Commentary: Past and Prospective Causes of High Unemployment

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Krugman correctly says that the increase in unemployment in Europe is an increase in the natural rate. What he means by that is that if policymakers tried to reduce the unemployment rate through expansionary monetary policy, the result would be inflation with only temporary effect on unemployment, if at all. Not many economists in Europe will disagree with that view.

He also writes, however, that following massive amounts of research in the Organization for Economic Cooperation and Development (OECD), "many economists have coalesced around a common view of the nature of the problem." And the reason that policymakers do not all subscribe to that conventional economic wisdom is partly because of our "failure to explain that view clearly." Krugman has succeeded in putting forward the view that he considers to be the conventional wisdom with exemplary clarity. But although he says many correct things about European unemployment, I have doubts whether his interpretation would be as generally accepted as he claims or that the picture is as simple as he makes it out to be.

Krugman attributes virtually the whole of the rise in European unemployment to a single cause, welfare policy. Simple diagnosis to complicated problems is, of course, what we are all after, but unfortunately the truth, as I see it, is much more boring. Social security is certainly a factor, and an important one at that, in the comparison of the U.S. and European unemployment experience. But there is a lot more to the dynamics of European unemployment, some of it related to policy, some not. There is also the question of the tradeoffs, whether less unemployment at the cost of more dead-end, low-paid jobs is better than what we have now, which I will not touch upon here.

Let me explain by taking first some specific points raised by Krugman. One of the views about European unemployment that he plays down is what he calls the hysteresis hypothesis, though a better term for it would be unemployment persistence. It is the view that after unemployment goes up, for whatever reason, supply-side influences are set into motion that prolong the return of unemployment to its initial natural rate. This prolongation could take anything up to three or four years or, some would claim, even longer.

Krugman dismisses this view because of three facts. First, the United States has not experienced it; second, Sweden that avoided unemployment in the 1980s still experienced an upsurge in unemployment in the 1990s; and finally; other factors, notably welfare policy, can explain the differences in unemployment experience between countries.

On the first point, the evidence on the U.S. experience does not contradict persistence. I believe that the most plausible cause of persistence is the loss of skill and the will to work associated with long-term unemployment. Since the United States has not experienced long-term unemployment, it should not experience persistence.

In Krugman's comment on Sweden, there is confusion in the discussion between the impact effect of a shock and its propagation effects that are associated with persistence. What Sweden suffered in the 1990s was a negative shock that raised unemployment on impact. Persistence deals with the return of unemployment to the natural rate after the shock goes away. Krugman can still be proved right if the Swedes managed to avoid long-term unemployment and yet their unemployment did not return to the level of the 1980s. The jury, however, is still out on that question.

Finally, the view that social security legislation can explain all the differences in unemployment experience between countries is simply not correct. Social security legislation can explain ***some*** of the differences in unemployment experience, but a lot remains unexplained. Krugman supports his view by referring to the study of Layard, Nickell, and Jackman. But what that study supported is not that a single factor, be it social security, globalization, or what have you, can explain unemployment, but (to use a phrase coined in another report by Layard and others) that the explanation of unemployment needs a two-handed approach, demand on the one hand, supply on the other.

I want to mention one or two other caveats about Krugman's claims before I give my own view about the policy options. **A** powerful argument made by Krugman is that the reason for the increased inequality in labor market fortunes is not competition from abroad. I do not want to argue either in favor or against this proposition but I want to dispute some of the evidence that he gives to support his argument, by referring to British data.

The claim is made that if there were competition at the lower end of the skills distribution, there should be a shift in industrial structure in favor of industries that employ more skilled labor; and within industries, there should be a rise in the ratio of skilled to unskilled labor. Krugman refers to evidence that shows that this has not happened.

In Britain, however, increased unemployment has affected primarily unskilled ***manual*** workers, not all unskilled workers. The unemployment of all occupational groups went up during the 1980s and 1990s, but that of unskilled manual workers went up by much more than the rest. (Interestingly, figures just released show that in the recession of the 1990s, the professional classes suffered more unemployment relative to the unskilled than they did in the recession of the 1980s.) In 1986, the lowest skill non-manual worker group suffered 7.9 percent unemployment; the unskilled manual group suffered **23.3** percent. (See Pissarides and Wadsworth, 1992; Krugman correctly reproduces Table 2 from Layard and others showing different figures for 1984. I am puzzled by their numbers.) Therefore, the relevant evidence for Britain should compare industries using manual workers and industries using non-manual workers. The shift from manufacturing to services that took place in the 1980s is the kind of evidence

Krugman is looking for. It is generally recognized in Britain that part of that shift was caused by the appreciation of sterling in the early 1980s, which is a cause similar to the one dismissed by Krugman. Regardless of cause, however, there is a strong simple correlation in Britain between the share of employment in production industries, which employ most manual workers, and the unemployment rate.

Another comment refers to the European Commission White Paper of 1993. Written in Eurospeak, perhaps it is not surprising that it is open to more than one interpretation. My reading of it, which does not strike me as too unreasonable an interpretation of the European scene, is this. Foreign countries increased the supply of manufactured goods in international markets and this is one area where the European Union does not have the comparative advantage (point 4). Therefore, their emergence requires the shift of labor and capital in European markets from the production of those goods to the production of others, notably services, telecommunications, pharmaceuticals, and so on (point 1). But European labor costs (point 2) and employment protection legislation, social security provisions, and a host of other factors that reduced the flexibility of the labor market (point 3) have not allowed firms to switch production, giving rise to the unemployment of recent years.

Does this report put the blame for European unemployment on international competition or on Eurosclerosis? European labor markets, like markets in the rest of the world, are continuously subjected to shocks: witness the decline of coal mining, shipbuilding, and steel in Britain in the 1950s and 1960s, and the emergence of services and light engineering, all achieved without unemployment. The difference this time is that European markets have not been able to respond to the shocks without crisis. The source of the shock is not really important in adiscussion of unemployment because if the labor market is flexible enough to absorb it, unemployment will not occur. What matters for unemployment and what policymakers can do something about is the market mechanism that transmits the shock to employment and wages.

Let me now turn to labor market policies and the implications that they have for the market mechanism. Some labor-market policies in

Europe slow down the ability of the market to respond to shocks without obvious benefits to employers or workers. The most important of these are restrictions on the dismissal of labor, that come under the heading "employment protection legislation." There is evidence that employment protection legislation in Europe has held back both job creation and job destruction. This has created long-term unemployment, disenfranchisement of the unemployed, and persistence of unemployment. With less restrictions, the turnover of the unemployment stock would increase, making it easier for dismissed workers to find jobs and so removing the need to protect their jobs in the first place. Long-term unemployment would also fall, removing the hysteresis implications of the shocks.

Other policies in Europe slow down job creation but with obvious benefit to some workers. The payment of compensation to unemployed workers is the best example of this kind of policy. The evidence here is becoming clear: the level of benefit is not all that important; what matters is the length of time that benefits are available. Long-duration benefits lead to long-duration unemployment, again with bad implications for the long-term unemployed.

The principles that should guide policy reform here are obvious, though the details of the implementation and the practicality of the solution are matters of disagreement. There are two options. The first is to pay benefit for a short period of time, say six months or one year, and then leave the workers to fend for themselves. One need not go to the American extreme, where the coverage of benefit is also restricted. Coverage could be as universal as it is in Europe today with no bad implications for unemployment. The other option is to change the form of support after the initial period. This brings in active labor market policy.

Active labor market policy includes spending on measures that help the unemployed get into jobs. Job matching services, training opportunities, employment subsidization, youth schemes and other similar measures come under the heading of active policy. The OECD has spent a lot of effort recently collecting data on active policy. Currently in the OECD, spending on active policy is about as much as half of spending on income support for the unemployed. The big spenders are the Scandinavian countries; the small ones, the North American ones.

The recent experience of Sweden with unemployment has done much to undermine the popularity of active policy. But one need not go as far as Sweden did in the 1980s and also, since we are still talking about the natural rate here, final judgment on Sweden will have to wait the emergence of that country from its recent recession. The evidence accumulated by the OECD shows that countries that spend more on active policy than on passive have less long-term unemployment and consequently less overall rate of unemployment and less sluggishness in response to shocks. Active policy can undo what passive policy does to incentives and wages, admittedly at a cost.

Concluding, I find myself a little less sure than Krugman is of the cause of Europe's unemployment problem but a little more optimistic about the policy options. Employment protection legislation will have to go. On income support, one does not have to take the cruel route that the United States has taken. Income support can and I think should stay, but it should be backed up with active measures to reduce its disincentive effects. How far both passive and active measures should go is a matter of policy choice. Perhaps Sweden has overdone it but I do not think anyone can claim that the Britain of the 1990s is overdoing it. (Britain is not moving in the direction of the United States. It is relaxing restrictions on the dismissal of labor but it is not restricting the availability of unemployment compensation. On the contrary, it is increasing spending on active measures to help the unemployed get back to work. The critics claim that Britain has not done enough and its unemployment experience in the recent cycle gives them some support. The recent unemployment cycle has many features in common with the earlier one and the average unemployment rate has not changed since 1984.)

Reference

Pissarides, C.A., and Wadsworth, J. "Unemployment Risks," in E. MacLaughlin, ed., *Understanding Unemployment: New Perspectives on Active Labour Marker Policies.* London: Routledge, *1992.*