Commentary: The Extent of High Unemployment in OECD Countries

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John Martin's paper is an excellent survey of the extent of the OECD unemployment problem and its salient features in recent times. The following five stylized facts about OECD unemployment are documented in it:

(1) Different OECD countries have experienced very different long-term trends in unemployment, with unemployment rising dramatically in the European Community (EC) since the mid-1970s and in the European Free Trade Association (EFTA) countries since 1990, while showing little, if any, trend increase in North America or Japan. Over the past two decades, the average level of unemployment has been much higher in the EC and Oceania than in the United States, Japan, and EFTA.

(2) OECD unemployment rates display "persistence," or positive serial correlation. In other words, high unemployment today is associated with high unemployment in the future. This phenomenon is more pronounced in the EC and Oceania than in the United States or EFTA.

(3) The duration of unemployment varies widely among OECD economies, even after normalizing for differences in unemployment rates. Over the past two decades, unemployment durations have been much longer in the EC than in the United States and Japan (for given unemployment rates), and increases in unemployment have been

associated with more long-term unemployment in the former countries than in the latter.' Thus the burden of unemployment is distributed more unevenly in the EC than in the United States and Japan.

(4) Unemployment rates are particularly high among the young and, to a lesser degree, among women.[2]

(5) Unemployment is concentrated among unskilled people. In particular, unemployment rates are higher for blue-collar workers than for white-collar workers and for workers with low educational attainment than for those with a secondary or higher education.[3]

In addition to these indisputably noteworthy empirical regularities, here are five more which, to my mind, are equally worthy of attention:

(6) The longer people are unemployed, the lower are their chances of finding employment.

(7) Over the past 25 years, EC unemployment rates have varied less within business cycles than across them. In other words, the difference between the peak and trough unemployment rates within a business cycle is less than the difference between the unemployment rates at the same stage of successive business cycles. This tendency, however, is not evident in the United States or Japan.

(8) Over the 1950s and 1960s, the average unemployment rate in Europe was significantly lower than that in the United States; since the mid-1970s, however, the average European unemployment rate has significantly exceeded the U.S. rate.

(9) In the United States, labor and product market activity levels tend to move in tandem. In particular, production and employment tend to move in the same direction; production and unemployment, in opposite directions. This tendency is far less pronounced in most European countries.

(10) Despite the massive increases in productivity and the somewhat smaller increases in the labor force experienced by most OECD countries over the last century, OECD unemployment rates do not

vary with the level of productivity or the size of the labor force in the very long run.

These ten stylized facts represent a challenge to theorizing about unemployment. A respectable theory of unemployment should be able to explain all of them. In the remainder of the paper, I wish to consider how our various unemployment theories have performed by this criterion.

Let me begin with the market-clearing theories, which on the whole imply that unemployment policy is unnecessary and even undesirable; for when people freely choose to remain unemployed, it is often inefficient for government to use taxpayers' money to create jobs for them.

According to the traditional, market-clearing natural rate theory, unemployment is at its "natural rate" (which depends only on the structural characteristics of the economy, such as people's tastes, technologies, and resource endowments) when people have correct expectations about wages and prices. The dominant theory of how expectations are formed is the rational expectations theory, which asserts quite plausibly that people are not fooled in ways that they, themselves, could have predicted.

Whatever its academic appeal, this theory fails to address many of the facts above. With the decline in union density, no significant upward adjustment of unemployment benefits and benefit durations, and the moves toward deregulation, privatization, and liberalization of labor markets in many OECD countries over the 1980s, it is hard to argue that the natural rate of unemployment could have risen significantly. Furthermore, given the stable rates of inflation over much of the decade, it can't be argued that people's wage-price expectations were getting further and further out of line with reality. Nevertheless, European unemployment rose massively. There is nothing in the market-clearing variant of the natural rate hypothesis that provides even a clue about why this happened.

According to the intertemporal substitution theory, if workers believe that real wages are temporarily depressed and will rise in the future,

they may wish to partake in more leisure now and work harder later. The same may be true if they perceive real interest rates to be temporarily low, since that means that their current wage income cannot be transferred into the future at an advantageous rate. The *real business cycle theory* builds on this idea by identifying technological shocks as the main source of macroeconomic fluctuations and assumes that individuals respond to these technological shocks by intertemporally substituting between labor and leisure.

How this theory could seriously explain European unemployment defies my imagination. Many millions of people in Europe joined the unemployment register in the mid-1970s, early 1980s, and early 1990s. Can we honestly believe that these were simply colossal leisure binges, taken because workers were expecting real wages or real interest rates to rise later on? Regarding the upward trend in European unemployment rates since the mid-1970s, can we honestly assert that we are observing a very long-term intertemporal substitution, whereby workers have decided to enjoy a lot of free time for two decades, perhaps with the intention of working very long hours for the next two decades? And even if the monstrous implausibility of these suppositions is put aside, we are still left with the fact that the available empirical evidence indicates that people's hours of work are unresponsive to real wage and real interest rate variations, and that much of these variations tends to be permanent rather than temporary.

Now let me turn to the non-market-clearing theories. According to the *efficiency wage theory*, firms have imperfect information about the productivities of individual employees, but they can observe that higher wages stimulate the average productivity of their workforces. The reason is that higher wages enable firms to recruit more highly qualified employees or motivate employees to work harder. Or, higher wages discourage workers from quitting their firms, thereby reducing the firms' labor turnover costs. Consequently, firms may have an incentive to keep wages above the level that would be necessary to ensure full employment. The unemployed are unable to get jobs even by offering to work for less than the prevailing wage, because it is not in the firms' interests to allow the wage to fall.

The great strength of this theory is that it provides one conceivable

explanation for why people may remain unemployed even though they would prefer to do the prevailing work at less than the prevailing wages. Beyond that, however, it is not clear that the efficiency wage theory can shed much light on why EC unemployment has risen over the past two decades, why **U.S.** and Japanese unemployment has fared better, or why unemployment in many countries varies less within a business cycle than from one cycle to the next. Contrary to the predictions of the theory, the skilled workers (whose work is generally difficult to monitor) have low unemployment rates, while the unskilled workers (whose work tends to be more easy to monitor) have high unemployment rates. Nor is it plausible that **U.S.** unemployment should have recovered more quickly from recessions than EC unemployment because **U.S.** firms have more information about their employees than EC firms.

The theories of *labor union* behavior picture the unions as exercising market power on wages, driving wages up and employment down. Thereby, some people become unemployed. On the empirical front, it is worth noting that although there is evidence that, over several decades, intercountry differences in the coverage of collective bargaining agreements help account for some of the intercountry differences in unemployment rates among OECD countries, the union theories have not performed well over the past decade in predicting movements of unemployment through time. In the first part of the 1980s, for example, union membership in the United Kingdom and several other European countries fell while unemployment rose.

That still leaves the most popular unemployment theory of the 1950s and 1960s: the *Keynesian theory*. Here people can't find work because firms are not producing enough; the firms are not doing so because there is too little product demand; and demand is deficient because people can't find work. What lies at the source of this vicious cycle is the insight that deficient demand in the labor market originates in the product market, and deficient demand in the product market originates in the labor market. Activity in these two markets goes up and down together. The mechanism that puts this vicious cycle into operation is wage-price rigidity. A fall in product demand will reduce labor demand if wages don't fall sufficiently; a fall in labor demand will reduce product demand if prices are downwardly rigid.

This view sheds some light on the unemployment experience of the 1980s. At times of high unemployment and much excess capital capacity, it is generally true that increases in aggregate demand lead to increases in employment, and demand reductions lead to employment reductions. But the 1980s have exposed an important shortcoming of the Keynesian theory: for most of this period, European labor and product market activity did not move together at all. Product demand started to pick up toward the end of 1982, but employment did not start to improve until 1986 in the United Kingdom and even later in most other EC countries. The Keynesian vision of tightly linked labor and product demand is called into question here. It turns out that the link was much stronger in the United States and the EFTA countries than in the EC over the 1980s, but it would be implausible to rationalize this by suggesting that the United States and EFTA face much more wage-price sluggishness than the EC.

Finally, the ***insider-outsider theory*** focuses attention on labor turnover costs as a source of unemployment. These costs, falling on firms, give market power to the "insiders" (experienced, incumbent employees), who know that their employers would find it costly to replace them. The insiders use this power to improve their wages. The labor turnover costs discourage firms from firing their current insiders, but the high insider wages also discourage the hiring of new entrants.

This theory is able to account for many of the stylized facts summarized above. The relatively high labor turnover costs in Europe often insulate the insiders from the danger of becoming unemployed, and consequently, high unemployment has little effect on wage settlements. Wages are more responsive to unemployment in the United States, where labor turnover costs tend to be lower. When business cycles are short-lived and mild, most European countries — with comparatively high labor turnover costs — may be expected to do relatively little hiring or firing, hoarding labor in the slumps and bringing it back into use in the booms. But in the face of deep, prolonged recessions, these countries will stop hoarding and start firing labor. Then firms will be comparatively slow to rehire this labor in a subsequent recovery, fearing that they may incur further firing costs should the recovery not materialize, and thus investment in labor-saving capital equipment may then take the place of new employment. This helps explain (1)

why unemployment rates in Europe were significantly lower than in the United States in the 1950s and 1960s (when business cycles were short-lived and mild), but significantly higher since the mid-1970s; (2) why U.S. unemployment has been more variable than European unemployment; and **(3)** why there has been more "decoupling" of employment and production in Europe than in the United States, where labor turnover costs are generally lower.

Insofar as many of the full-time, unskilled jobs in the traditional industrial sectors are associated with significant labor turnover costs, the insider-outsider theory also helps explain why wages in these sectors have refused to fall with falling demand. It also helps explain why much service sector employment and temporary employment—associated with relatively low turnover costs—has been buoyant in comparison with industrial employment in the OECD. As noted in John Martin's paper, it suggests a reason why the long-term unemployed have much less influence on wage inflation than the short-term unemployed. And insofar as hiring and firing costs tend to be lower in the United States than in Europe, the theory sheds some light on why U.S. firms have been more successful than European ones in creating jobs in the secondary sectors.

So much for my whirlwind survey of theories to account for the ten stylized facts above. We still have a long way to go in explaining these facts, and in the absence of reasonably comprehensive explanations, policy advice will inevitably continue to rest on reasonably shaky foundations. John Martin's paper highlights both the magnitude and the importance of this task.

Endnotes

[1]The EC countries tend to have lower inflow and outflow rates from unemployment than the United States. Japan has a low inflow rate and a high outflow rate relative to the EC.

[2]The youth unemployment rate is well above twice the adult unemployment rate in the EC, Japan, North America, and Oceania, but well under twice the adult unemployment rate in the EFTA. The female unemployment rate is significantly greater than the male unemployment rate in the EC, but not in the EFTA, Japan, North America, or Oceania.

[3]John Martin shows that the ratio of blue-collar to white-collar unemployment rates is not rising consistently among OECD countries. He states that this finding fails to support the hypothesis that the demand for unskilled labor is falling relative to the demand for skilled labor. But this inference is unwarranted. The employment of white-collar workers has risen relative to employment of blue-collar workers in the OECD; if the unemployment rates of these workers have not moved in the opposite direction in some countries, then that must be because the supply of skilled labor has risen sharply relative to the supply of unskilled labor in these countries.