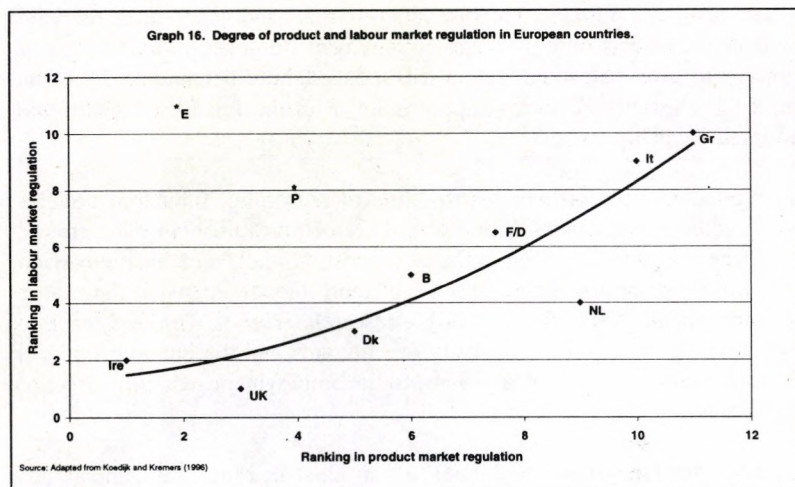
While functionally equivalent in the “workers protection” space, different combinations of job security provisions and unemployment benefits are not neutral with respect to economic and employment performance. We have already seen that interventionist regulations appear to be correlated with the excess bargaining coverage. Furthermore, the rigid EPL – low UB combination may be highly inefficient in the event of sectoral, technological and organisational shocks entailing changes in comparative advantages and requiring swift labour reallocation between firms and sectors. The relative importance of such kind of shocks may be increased by the process of globalisation, as well as the increasing interdependence arising from EMU and the deepening of the Single Market.

5. Mutually supporting rigidities in product and labour markets

The regulation of product and labour markets provides an example of the linkages that exist between institutional sets within each national system, of which the employment system is itself a part.

As Graph 16 shows, a fair degree of correlation seems to exist between the relative rigidity of product and labour market regimes⁴⁷: countries that rank high in labour market regulations, such as Italy and Greece, tend to have the highest degree of product market regulation; the Anglo-Saxon countries have the lightest regulation both in product and labour markets; the other European countries tend to fall in between on both dimensions. This in turn suggests a relationship of complementarity between the two institutional sets: as product and labour market regulations reinforce each other, lack of competition in the product markets compounds the labour market problems created by employment rigidities, with the effect of one being difficult to disentangle from that of the other.

⁴⁷ The classification of product and labour market regimes inevitably contains judgmental elements. The data used in our example are drawn from Koedijk and Kremers (1996). The regression line in Graph 16, however, excludes the data for Spain and Portugal, whose classification as ‘liberal’ product markets seems to be particularly open to question.



“Defensive” industrial policies can also be interpreted within our institutional framework. By defensive industrial policies we mean various forms of support granted by governments to industry, particularly in connection with situations of crisis. State aid to industry can be taken as a proxy for the extent of such policies, which can be seen as part of a wider pattern of product market regulation: data indicate that countries where state aid to industry is the highest tend to have heavily regulated product markets⁴⁸.

Leonard and Van Audenrode (1993) provide an interpretation of the genesis of industrial policies and their effects on the labour market that stresses the risks of degeneration of the corporatist model prevailing to different degrees in (continental) European countries. In a corporatist setting, the government is supposed to engage in political exchange with the trade unions and the employers’ organisations on a broad set of policies, with the objective of lowering aggregate wages and thereby increasing employment. Insofar as these defensive policies are endogenous, the rise in unemployment could itself have created a vicious circle by heading to further pressure for state aids.

⁴⁸ According to the Fifth Survey on State Aid (European Commission, 1997a), based on the data for the 1992-94 period, the highest intensity of state aid to industry (state aid as percentage of value added) is found in Greece and Italy, followed by Belgium, Germany and Portugal.

The bias in favour of established organisations implicit in such arrangements, however, can result in policies that discourage firms' and jobs' turnover with ultimately negative effects on output and employment. In general, taxing the rest of the economy to subsidise some sectors will reduce labour demand at any given wage rate, if the elasticity of output supply is lower in the subsidised sector and the capital intensity is higher.

Some empirical evidence corroborates this line of reasoning. Industrial policies tend to privilege large enterprises in established sectors, presumably on the ground of better access to the decision-making process. Small and medium-sized enterprises, which are relatively penalised, are more labour intensive than large enterprises (European Network for SME Research, 1997). The existence a negative relationship between the intensity of state aids and the employment rate across EU countries also lends some support to the employment-reducing effect of industrial policies.

The complementarity between labour and product market arrangements has also implications for the employment outcomes of possible reforms. If product markets regulations are a significant source of rents and underemployment, a movement towards decentralised bargaining in the labour market that is not accompanied by an adequate product market liberalisation may actually exacerbate the problem. If wage setting is decentralised, the single firms' unions may be less restrained from seeking to exploit rents in the product market to the benefit of their members, possibly to the detriment of employment in the rest of the economy.

6. Lack of institutional variety within national employment systems

The approaching of EMU has spurred some interest on the regional dimension of unemployment in Europe. The issue usually examined has been that of the labour market reaction to an idiosyncratic shock, the ultimate aim being that of rating EMU according to the theoretical criteria of an "optimal currency area".

The common wisdom is that the unemployment effects of a demand shock are not more persistent in Europe than in the US; however the adjustment mechanism is drastically different in the two cases, with a change in the participation rate, and therefore in the employment level, in Europe and the workers' migrations in the US⁴⁹. Concerning EMU, these are somehow mixed news: the lack of labour

⁴⁹ On the two different sets of results see Blanchard and Katz (1992), for the US case, and Fatas and Decressin (1994) for Europe.

mobility is, *per se*, a minus in the assessment of the “optimality” of EMU as a currency area⁵⁰; however, this lack of mobility is a feature characterising also each individual country, having no direct implication for the EMU related irrevocability of the between countries exchange rates⁵¹.

While in this literature the relevant issue is that of the dynamic reaction to idiosyncratic shocks, the point which will be mostly here developed is that the amount of regional (infra-national) variation in unemployment is, in some cases, so large to put into question the same reference to the country as the relevant unit of analysis. Not only national rates of unemployment average out significant regional differences, but the distribution of unemployment in some countries tends to be significantly asymmetric, with national (average) rates of unemployment inflated by few high-unemployment regions.

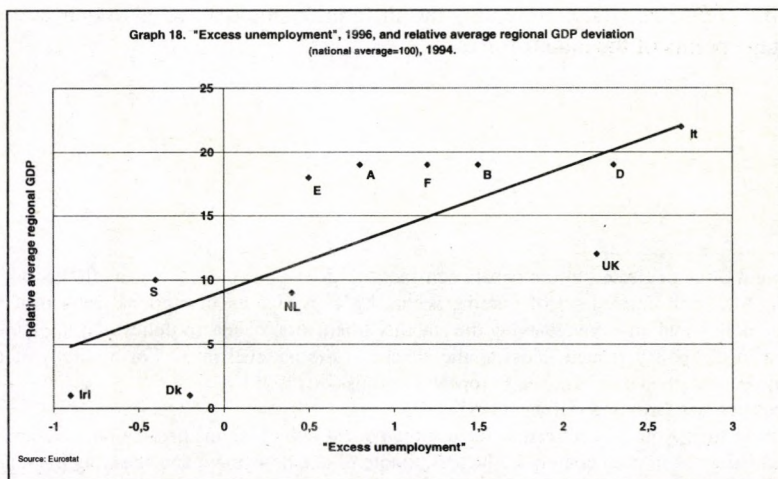
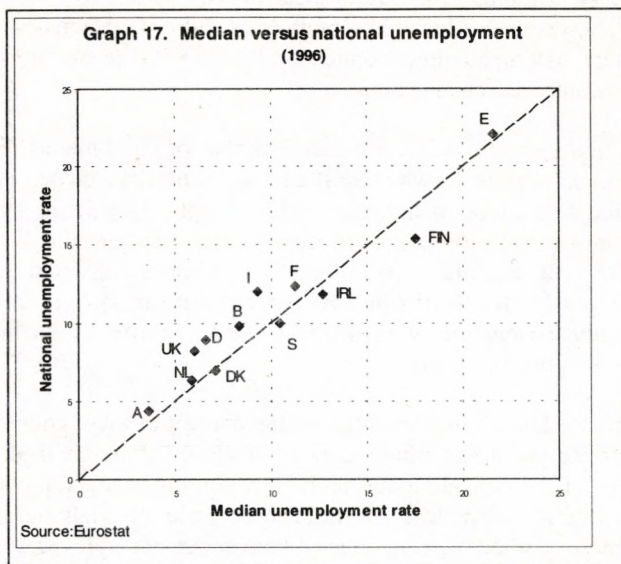
One might say that the high average unemployment of these countries is not representative of the prevailing labour market situation. Taking the median region as representative of the typical labour market institutions of a given country, the “excess” of the average unemployment (inflated by those few high unemployment regions) with respect to the median value of unemployment⁵² provides a measure of the “excess unemployment” due to the presence of regional outliers (Graph 17). For some countries (Italy, Belgium) the difference amounts to as much as two percentage points of the labour force⁵³.

⁵⁰ The point often neglected in the debate considering EMU as a “currency area”, to be judged according to a well defined set of criteria, is that EMU is also an institutional reform of the economic policy making, strengthening the stability orientation of macro policy and implying a reduction in the policy related idiosyncratic shocks at the national level. For a survey of the several aspects implied by EMU, see European Commission (1998).

⁵¹ For instance, see Gros and Hefeker (1997).

⁵² Median unemployment is defined as the unemployment rate of the median region, obtained by ranking the regions in each country by increasing rate of unemployment and selecting the region containing the 50th percentile of the labour force. Regions are defined according the most detailed level (NUTS3 level) in the classification of the European Communities.

⁵³ Our definition of “excess” unemployment simply relates to the asymmetries in the across regions unemployment distribution, aiming at pinpointing the presence of few high unemployment regions. Other definitions might be constructed starting from the dispersion (as measured by across regions standard deviation) of unemployment, relating the excess of unemployment to the non-linearities in the wage-unemployment relationship which lead to a positive relationship between the average unemployment rates (see Lipsey, 1960).



Persistent regional differentials in the distribution of unemployment have to be related to those institutional characteristics, such as those of the housing market, which discourage inter-regional mobility, along the lines of the literature previously discussed.

The asymmetries⁵⁴ emphasised here can be taken as an indication of a mismatch between institutions, mostly shaped at the national level and very often unduly homogeneous inside a given country, and the economic environment prevailing in some of its regions. Specifically, pressures for wage equalisation within the same country may arise, because of several institutional factors, irrespective of productivity differentials, resulting in a wage gap in the low-income regions. Besides the pressures coming from trade unions (particularly where bargaining is made at the national level), other institutional factors will be at work in the same direction, including the availability of income maintenance programmes geared toward the national average and, more in general, the very existence of a (large) public sector, where conditions tend to be the same across the country⁵⁵.

Excess unemployment arises when a country is strongly differentiated on regional lines (as distinct, for example, from differentiation on industrial lines) and its political and social institutions are uniformly shaped from the centre. The presence of both conditions (regional income inequality being a proxy of one of them) is necessary for excess unemployment to arise.

An empirical inspection lends some support to the hypothesis that countries with larger internal differentiations in the economic situation tend to have a worse unemployment performance at the national level. Specifically, countries with a high degree of regional income inequality seem to have higher "excess" unemployment (Graph 18).

In a sense, the institutional mismatch hypothesis boils down to some standard explanations of European unemployment, in terms of wage rigidities and the disincentive effects of the welfare state: in the absence of pressures for wage equalisation and income support from the richer to the poorer regions excess unemployment in the less developed and depressed regions would not follow from their lower income level. At the same time it differs from those standard

⁵⁴ Unfortunately we do not have data long enough for testing the persistence over time of these asymmetries, so as to rule out the possibility that they simply derive from asymmetries in the current shocks. Our feeling is that the picture which would emerge from a longer run view of the across regions distribution of unemployment is not much different from that shown in the previous chart.

⁵⁵ An analysis of the Italian case along these lines is in Bodo and Sestito (1991).

explanations, at least in their usual formulations, as it highlights the fact that the same institutional arrangements may be neutral or even supportive towards employment in a given environment and detrimental to it when they are applied in different conditions.

7. Conclusions and policy considerations

This paper claims that the way institutions interact is important both to understand the structural nature of Europe's unemployment and to devise the appropriate policy responses.

Our conclusions can be summarised as follows:

1. As national employment systems tend to be closely interlocked, comprehensive action, rather than scattered measures seems to be the key for success in tackling unemployment. The reforms should span both labour and product markets, as rigidities in the two fields are often related.
2. The internal structure of the welfare system may be relevant for the employment outcome. An important aspect which may explain why both US and Nordic models, while not without problems of their own, produce high employment, is that both are conducive to the development of the social services sector.
3. Different labour market institutions often pursue similar objectives (typically protection of workers) and, as such, are "institutional equivalents". Relations of substitutability exist between job protection legislation and unemployment compensation, or, within the welfare system, between unemployment and invalidity benefits. However, institutional equivalence does not imply economic equivalence, in terms of employment performance and ability to respond to shocks. Specifically, the high EPL-low UB combination is likely to become increasingly inefficient.
4. In a number of continental countries there exists a combination of relatively weak trade unions, typically unable to shoulder the national interest and to coordinate their action, and high bargaining coverage, through administrative extension to the bulk of the workforce of collective agreements. This "excess bargaining coverage" seems to be particularly bad for employment.

5. The importance of the regional component of unemployment in several EU countries points to a lack of "institutional variety" within EU countries. When a uniform institutional set-up is super-imposed onto a heterogeneous situation, in terms of productivity levels and, more generally, economic development, an institutional mismatch emerges, with negative consequences for employment.

How can the ongoing reform process in EU countries be judged in the light of these conclusions?

The imperative of implementing wide-ranging structural reforms involving a better functioning of labour markets and completing the Single Market has been at the heart of the EU employment strategy since the 1993 White Paper on Growth, Competitiveness and Employment (see BOX).⁵⁶

The EU strategy has been built on the idea that wide-ranging reform does not imply fully embracing the US model. This paper seems to confirm the possibility of preserving European peculiarities. For instance, the analysis of the substitutability of unemployment compensation and job-security legislation points to a possible "third way" between the full flexibility of the Anglo-Saxon model and the rigidity of many continental countries. The "low EPL-high UB" institutional mix of countries like Denmark or the Netherlands has the potential advantage of allowing structural change and labour re-allocation while maintaining an adequate degree of solidarity. On the contrary, a number of developments requiring higher flexibility (including EMU and the deepening of the Single Market) point to an increasing sub-optimality of rigid EPL as a means to achieve workers protection⁵⁷.

Accepting a suitable income replacement for the unemployed does not imply that further reforms of the current benefit systems in Europe are not warranted, for example, concerning the time profile of benefits and their administration⁵⁸. In this context, a stronger effort in Active Labour Market Policies, as recommended by the Luxembourg Employment Guidelines, and mobility-enhancing measures (such as housing policies) may also have an important role in shifting from workers'

⁵⁶ A comprehensive approach is considered a pre-requisite for success by the OECD (see OECD, 1997c). Coe and Snower (1997) stress the policy complementarities of wide-ranging measures. While a broad-based action is required, one should be aware that, even radical reforms, as the example of the UK shows, would take time to produce results.

⁵⁷ This conclusion seems to be consistent with the proposal by Rhodes (1997) to reform the continental model towards a sort of "competitive corporatism".

⁵⁸ Other more radical reforms – such as the use of personal insurance accounts, negative income tax or employment vouchers – may also be envisaged. See, e.g. Snower (1995 and 1996), Snower and Orzwaig (1998) and Franco and Sestito (1995)

support "on the job" (via rigid EPL) to support "on the market" (via adequate UB, training, etc.).

The EU efforts in labour market reforms have relied on the subsidiarity principle. This has been considered a weakness, in that no strong push to reform has been exercised on individual countries.

Our discussion shows that preserving institutional variety, far from being a constraint, may be a point of strength. It confirms that each country needs a specific package of reforms. Moreover, the importance of the regional (i.e. infra-national) dimension in European unemployment and its explanation in terms of institutional mismatch carry relevant implications concerning the conditions for success of monetary unification in Europe. Given the greater differentiation that exists across regions Europe-wide than within any individual country, pressures toward greater uniformity of labour market institutions or wage equalisation following EMU would carry the risk of increasing institutional mismatch and hence jeopardise the efficiency gains expected from the adoption of a single currency.

While the broad principles of the EU reform process appears to be soundly based, its actual implementation, so far, has remained patchy.

As the Joint Employment Report to the Luxembourg Jobs Summit puts it,

"(d)espite important structural reforms carried out in some Member States, the overall picture that emerges is somewhat obscure, given the insufficient integration between policy measures and the absence in many cases of any clear long-term strategy, or well defined policy goals. (...) In some cases, the reforms and policies have been too timid considering the scale of the problem or too patchy without a comprehensive and co-ordinated approach. (...) There remains the need to tackle the key problems in the functioning of the labour market and to gather support for bold reform projects." (JER, 1997, p. 8).

Implementing successfully the reforms raises a number of issues. The "time consistency" of reforms appears to be an important ingredient. Although not all the measures can, realistically, be implemented at once, it is paramount that each subsequent move creates a constituency in favour of further moves⁵⁹. This aspect may be important in reducing the costs of transition linked to the risk of reversibility of liberalisation (Bertola and Ichino, 1995). More competition in product markets, through the Single Market programme and the related Action Plan, as well as the fading of traditional forms of bail out in EMU (monetary bail

⁵⁹ This aspect may be important in reducing the costs of transition linked to the risk of reversibility of liberalisation (Bertola and Ichino, 1995)

out, government hand outs, “defensive” industrial policies), can be expected to feed back eventually to higher wage and labour market flexibility⁶⁰. However, in order to bring about a virtuous cycle, it is important that bold labour market reforms tackling the specific bottlenecks in the national employment system are quickly implemented⁶¹.

Achieving the necessary social consensus to ensure the success of reforms may be comparatively less difficult both in highly co-ordinated and in decentralised systems (though the reform paths would be completely different in the two groups of countries) whilst it may prove more complicated in poorly co-ordinated, “intermediate” Member States.⁶²

13.2.98

⁶⁰ See, European Commission (1997b).

⁶¹ The success of Denmark in tackling youth's welfare dependency and, on the negative side, the failure of the labour market reforms in Spain in the 1980s, which, by deregulating “at the margin”, consolidated de facto the power of insiders (Bentolila and Dolado, 1994) are clear examples. The recent agreement between the social partners in Spain which is significantly easing job-security provisions for permanent workers can be expected to have a much more favourable impact. An example of successful sequencing of reforms may come from New Zealand (see Evans et al., 1997).

⁶² Similarly, “vertical”, sectoral-based welfare systems (usually providing transfers to cohesed and vocal social categories) may prove more difficult to reform than “horizontal”, though on the whole more generous, welfare systems. The former are typical of continental countries, while the latter are found in the Nordic countries.

THE EU EMPLOYMENT STRATEGY FROM THE 1993 WHITE PAPER TO THE 1998 LUXEMBOURG GUIDELINES

The *1993 White Paper on Growth, Competitiveness and Employment* (European Commission, 1993) indicated a list of priorities for action on jobs in the labour market area, covering both “lenient” and “harsh” measures (amongst the former, lifelong education and training, reduction in the relative cost of low-qualified work, exploiting new sources of jobs; amongst the latter, greater flexibility in businesses, both internally and externally). These were complemented by measures aiming at promoting economic growth, such as the promotion of Trans-European Networks in telecommunications, transport and energy.

The *European Council in Essen* in December 1994 formalised the involvement of the Union: it selected five guidelines which were, in fact, a mix of final and policy targets and agreed upon a burden sharing between EU and national responsibilities (Member States would present Multi-Annual Employment Programmes; through Joint Reports, the Commission and the Council would monitor national efforts so as to enhance peer pressure).

The Essen approach paved the way to the new *Employment Title* in the Amsterdam Treaty which confirmed that the main focus on employment is to remain at the national level. The Essen monitoring process was formally supplemented by Employment Guidelines drawn up at the EU level, similarly to the Broad Economic Policy Guidelines of art. 103.

The *Luxembourg Jobs Summit* in November 1997 provided the ground for a first, *ex ante* application of the new Treaty. The Guidelines adopted by the Summit restated strongly MS own responsibility for employment, confirmed the need for a global strategy embracing growth, competitiveness and employment and indicated some quantified objectives in the area of ALMPs reflecting best practices.

The Guidelines were articulated in four themes (employability, entrepreneurship, adaptability and equal opportunities).

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