

Toronto2
17/6, 2006

OECD Minister Conference, June 15-16, Toronto

Assar Lindbeck:

Market Reforms, Welfare Arrangements and Stabilization Policy

-- A Triple Interaction in Employment Policy --

The OECD secretariat's follow-up of its influential Job Study from 1994 provides a comprehensive analysis of major labor market problems in the OECD area (OECD, 2006). Because of limited time, I will, however, mainly deal with the situation in Western Europe, although I will also make some comparison with the situation in the United States. I will concentrate on two aspects of the labor market situation in Western Europe. One is the high unemployment rates during the last three decades; the other is the high "benefit dependency" among individuals of working age, mainly financed through various social insurance arrangements. Both features lie behind the relatively few hours of work per person in working age (15-64) in Western Europe – nearly one third less than in the United States.

Clearly, policy measures designed to solve these problems often come in conflict with other important policy targets, although such conflicts, as I will illustrate, sometimes may be mitigated by specific institutional arrangement. It is often more difficult to deal with resistance to reforms from powerful interest groups in society.

The unemployment problem and alternative market reforms

The labor market situation in Western Europe may be described as a pronounced "insider-outsider" phenomenon. By that expression, I refer to the distinct asymmetry in market power between well protected incumbent workers, on the one hand, and unemployed workers, labor-market entrants and immigrants, on the other (Lindbeck and Snower, 1988). Those who already have a job automatically enjoy some protection against disturbances in product and labor markets, since it is usually costly for firms to fire and hire workers (resource costs as well as goodwill costs). Moreover, incumbent workers have powers to discourage attempts by outsiders to get jobs at wages below going insider wages ("underbidding"). In addition, both

unions and governments may, and often do, accentuate the insider-outsider divide by actions that further increase the market powers of insiders relative to outsiders. As a result, insiders also have powers to push up real wages during business upswings (without risking their jobs), which tend to reduce the hiring of outsiders.

There is also an insiders-outsider divide in product markets, since incumbent firms are often protected against potential entrants both by spontaneous anti-competitive behavior of firms, such as cartel agreements, and by national and local government regulations. This is bound to have consequences for the labor market as well. For instance, standard economic theory predicts that low competition in product market reduces labor demand. In sectors with large monopoly profits, there is also a large “surplus” to divide between firms and incumbent worker, and this tends to boost real wages and reduce the demand for labor. Since labor demand is “derived demand”, emanating from conditions in product markets, obstacles for the entry and expansion of firms also have negative effects on labor demand.

What, then, could be done about the severe unemployment situation in Western Europe? Specific policy recommendations on this issue depend partly on what we regard as the background for the high level of prolonged unemployment in this part of the world – an increase from 2-4 percent of the labor force in the 1960s and early 1970s to 8-11 percent in the 1980s and 1990s. (The figure is about 8 percent today.) Three attempted explanations have dominated in the research literature: *first*, an asserted increase in the equilibrium unemployment rate, i.e. the rate below which inflation tends to rise – basically as a result of changes in the structure of the economic system (such as more generous unemployment benefits or higher tax wedges on labor income);¹ *second*, a series of unemployment-creating macroeconomic shocks combined with unemployment persistence, in the sense that the return of the economy to the pre-shock unemployment level is a prolonged process, which may not have been completed before new shocks have occurred²; and *third*, increased search unemployment as a consequence of increased microeconomic turbulence (shifts in relative demand and supply for labor across production sectors), which existing institutions are not well adjusted to deal with.³ Schematically speaking, while the first explanation puts the blame on a number of structural (mainly institutional) changes, the last two explanations refer to interactions between existing institutions and strong macro- or microeconomic shocks.

There is probably some truth in all three explanations. It is, however, also important to look at the development of unemployment and benefit dependency in a more long-term, growth-oriented perspective. Long-term economic growth always require reallocation of resources across sectors – a point that Kuznetz always emphasized. This point has been elaborated by Richard Rogerson (2004) as an explanation of the labor market development in Europe. More specifically, Rogerson argues that Europe has been less successful than the United States to reallocate production and employment from industry to services, and that this shows up as a lagging aggregate employment share as compared to the United States.

All four suggested explanations of the relatively poor employment record in Western Europe suggest broadly similar remedies when it comes to *supply-side policies*. I refer both to reforms designed to improve the functioning of labor and product markets, “market reforms” for short, and to reforms of various welfare-state arrangements and the financing of these. The relatively large consensus among economists concerning supply-side policies does not, however, carry over to the issue of *demand-side* policies. More specifically, the second explanation of high and prolonged unemployment (emphasizing persistence mechanisms) gives a potentially more important role for demand-side policies than do the other two explanations. The purpose of such policies would be not only to counteract unemployment-creating demand shocks, from the very beginning, but also to speed up the return to the pre-shock unemployment level by stimulating labor demand – either directly or indirectly thorough increased product demand.

The least controversial example of supply-side policy probably is attempts to strengthen outsiders’ market powers by active labor market policies (ALMP), including assistance with job search and training. Indeed, such programs have been a favorite recommendation in the field of labor market policies in recent decades. The OCED study also seems to have strong believes in such policies. It is therefore important to clarify what can possibly achieved, and not achieved, by such policies. Some positive effects of such policies on the employment prospects of unemployed individuals have been reported in the research literature; see, for instance, the survey in OECD (2006, chapt. 3). However, such policies are far from unproblematic (Heckman, Lalonde and Smith, 1999; Martin and Grubb, 2001). In particular, when the volume of ALMP programs are very large, or have expanded very fast, the effects on the employment and wage prospects of participants in such programs have been quite disappointing; see, for instance, Calmfors et al. (2002). One reason is that the quality of the

programs then tends to be low. Governments may also be tempted to use large-scale training programs as a way of keeping down statistically recorded open unemployment, with little concern for the effects on the participants' employment prospects. More brutally formulated: training programs may simply be used as a method to hide rather than solve serious employment problems. This is not an innocent consequence, since the resources devoted to training programs for adults could instead have been used for something else, such as labor exchange activities, regular education, or apprenticeship training for younger cohorts – or for some entirely different purpose. Moreover, retraining programs are of little help for boosting aggregate employment if the demand for labor is very low, and hence the number of vacancies few.

Of course, *open* unemployment tends to fall as the result of expanded training programs simply because a large fraction of individuals participating in such programs come from the unemployment pool. It is, therefore, not surprising that empirical cross-country studies usually find a negative association between the size of ALMP programs and open unemployment. But it is reasonable to set the criteria for “success” of training programs higher, including a reduction in *total* unemployment (open unemployment *plus* individuals in ALMP programs). It would, however, seem that ALMP programs have seldom lived up to this criterion of success.⁴ Indeed, if the regressions reported by OECD's new Job Study are recalculated in terms of *total* rather than open unemployment, it turns out that there is a *positive*, rather than negative, association between ALMP activities and total employment; see Appendix. The conclusion is basically the same (qualitatively speaking) if we confine the study to training programs rather than look at total ALMP activities.

Empirical studies of individual countries suggest that both selective employment subsidies (equivalently selectively reduced payroll taxes) and public works programs usually have been more successful than retraining programs to shift specific individuals from unemployed into work.⁵ We also know, however, that selective wage subsidies have turned out to crowd out jobs for others to a considerable extent, which limits the improvement in *aggregate* employment.⁶ Such subsidies also reduce the incentives for investment in human. Thus, to be successful, both public works programs and wage subsidies have to be designed in ways that limit such undesired side effects. For instance, there is a strong case for making this type of support temporary, except mainly for handicapped and elderly workers.

My conclusion is that much more fundamental reforms than expanded ALMP programs are necessary to solve the European unemployment problem. Indeed, exaggerated beliefs in the power of ALMP programs may be an alibi for not pursuing important, but politically difficult, structural reforms.

The lists of potentially useful structural market reforms are well known. We may refer, for instance, to reduced minimum wages for young and inexperienced workers, including, immigrants; and a removal of laws that automatically extend collective wage agreements to firms without organized workers. A softening of job-security legislation is also a potentially useful method in some countries. While such a softening does not necessarily reduce the average aggregate unemployment over “normal” business cycles, it would certainly reduce employment *persistence*. It would also mitigate the discrimination of outsiders relative to insiders.

The effects of changes in job-security legislation depend, however, on the prevailing labor market situation. If we regard employment persistence as an important factor behind high and prolonged unemployment in Western Europe, we would expect that the effects of softer job-security legislation will differ depending on the initial situation in the labor market (Lindbeck, 1993, chapt. 7; 1996;.). For instance, it is likely that strict job-security legislation in a number of West European countries contributed to the persistently *low* unemployment rates from the mid-1950s to the early 1970s, when macroeconomic disturbances were rather modest. By contrast, after the large unemployment-creating macroeconomic shocks between the mid-1970s and the late 1990s (partly generated by governments), high firing and hiring costs instead contributed to prolong the *high* unemployment level that then emerged.

Anti-cartel policies, and the removal of obstacles for the entry of firms, are obvious policy measures to mitigate employment problems emanating from such deficiencies in product market – regardless of whether these obstacles are spontaneous market imperfections or the result of government regulations. Removals of barriers to the entry and expansion of firms in the service sector are particularly likely to boost aggregate employment since firms in such sectors are often quite labor intensive. Smaller obstacles to the entry of firms, including foreign ones, without much loyalty to incumbent firms in the country, would also be expected to facilitate the entry and expansion of firms. A removal of *de facto* public-sector monopolies in the field of tax-financed provision of human services – such as childcare, education, health

care and old-age care – would be another potentially important way of boosting the entry and expansion of firms in the service sector. These considerations are important both when we discuss how the labor market adjusts, or do not adjust properly, to different types of shocks and when we consider the long-term need for reallocation of resources, including labor, across sectors during the process of economic growth.

Moreover, to the extent that stronger microeconomic shocks, such as shifts in relative demand and supply of labor across sectors, lie behind that stark increase in unemployment in Western Europe, more flexibility of relative wages would be expected to help. Most likely, this would be facilitated by a decentralization of wage formation down to the level of individual firms – implying a departure from so-called “corporate” arrangements of wage formation. This would be an attractive strategy if we believe that it is better that an individual gets a job at a wage below current insider wages rather than being unemployed in expectations of a *potential* insider wage if he/she would actually get a job. Moreover, some elderly workers would probably be willing to work for reduced wages when their productivity goes down, rather than becoming unemployed.

So far, I have been talking mainly about the situation in Western Europe. Let me add that the United States has its own insider-outsider divide. The problem there is mainly that a large fraction of individuals in working age, approximately a fifth, has much poor educational background than the corresponding fifth in Europe. In this case, the insider-outsider divide show up, to a larger extent than in Western Europe, in a dispersed distribution of wages, and a large number of “working poor”, rather than in unemployment and benefit dependency. Improvement of education, in particular early training for disadvantaged groups, is one obvious remedy (Heckman, 2004). As we know, the much wider dispersion of wages in the United States than in Western Europe is a relatively new phenomenon, which has emerged mainly between the early 1980s and the late 1990s. The most realistic explanation is probably that the relative demand has increased both for skills and for personal characteristics that are particularly important in a world with rapid change, such as flexibility and individual ambitions. While the increased demand for such characteristics have contributed to widen the wage dispersion in the United State, it is likely instead to have contributed to increased unemployment in Europe, where the flexibility of wages and the mobility of labor are smaller – a hypothesis developed by several economists.

Benefit dependency and welfare-state reforms.

Unemployment (open or total) is just one example of a more general problem, namely *benefit dependency*. In Western Europe, about 20 percent of individuals of working age are today financed by various types of benefit programs (excluding individuals in education and ALMP programs) – as compared to about 13 percent in the United States. In Denmark, Belgium and France, the figures are even higher (23-24 percent). This large benefit dependency partly reflects so called “moral hazard” behavior: some individuals use the systems of income insurance for much broader purposes than what the systems were originally designed.

It is useful to distinguish between two different expressions of such moral hazard. One is that some individuals use various benefit systems as substitutes for unemployment insurance – important examples being temporary disability insurance (sickness-absence insurance), permanent disability insurance and early retirement pensions. The background is that the benefit levels in these systems often are more generous, and/or more long-lasting, than the benefits in the unemployment insurance system.⁷ We also know that firms and labor unions often have actively encouraged early retirement of elderly workers, for instance, to cut the wage bill for firms during recessions. Moreover, governments may want to “beautify” the unemployment statistics this way.

Another type of moral hazard is that some individuals utilize various social insurance systems to get more leisure at very small income loss for themselves (“overuse”). In combination with high taxes on labor earnings, generous benefits imply that the difference in disposable income from work and from benefits is quite small for large groups of citizens – not just in the case of pronounced low-income groups. In some countries, the notorious “poverty trap” has moved up the income ladder, and it has turned into a general “benefit trap”. While most individual are usually allowed to keep more than half of their additional earnings when working longer hours, the difference in total income when working, rather than living on benefits, are often only 10 or 20 percent – and even less when we consider various costs connected with work. In other words, the dominant distortion of labor supply decisions in Western Europe probably usually refers to the choice between working and living off benefits (a choice on the “extensive margin” in economists’ terminology) rather than the choice of hours of work for those already working (choice on the “intensive margin”). While the latter choice depends on marginal tax rates, the former depends on the *difference* between total after-tax labor income

and (after-tax) benefits. It is, therefore, hardly surprising that many individuals in working age in Western Europe live on benefits rather than on the earnings from work.⁸

Here, then, is one important explanation for the relatively few hours of work per person in working age in Western Europe today. For instance, some elderly take the chance to shorten their working life in response to high subsidies of early retirement; indeed, we have considerable empirical evidence that generous subsidies of early retirement reduce the effective retirement age. The high youth unemployment in Western Europe, often above 20 percent, is another explanation for the few average hours of work, reflecting a complex combination of involuntary unemployment and long periods of “wait” and “search” unemployment. Indeed, it is in these two age groups – the elderly and the young – that we find the main difference in hours of work per person in the United States and Western Europe. As a result, about two thirds of the difference in hours of work per individual in working age in Western Europe and the United States depends on differences in employment rates, and hence no more than one third on differences in hours of work per actually employed individual (Gordon (2006)).⁹

These observations are no arguments against having mandatory income insurance. However, they highlight the classical conflict between insurance and incentives; hence they emphasize the importance of choosing a “proper” design of such systems. When considering ways of doing just that, we might want to distinguish between “lenient” and “harsh” reforms, although the distinction is hardly sharp. One example of the former is a shift to *individual* taxation of spouses, which tends to keep down the average and marginal tax rate for the “second” income earner in the family in countries with progressive tax system, thereby stimulating both spouses to work in the open market. Another example is to make expected future benefits contingent on previous work, which also tends to boost labor force participation. Moreover, labor-force participation over the individual’s life cycle may be boosted by a tight link, on the margin, between life-time earnings (or contributions) and the individuals expected future benefits (as in “quasi-actuarial” social insurance systems). The more the individual works during his life-time, the higher will be the expected future benefits. (Such reforms tend, however, to make social insurance system less distributive.) Moreover, to the extent that tax revenues are used to finance services that are close complements to labor supply, such as child care and old-age care outside the household, negative labor supply effects of taxes are

counteracted – in economists' terminology through a positive “cross substitution effect” on labor supply of the subsidy (Lindbeck, 1982).

Such benefit arrangements already exist in some OECD countries, although to varying degree. They are particularly usual in the Nordic countries, which help explain why labor force participation is rather high in these countries in spite of relatively large tax wedges and generous benefits. Another policy measure for boosting labor force participation is, of course, to increase the return to work through reduced average, and possibly also marginal, tax rates for labor income (for instance, by way of increased tax deductions against earned income – “earned-income tax credit”). For instance, The United States and the United Kingdom have followed this route in the case of low-wage groups. Similar arrangements may be appropriate for income earners higher up in the income pyramid to reduce benefit-dependency among such individuals, although the fall in tax revenues for the government they may be quite large. Medical “rehabilitation” of individuals with health problems may also help individuals move from benefit dependency to work.

“Lenient” methods like these may not be enough, however. One reason is that high labor force participation is not the same thing as many hours on the job. Although regulations of working hours may make it difficult for many employees to cut the number of working hours, there are certainly some possibilities by abstaining from overtime and by taking part-time work. Moreover, if individuals because of generous benefits and high tax wedges actually would prefer fewer hours of work, politicians and labor union leaders will, most likely, respond by legislation or bargaining to bring this about. The individual may also choose to be absent from work, for instance, by using sickness absence insurance or insurance that gives parents the right to stay home to care for sick children.¹⁰ Moreover, some perfectly healthy individuals with regular jobs may, and in fact do, take occasional brakes from work by calling sick without much loss in income to themselves – because they are bored by the job, have problem in their family, or because they want to participate in some attractive leisure activity (Lindbeck, 2006).

All this means that there may be a huge difference not only between the number of individuals in the labor force and those actually employed, but also between the number of employed individuals and those actually on their jobs. For instance while in Sweden in 2004, 80 percent of men in working age were in the labor force, and as many as 75 percent were

recorded as employed, only 64 percent were actually at work (OECD, 2005, figure 1.7) – reflecting not only vacation but also various types of possibilities of being absent from work. For females no more than 57 percent were at work. (In societies with a large fraction of individuals in the labor force, more actually employed individuals than in other societies are likely to feel that they have important duties outside work, such as childcare).

“Lenient” methods to reduce benefit dependency, and hence to boost labor supply, may not be regarded as sufficiently effective. Obvious examples of “harsher” methods to increase labor supply are reduced benefit levels (lower “replacement rates”), which by contrast to earned-income tax credit also improves the financial position of the government. Controls are another example, that is, attempts to reduce the individual’s discretion in choosing to live on social insurance benefits. Indeed, experience suggests that strict controls, sometimes in the connection with medical “rehabilitation”, are an important method to influence individuals’ behavior in these respects. For instance, the potential moral hazard effects of 100 percent replacement rates in Germany’s sick-pay insurance seems to have been counteracted to a considerable extent by tight controls of individuals on work places by firms, local labor unions and the local Chamber of Commerce. As another example, sickness absence from work fell abruptly by 5 days per privately employed individual in Sweden when firms in 1991 were forced to pay sickness compensation during the first 14 days. It would seem that both employers and (relevant) non-government organizations may be better than government administrative bodies to monitor “excessive” use of benefit systems, that is to contain moral hazard behavior. It should, however, be emphasized that controls may be quite as painful for individuals as reduced benefit levels, in particular, for those who actually are unable to work, without being able to convince the insurance administrators that this is the case.

Indeed, there has been a tendency during the last two decades in several West European countries both to make various benefit systems less generous and to make the controls stricter (OECD, 2006, chapt. 3). These reforms probably help explain why labor-force participation started to increase somewhat in Western Europe in the mid-1990s after several decades of a continuous fall; for statistics indicating such a change, see OECD (2006). Clearly, less generous benefits and stricter controls may be seen as complements rather than as substitutes.

Social norms in favor of work, or against living on benefits, also tend to constrain the “overuse” of various benefit systems, provided many individuals in society, and in the

individual's neighborhood, obey the norms. However, such norms, which are inherited from the past, may erode over time. This is particularly likely if the number of individuals living on benefits has increased drastically, for instance, after economic shocks that have thrown out many individual onto various benefit systems (Lindbeck, 1996). This hypothesis, if correct, suggests that politicians should be careful with policies that stimulate benefit dependency.

Of course, explanations of increased benefit dependency in the connection with an erosion of social norms is not an *alternative* to explanations in terms of economic incentives and moral hazard. We may rather say that induced (endogenous) changes in social norms give "leverage" to such more traditional explanations (Lindbeck and Persson, 2006). Moreover, references to economic incentives, moral hazard and social norms do not, of course, rule out involuntary unemployment, as another important explanation of the high benefit dependency, and the relatively few hours of work in Western Europe.¹¹ This point brings us to the issue of stabilization policy, since unemployment may be regarded as a combined effect of the malfunctioning of the labor market, welfare-state arrangements and deficiencies in stabilization policy.

iii. Stabilization policy

As has been pointed out by several authors, such as Coe and Snower (1997), there is a case for exploiting *complementarities* of different policy measures when trying to improve the employment situation in a country. The OECD secretariat's new Job Study (2006, chapt. 6) also emphasizes the potential usefulness of combining a number of market reforms and welfare-state reforms, such as deregulations of labor and product markets, increased subsidies of labor market exchange and training, smaller tax wedges for labor income, and less generous unemployment benefits.

I would, in particular, emphasize the complementary between policy measures that stimulate labor supply and labor demand. It is not enough to induce beneficiaries to choose work rather than benefits, hence to boost aggregate labor supply in the open market. Such policies will result in higher employment only if also the *demand* for labor increases. One might think that this will occur automatically when firms employ more individuals, since labor and capital income then will increase, which tends to generate higher demand for goods and services and indirectly also for labor – as asserted by "Say's Law" in traditional economic theory. In a long-term perspective, when general equilibrium effects have had time to work themselves

out (changes in relative prices and wages) this is a relatively realistic view. It may not hold, however, in a short- and medium-term perspective (such as one to five years). In particular, to the extent that newly employed individuals earlier lived on generous benefits, they will experience only a modest increase in their income when shifting to work (in many cases no more than ten per cent), and hence their spending may increase only marginally. In this sense, “Say’s Law” may largely be repealed by the welfare state in a short-term perspective. This means that it is also important to take policy measures explicitly designed to stimulate the demand for labor. Otherwise it may take a very long time before labor demand has fully adjusted to increased supply (via general equilibrium effects). In the meantime, open unemployment would tend to increase.¹²

When trying to boost the demand for labor, a number of important and difficult policy choices have to be dealt with. I would argue that the first priority should be to remove, or reform, deficiencies in markets regulations and welfare-state arrangements that hold back labor demand – an issue that I have already discussed. Another question is whether deliberate policies to boost the demand for labor should be general or selective. While selective policies in this field usually are more cost-effective for the government than general policy measures, at least in a short-term perspective, they run the risk of messing up the price system, in particular if selective measures become permanent rather than temporary. In the long term, the costs may therefore, in fact, be higher for society at large by strongly selective measures.

Of course, to the extent that the unemployment problems are cyclical rather than structural, general monetary and fiscal policy measures, i.e. traditional stabilization policies, are the most obvious answer. Countries within monetary unions then have, of course, to rely on fiscal rather than monetary policy measures. There are, however, limitations for monetary policies also in countries that are not members of such unions. The most obvious example is perhaps that it is difficult to bring down nominal interest rates below zero. Moreover, huge fluctuations in interest rates may create problems for asset markets, including housing prices, although we could think of complementary fiscal measures that mitigate such effects (including taxes on transactions in asset markets).

More importantly: fiscal policies are an important complement to demand management through monetary policy. An obvious example is temporary reductions in sales taxes for the purpose of shifting consumption from the future to today, hence strengthening the

intertemporal substitution of consumption that may be achieved also through lower interest rates. Another example is employment subsidies (or lower payroll taxes), which tend to reduce the relative price between labor and capital at least for a while – by contrast to lower interest rates, which has the opposite effect. Moreover, if the national governments wants to influence the composition of labor demand, for instance in favor of disadvantage groups, fiscal policies certainly provide more useful instruments than monetary policies, although with the earlier mentioned risk of messing up the price system.¹³

It is also a commonplace that discretionary fiscal policies are connected with severe administrative and political problems. One celebrated example is that time lags create the risk that expansionary policies undertaken in recessions, in fact, do not materialize until the next boom. This difficulty is, however, not very serious in the case of *deep and long* recessions, since it is then unlikely that the effects, even if considerably delayed, will emerge in the wrong cyclical situation. While aggregate demand management for the purpose of “fine tuning” often has failed, “coarse tuning” of aggregate demand management, i.e. demand management policies confined to extreme situations, is more promising (Lindbeck, 1993, pp. 150-157) Experience also shows that there is a risk that “temporary” budget deficits will, in fact, contribute to galloping government debt. The budget position would, however, not deteriorate much, if at all, in the case of policies that induce individuals to shift from benefits to subsidized work.

But my main point is really not to recommend some specific policy tool, but rather to emphasize that in a short- and medium-term perspective it is not enough to stimulate the supply of labor. It is also important to pursue policies that simultaneously boost labor demand – if we want to avoid a further rise in unemployment in the connection with increased labor supply. As recently emphasized by Rogerson (2004), in a more long-term perspective, it is, however, probably more important to emphasize the ability to reallocate labor from declining to spending sectors – broadly speaking from industry to services – and then we are back to issues on the supply side of the economy.

References

- Alesina, Alberto, Edward Glaeser and Bruce Sacerdote, 2005, "Work and Leisure in the United States and Europe: Why So Different?" *NBER Macroeconomic Annual* 2005, no. 20, pp. 1-64.
- Blanchard, Olivier, 2004, "The Economic Future of Europe", *Journal of Economic Perspectives*, 18(4), pp. 3-26.
- Blanchard, Olivier and Justin Wolfers, 2000, "The Role of Shocks and Institutions in the Rise of European Unemployment: The Aggregate Evidence", *The Economic Journal*, 110(462), pp. C1-C33.
- Calmfors, Lars, Anders Forslund and Maria Hemström, 2002, "Does Active Labour Market Policy Work? Lessons from the Swedish Experiences", Institute for Labour Market Evaluation (IFAU), Working Paper 2002:4, Uppsala.
- Coe, David and Dennis Snower, 1997, "Policy Complementarities: The Case for Fundamental Labour Market Reform", *IMF Staff Papers*.
- Gordon, Robert, 2006, "Issues in the Comparison of Welfare Between Europe and the United States", Paper presented to IUI Seminar, Stockholm May 3, 2006.
- Heckman, James, Robert Lalonde and Jeffrey A. Smith, 1999, "The Economics and Econometrics of Active Labor market Programs", in Orley C. Ashenfelter and David Card, 1999, *Handbook of Labor Economics*, Volume 3A, Amsterdam: North-Holland.
- Heckman, James and E. Vytlacil, 2004, "The Econometric Evaluation of Social programs", in J. Heckman and E. Leamer (eds.), *Handbook of Econometrics*, Vol. 6, Amsterdam: Elsevier.
- Karanassou, M, And D. Snower, 1998, "How Labour market Flexibility Affects Unemployment: Long-Term implications of the Chain Reaction Theory", *The Economic Journal*, 108(44).
- Lindbeck, Assar, 1982, "Tax Effects versus Budget Effects on Labor Supply", *Economic Inquiry*, XX, pp. 473-489.
- , 1993, *Unemployment and Macroeconomics*, Cambridge, Mass.: MIT Press.
- , 1996, "The West European Employment Problem", *Weltwirtschaftliches Archiv*, 132(4), pp. 3-31.
- , 1996, "Hazardous Welfare State Dynamics", *American Economic Review*, LXXXV, pp. 9-15.
- , 2006, "Sustainable Social Spending", *International Tax and Public Finance*, forthcoming.
- Lindbeck, Assar and Dennis J. Snower, 1987, "Union Activity, Unemployment Persistence, and Wage-Employment Ratchets", *European Economic Review*, 31, pp. 157-167.
- , 1988, *The Insider-Outsider Theory of Employment and Unemployment*, Cambridge, Mass: MIT Press.
- Lindbeck, Assar, Sten Nyberg, and Jörgen W. Weibull, 1999, "Social Norms and Economic Incentives in the Welfare State", *Quarterly Journal of Economics*, 114(1).
- Lindbeck, Assar and Mats Persson, 2006, "A Theory of Income Insurance with Moral Hazard and Social Norms," CESifo Working Paper.
- Ljungqvist Lars and Thomas J. Sargent, 1998, "The European Unemployment Dilemma", *Journal of Political Economy*, 106(3), pp 514-550.
- OECD, *Employment Outlook*, 2006, Paris: OECD.
- OECD, *Economic Survey Sweden, vol. 2005/9*, Paris: OECD.

- Prescott, Edward C., 2004, "Why Do Americans Work So Much More than Europeans?", *Federal Reserve Bank of Minneapolis Quarterly Review*, 28(1), pp. 2-13
- Martin, John P. and David Grubb, 2001, "What works and for whom: A review of OECD countries' experiences with active labour market policies", *Swedish Economic Policy Review*, 8, pp 9-56.
- Nickel, Stephen, Luca Nunziata, and Wolfgang Ochel, 2005, "Unemployment in the OECD since the 1960: What do we know?", *Economic Journal*, 115(1)
- Rogerson, Richard, 2004, "Two Views on the Deterioration of European Labor Market Outcomes", *Journal of the European Economic Association*, 2004, 2(2-3), pp. 447-455.

Appendix

Transformed OECD Estimates of the relation between ALMP (alt. Training) on open unemployment (Tables 1.8a and 1.9a) and on total unemployment (1.8b and 1.9b) ¹⁴

Table 1.8a column 1 – estimates of ‘beta’ (effect on open unemployment):

r = percentage of labour force in ALMPs

u = open unemployment rate

Standard errors in parentheses

For all entries in the table, the t-value is -4.23 and the estimates are significant at 1%

	u = 0.05	u = 0.07	u = 0.10
r = 0.01	-0.297 (0.070)	-0.206 (0.049)	-0.142 (0.034)
r = 0.02	-0.315 (0.075)	-0.212 (0.050)	-0.144 (0.034)
r = 0.03	-0.337 (0.080)	-0.219 (0.052)	-0.146 (0.035)
r = 0.04	-0.361 (0.085)	-0.226 (0.053)	-0.148 (0.035)

Table 1.8b column 1 – estimates of ‘delta’ (effect on total unemployment):

r = percentage of labour force in ALMPs

u = open unemployment rate

t-values in parentheses

Standard errors are the same as for the corresponding positions in the table above. Clearly, all estimates are significant at 1%.

	u = 0.05	u = 0.07	u = 0.10
r = 0.01	0.703 (10.031)	0.794 (16.316)	0.858 (25.561)
r = 0.02	0.685 (9.185)	0.788 (15.711)	0.856 (25.138)
r = 0.03	0.663 (8.339)	0.781 (15.107)	0.854 (24.715)
r = 0.04	0.639 (7.493)	0.774 (14.503)	0.852 (24.292)

Table 1.9a column 1 – estimates of ‘beta’ (effect on open unemployment):

t = percentage of labour force in ALMP training programmes

u = open unemployment rate

Standard errors in parentheses

For all entries in the table, the t-value is -4.92 and the estimates are significant at 1%

	u = 0.05	u = 0.07	u = 0.10
t = 0.005	-0.846 (0.172)	-0.580 (0.118)	-0.398 (0.081)
t = 0.01	-0.924 (0.188)	-0.605 (0.123)	-0.406 (0.082)
t = 0.02	-1.134 (0.230)	-0.663 (0.135)	-0.423 (0.086)
t = 0.03	-1.466 (0.298)	-0.732 (0.149)	-0.442 (0.090)

Table 1.9b column 1 – estimates of ‘delta’ (effect on total unemployment):

t = percentage of labour force in ALMP training programmes

u = open unemployment rate

t-values in parentheses

Standard errors are the same as for the corresponding positions in the table above.

*** : significant at 1%

** : significant at 5%

* : significant at 10%

	u = 0.05	u = 0.07	u = 0.10
t = 0.005	0.154 (0.896)	0.420 (3.559) ***	0.602 (7.449) ***
t = 0.01	0.076 (0.404)	0.395 (3.208) ***	0.594 (7.203) ***
t = 0.02	-0.134 (-0.580)	0.337 (2.505)**	0.577 (6.711)***
t = 0.03	-0.466 (-1.564)	0.268 (1.802)*	0.558 (6.219)***

¹ On the basis of an empirical study, Nickel et al. (2005) have recently argued that institutional changes explain about half of the rise in average unemployment in Western Europe between the 1960s and the 1980s/early 1990s. Others are more doubtful to the proposition that such a large part of the rise in unemployment would be a result of a rise in the equilibrium unemployment rate. For instance, it is striking that estimated movements of the equilibrium unemployment to a considerable extent has “shadowed” the actual rate.

² For a recent empirical study with this message, see Blanchard and Wolfers (2000). The theoretical literature on unemployment persistence harks back mainly to the 1980s.

³ For two variations on this theme, see Ljungqvist and Sargent (1998) and Karanassou and Snower (1998).

⁴ As has been shown by Calmfors et al. (2002, Appendix), the negative statistical association between ALMP activities and *open* unemployment in a number of cross-country studies does not seem to carry over to a negative association between ALMP activities and *total* unemployment.

⁵ Reductions in labor costs are particularly likely to raise the demand for low-skill workers, since it is unlikely that the subsidies would be shifted to higher wages for such workers, since wage rates are often quite regulated in this part of the labor market.

⁶ According to several studies, the crowding out effect on other jobs are often in the interval 50-80 percent (Calmfors et al., 2002).

⁷ Of course, generous and long-lasting unemployment benefits themselves are also vulnerable to moral hazard, in the sense that some unemployed workers tend to be choosier when searching for, or being willing to accept, offered jobs. Indeed, according to much empirical research, open unemployment tends to rise as a result of generous and long-lasting unemployment benefits; see, for instance, the surveys of the literature in this field in OECD (2006). Up to a point, such choosiness may improve job matching in the labor market. But very large choosiness may, of course, contribute to economic inefficiency.

⁸ Prescott (2002) has instead argued that the difference in hours of work per person in working age in Western Europe and the United State can be fully explained by the higher tax wedges in the former part of the world. As several observers have pointed out, the author then assumes unrealistically large labor supply elasticities; see, for instance, Alesina et al. (2005). As pointed out by Gordon (2006), if Prescott were right, we would have expected a large difference in hours of work also for “core workers” in the age group 30-50, which is not the case.

⁹ Gordon argues that this fact throws considerable doubt on suggestions, for instance, by Blanchard (2004) that the difference in average hours of work in Western Europe and the United States would simply reflect differences in intrinsic preferences of leisure, which would be expected to have resulted in shorter hours of work rather than non-work. Moreover, as Gordon argues, explanations in terms of intrinsic differences in preferences would have to explain why these preferences would have reversed in 1970s, since Europeans, in fact, earlier worked more than Americans.

¹⁰ This is an example when moral hazard in the connection with social insurance creates individual adjustments on the “intensive” rather than the “extensive” margin.

¹¹ Social norms concerning work and benefit dependency are rather different from preferences for leisure. For instance, in Lindbeck, Nyberg and Weibull (1999), the individual has preferences concerning leisure and consumption, at the same time as he/she is influenced by social norms in society. Behavior influenced by social norms means that the individual’s propensity to live on benefits would depend on how such behavior is regarded by others (which makes the norm “social”), and this propensity is assumed to change depending how many others behaves similarly. More specifically, social norms in the connection with income insurance refer to moral hazard behavior rather than just the choice between leisure and consumption.

¹² In models where the employment level is determined by the intersection of a labor demand relation and a wage setting curve (rather than a an aggregate labor supply curve), aggregate employment will be boosted by higher labor supply only to the extent that the wage-setting curve shifts to the right in response to higher labor supply.

¹³ While I define monetary policy as measures taken by the central bank, I define fiscal policy as measures registered on the government budget, including measures that change relative prices, such as subsidies or taxes on consumption, investment or employment, as well as temporary changes that influence intertemporal relative prices.

¹⁴ I am grateful for assistance with these calculations from David von Below. The calculations apply the same simple approximations as in Calmfors et al. (2002) When open unemployment is the dependent variable, the

implicit regression coefficient in the OECD study for the share of the labor force involved in ALMP programs is about *minus* 0.3 , suggestion that open unemployment falls by 0.3 percentage points when the share of the labor force in ALMP programs increase by one percentage point. If the dependent variable instead is total unemployment, the corresponding coefficient is usually about *plus* 0.7.

An alternative analytical approach would be to regresses aggregate *employment* (rather than some measure of unemployment) on ALMP spending. There are, however, serious problems of such studies, since differences in the level of aggregate employment depends on many non-included variables, such as the system of early retirement and the extent to which married females work in the home and in the open market – features that may very well be correlated with ALMP spending. It is not clear that this problem can be satisfactorily be dealt with by inserting “fixed effects” in the form of country dummies in the regression equations, since such ”fixed effects”, in fact, may not be constant over time; they may, in fact, change in response to variables correlated with ALMP spending.