NBER WORKING PAPER SERIES

EVALUATING THE EUROPEAN VIEW THAT THE U.S. HAS NO UNEMPLOYMENT PROBLEM

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Working Paper No. 2562

NATIONAL BUREAU OF ECONOMIC RESEARCH
1050 Massachusetts Avenue
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April 1988

The research reported here is part of the NBER's research program in Labor Studies. Any opinions expressed are those of the author and not those of the National Bureau of Economic Research. Support from The Lynde and Harry Bradley Foundation is gratefully acknowledged.

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ABSTRACT

This study contrasts the labor market performance of the U.S. and OECD Europe in the 1980s and critically evaluates the view that the U.S. has generated more jobs because its labor market is more 'flexible'. The study finds that the greater employment expansion in the U.S. was associated with slower growth of real wages and productivi ty than in most of OECD Europe rather than with relatively costless flexibility. It also finds that while some aspects of relative wage flexibility, for instance in youth versus adult wages, helped limit U.S. unemployment, other aspects, for instance regional wage, show no greater flexibility in the U.S. than in the U.K., where labor markets are allegedly less flexible. Finally, the study argues that the disparate experiences of the U.K., with a relatively decentralized labor market, and Sweden, with a centralized wage-setting system, show that decentralized labor markets are neither necessary nor sufficient for employment-enhancing wage settlements.

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Evaluating the European View that the US has No Unemployment Problem

"A session on unemployment in America? Ridicule! The U.S. has produced 20 million jobs since 1975. If only Europe had America's flexible labor market and 'unemployment'." -- Archetypal European economist, circa 1987.

Significant differences between the unemployment and employment experiences of the US and OECD-Europe have made views like these popular overseas and led many European observers to look longingly at the American labor market as a paragon of decentralized wage and employment flexibility.

Do the labor market performances of the US and OECD-Europe support this view? How much of the difference between American and European employment and unemployment can be attributee to differences in labor market 'flexibility'?

In this paper I examine these questions. I review the labor market outcomes that have led many Europeans to see the American economy as having no 'real' unemployment problem; evaluate the claim that greater labor market flexibility underlies US-OECD Europe differences in outcomes; and consider the costs that accompanied American employment expansion. My main claim is that the US paid for its employment expansion with reduced growth of real wages and productivity rather than with relatively costless flexibility. I find that some aspects of flexibility in relative wage setting helped limit US unemployment while others did not and argue that the disparate experiences of the UK and Sweden show that a decentralized labor market is neither necessary nor sufficient for employment-enhancing wage settlements.

Contrasts in Unemployment/Employment Experiences

Three fundamental facts underlie the European view of American unemployment: first, the 1980s reversal of the longstanding pattern of higher rates of unemployment in the US than in OECD-Europe (fig. 1A); second, the growth of employment in the US, evinced in a rising employment/working age population ratio compared to a declining ratio in OECD Europe and even more dramatically in employment rates adjusted for the sizeable drop in annual hours per employee

in Europe (fig. 1B); and, third, the relatively short duration of unemployment spells in the US, where incomplete spells have averaged from 12 to 20 weeks compared to several years in many OECD European countries (fig. 1C). While spell lengths differ partly because many US spells end in labor force withdrawal (Clark and Summers) adult male durations are so much longer in Europe than in the US that this cannot explain the differences (OECD 1987, table R).

Youth unemployment is also widely judged to be a greater problem in Europe than in the U.S., though differences in schooling and student work behavior creates problems in comparisons. In some European countries, such as Italy, Spain, France, and the UK (but not Germany) the ratio of youth to adult unemployment rates exceeds that for the U.S. The duration of unemployment among European youths also tend to be quite long, exceeding durations for the young blacks who bear a disproportionate brunt of US unemployment. And OECD-Europe had nothing like the US's 1970-1980 6 point increase in the employment/population ratio of 16-24 year olds when the influx of baby boomers into the job market could have created massive youth joblessness.

Less widely recognized, US and European patterns of unemployment also differ along gender lines, with the rate of female unemployment relatively lower in the US than in Europe (save for the UK and Ireland). Because of the differences in youth and female unemployment rates, adult male unemployment rates in the US are closer to those in Europe than the average rates shown in figure 1A, offsetting somewhat the presumptively greater cost of unemployment in Europe due to the long durations (OECD 1987, table 2).

Turning to growth of employment, there is a widespread belief that US growth has been concentrated in low-wage Mcdonald's-type service jobs. Some hail this as the desireable outcome of flexible wage-setting that permits wide variation in pay among industries. Others view it as a sign of American economic decline. In fact, there is nothing special about the growth of

service sector employment in the US. From 1973 to 1984 OECD data (1986a) show that the service share of employment rose by 9 percentage points in OECD-Europe (45% to 54%) compared to an increase of 5 points in the US (63% to 68%). Moreover, the shift to services has had only a modest impact on average wages, in part because the service sector includes high-paying professional and business services as well as burger joints. Perhaps most telling, employment and wages have grown more in high level than low skill occupations, not what one would expect if the skill structure was deteriorating.

This said, it is the patterns of unemployment and employment shown in Figure 1 that has altered European thinking about the American labor market: "What at the start of the period was being dubbed as a poor labour productivity performance in the United States was being hailed at the end as an impressive job creating performance" (OECD,1986b,p.8). Whereas in the 1950s and 1960s analysts rejected textbook claims that decentralized labor market arrangements work best on the basis of actual outcomes ("you say unfettered labor markets, but our ... arbitration tribunals (Australia); bargaining with legal extension (France); shop-floor unionism (UK) ... produce unemployment far below that in America") in the 1980s the word is flexibility, US style.

So, the question is: to what extent is the US unemployment/employment record the result of the flexibility of decentralized labor markets? The answer turns on the ways in which wage-setting and employment determination is in fact more flexible in the U.S. than in OECD-Europe and on the quantitative contribution of those aspects of flexibility to employment. It requires consideration of aggregate wage change and of wage adjustments and labor mobility along disaggregate industry, occupation, region, etc. lines.

the contribution of macro-flexibility

In terms of aggregate wages, recent studies in the Phillips curve tradition suggest that wages in the US react less to price changes and more to

unemployment than wages in many European countries, producing greater 'real wage flexibility' (Bruno and Sachs, Coe). As I am uneasy about the robustness of inferences from these time series regressions, I focus instead on the basic fact that the US (and Sweden and some other countries) had smaller changes in real wages in the 1970s-early 1980s than most of OECD-Europe and ask: were these modest wage changes (call them the 'flexible' response to the post-oil shock economic world) associated with differences in employment growth across countries? As table 1 shows, conditional on the growth of real GDP (which increased more rapidly in the US than in OECD-Europe in total but not in per capita terms), the answer is yes: in each period countries with large increases in real wages (measured by mfg hourly earnings, employee compensation/employees or mfg hourly compensation) had smaller growth in employment or total hours than countries with small wage increases, with elasticities ranging from -0.5 to -0.9. As changes in output per worker and wages are highly correlated across countries, moreover, there is a parallel inverse relation between employment and productivity growth, with, for example, wages and productivity growing slowly and employment rapidly in the US and Sweden and the converse occuring in Belgium, Spain, and in the 1980s the UK, among others.

If one takes country differences in changes in wages as exogenously determined by labor market institutions (about which I have some doubts) and assumes similar rates of exogenous productivity advance in the US and OECD-Europe, the estimated wage-employment trade-off schedule suggests that much of the US-OECD Europe difference in employment growth was 'paid for' by lower real wage growth in the U.S. Between 1973 and 1979, for instance, the OECD (1986a) estimates that compound annual rates of GDP growth differed only modestly between the US and OECD-Europe (2.6% versus 2.4%) while the difference in annual growth in manufacturing wages relative to the GDP deflator was huge (1.0% in US versus 4.7% in OECD-Europe), implying a dominant role for the wage-

employment trade-off in the difference in employment growth. While from 1979 to 1984 differences in real wage growth lessened (-0.3% in US v 0.3% in OECD-Europe) and differences in GDP growth widened (2.0% in US v 1.1% in OECD-Europe) the trade-off still remains important in the employment story.

Now for problems with this interpretation. First, differences in real wage growth cannot be firmly tied to specific labor market structures. On the one hand, as noted, Sweden and some other countries with quite different labor market institutions than the US had similar slow real wage growth and sizeable employment expansion, indicating at the minimum that decentralized US style labor markets were not necessary for real wage moderation (Indeed, the performance of Scandinavia and Austria has fueled claims that corporatist economies perform best in this respect). On the other hand, the UK -- which has the most decentralized and unregulated labor market in OECD-Europe -- had sizeable growth of real wages in the 1980s and experienced the employment consequences thereof. Reinforcing this point, OECD countries with disparate labor market institutions such as Belgium, Australia, and Italy reduced their growth of real wages in the early 1980s, some with noticeable employment consequences, but others with no upswing in employment. Second, workers bargain for money wages while real wages depend on prices as well as wages, raising the possibility that country differences in price-setting also contributed to observed differences in real wage patterns across countries. As Solow has stressed in this context, the trade-off curve can be interpreted as reflecting the joint determination of wages and employment by exogenous aggregate demand factors, suggesting the need to examine differences in those factors across countries and their relation to the observed changes. Regardless of how one interprets the evidence in table 1, however, the wage-employment trade-off represents the key fact that any explanation of US and OECD-Europe differences must address.

the contribution of relative flexibility

Turning to relative wages and employment (where labor economists feel more comfortable as they can get 'in close' to behavior), the evidence suggests that along some dimensions the US labor market has evinced flexibility of the kind likely to be unemployment reducing, while along other dimensions, it has not.

The strongest case for employment-enhancing flexible market responses is found in the changing wage and employment of young workers. Between 1970 and 1983 when baby-boomers flooded the U.S. job market, the earnings of the young men fell sharply: real median weekly earnings of workers 16-24 dropped by 25% between 1970 and 1985, with the result that the premium of men 25 and older to the 16-24 year olds jumped from 43% to 90% (US Department of Labor). On the demand side, the reduced cost of young workers induced employers to increase the youth share of employment in virtually all industries, from manufacturing to services. In several European countries, by contrast, the relative wages of youths rose or remained steady through the 1970s-early 1980s. Regressions of youth unemployment rates on adult unemployment rates and the ratio of youth to adult pay in a pooled time-series cross-section of OECD countries shows that countries where relative pay for youths declined, such as the US, had less youth unemployment than countries without such responses (Bloom and Freeman; OECD 1986). While the drop in youth wages presumably affected overall unemployment more modestly (due to substitution among workers of different ages), it more likely than not dampened total unemployment as well.

Relative wages by region tell a different story. Consider, for example, the summary data on the relation between pay, changes in pay and unemployment across geographic units in countries X and Y in table 2: in Y wages are higher in high unemployment areas and increases in unemployment have no impact on area wages; in X wages are uncorrelated with unemployment at a point in time and declined in areas with relatively rising unemployment -- seemingly indicative

of a more responsive labor market. Who are the mysterious economies? 4 is the US, with states as areas. X is the UK, with counties as areas. While the different pattern of wages might be due to differences in labor market conditions not reflected in unemployment rates, the data seem prima facie to reject the notion that geographic wage adjustments are more responsive in unemployment-reducing ways in the US than in the UK.

It is not only along geographic dimensions, moreover, that the US does not seem to have more flexibility in the labor market than other OECD countries. While there are sizeable differences in wage differentials between the US and some countries (e.g. dispersion of industry wages is much smaller in Sweden and Denmark than in the US), analyses of changes in wages by industry in West Germany (Bell) and the UK (Freeman,1987) show the same factors altering relative wages in those countries with similar magnitudes as in the US. In addition, in the 1980s pay differentials by skill and by age changed at least as much in the UK as in the US (with no sizeable impact on unemployment).

With respect to mobility, the U.S. labor market evinces enormous short run changes in employment among establishments, with gross employment flows far exceeding the net flows that determine whether aggregate employment expands or contracts (Leonard). A recent OECD analysis (1987, chapter 4) estimates that the annual rate of 'job turnover' (the sum of gross job gains and gross job losses among establishment relative to employment) among Pennsylvania establishments averaged 25.8% from 1976 to 1985. If European labor markets were less flexible (say because of hiring and firing laws), one would expect smaller job turnover rates there. But the OECD reports job turnover rates of 23.3% in France and 23.5% in Sweden. While Germany had a low job turnover rate (16.5%), Japan had the lowest (7.7%) as well as the lowest unemployment -- fair warning to anyone who believes that high mobility is necessary for low unemployment.

Costs of Employment Expansion

If the 1970s and 1980s employment growth in the US resulted from relatively costless 'flexible' labor market adjustments, the European assessment of the experience "as an impressive job creating performance" would be difficult to assail. But the evidence suggests, au contraire, that there were substantial costs associated with the US expansion. First, the cross-country analysis of the wage-employment tradeoff suggests that the U.S. paid for job creation with slow growth in real wages and productivity. The magnitude of the trade-off was such, moreover, that despite the fact that employment/population rates and annual hours per employee increased in the US relative to OECD-Europe, per capita GDP grew at the same 1.3% rate. From this perspective, Americans worked harder for the same gain in living standards as Europeans. Second, if, as seems reasonable, some persons entered the labor market in response to low earnings of heads of households (e.g. married women with children under 1 year of age, whose 1987 participation exceeded 50%), their employment reflects a worsening not an improvement in economic well-being. Third, to the extent that the GDP-expansion generated part of employment growth entailed the 'double deficits' that turned the nation into the world's greatest debtor, future living standards will be lower, implying an even higher cost to job creation. Finally, even with employment expansion, the U.S. unemployment rate was markedly greater in the 1980s than in the 1970s, which itself exceeded that in the 1960s, while, as noted, unemployment (and wages) were more unequally distributed along some dimensions than in the past.

In sum, the US paid more for its improved employment and unemployment position relative to OECD-Europe than is recognized by those who peddle flexible decentralized labor markets, US style, as the 1980s Economic Cure-All. There were pluses to the US experience but there were also costs that make the change in overall economic well-being not so different than in OECD-Europe.

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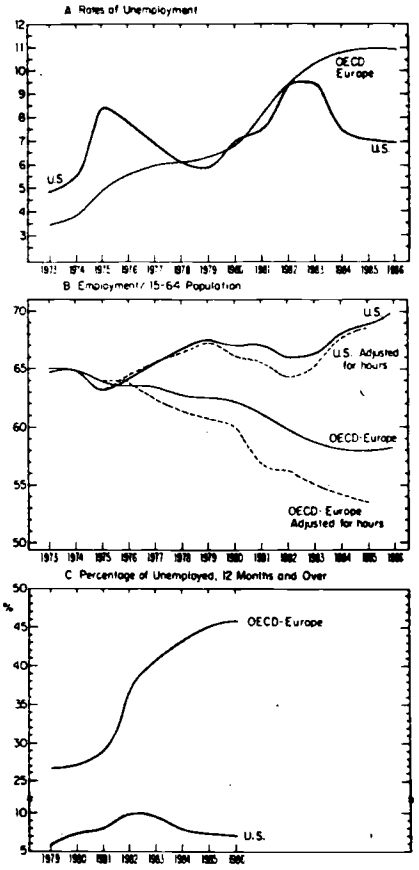
FIGURE 1: U.S. - OECD

European Employment and Unemployment Record, 1973-86



SOURCE: OECD (1986a and 1987)

OECD-Europe figures in panel B obtained as a weighted average for countries reporting data with 1985 employment used as weights for all years. OECD-Europe figures in panel C obtained as weighted average for all countries reporting data using 1985 unemployment as weights for all years.

Table 1: Regression Coefficients and Standard Errors For the Impact of Real Wages and Output on Employment, OECD Countries, 1960-85,

A) Dep. Variable: Change in ln Employment

	Change in ln Real Wage	Change in ln GDP	R^2
1960-73	-.57 (.11)	.62 (.14)	.65
1973-79	-.45 (.11)	.71 (.17)	.59
1979-84	-.54 (.15)	.62 (.19)	.56

B) Dep. Variable: Change In ln Employment

	Change in ln Real Labor Costs	Change in ln GDP	R^2
1960-73	-.76(.05)	.90 (.07)	.94
1973-79	-.62 (.10)	.75 (.13)	.74
1979-84	-.53 (.16)	.88 (.22)	.53

C) Dep. Variable: Comp. Annual Change, Total Mfg Hrs

	Change in Real Mfg Compensation	Change in Mfg Output	R^2
1960-73	-.53 (.08)	.62 (.08)	.86
1973-79	-.89 (.22)	.36 (.22)	.67
1979-85	-.75 (.24)	.80 (.13)	.81

Source: Panels A and B, 19 OECD countries from London School of Economics Center for Labour Economics-OECD data set. Panel C, 12 Countries (US, Canada, Japan, France, Germany, Italy, UK, Belgium, Denmark, Netherlands, Norway, and Sweden) as given by A. Neef (1986), with wages deflated by GNP deflator, using OECD data.

Table 2: Regression Coefficients and Standard Errors For the Relation of Wages to Unemployment, by Area: Country X vs Country Y

Dep. Variables:	1985-79 Change in ln Wages		1985 Unemployment Rate	
	Country X	Country Y	Country X	Country Y
Independent variables				
1985-79 Change in unemployment rate	-.92 (.27)	-.43 (.30)		
ln wage/earnings 1985			.03 (.06)	.11 (.02)
% employed mfg,1985	x	x	x	x
1985 education of workforce,1985	x	x	x	x
R^2	.39	.51	.25	.51

Notes: For country X there are 61 areas; the wage change variable is the 1979-85 change in ln weekly wage of male manual workers.

For country Y there are 50 areas; the wage change variable is the 1979-85 change in ln hourly mfg earnings.

Source: R.B. Freeman (1987) and (1988)