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**THE WEST EUROPEAN
EMPLOYMENT PROBLEM**

BY ASSAR LINDBECK

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Assar Lindbeck:

THE WEST EUROPEAN EMPLOYMENT PROBLEM*

How do we explain the poor employment performance in Western Europe since about the mid-1970s? This question is in fact twofold: what initiated the dramatic rise in unemployment, and what mechanisms have made it continue for so long? My attempts to answer these questions form the basis for a discussion of various policy options. A main point of the paper is the complex interaction, often in the form of complementarities, between different explanatory factors behind the West European employment problem. Unfortunately, this complexity makes it difficult to test and estimate attempted explanations. Moreover, the complementarities between different factors often preclude any positive effects of *isolated* policy actions on the employment situation; a battery of policy actions seems necessary.

I. The emergence of heavy unemployment

It is useful to approach the deteriorating employment performance after the mid-1970s against the background of the situation in the period immediately precedent, i.e., in the 1960s and early 1970s. During that period, the unemployment rate hovered around 2-3 percent in Western Europe. It was higher in the United States, but fell from 6 to 4 percent during the course of the 1960s (Figure 1). These developments were accompanied by a rise in inflation, starting around 1964 in the United States and around 1968 in Western Europe (Figure 2).

A tempting interpretation in this context is that the unemployment rate was kept below levels consistent with low and constant inflation, i.e., below what is often defined as the long-run "equilibrium unemployment rate", which is usually assumed to be

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determined by “exogenous” institutional features of the economic system. We may also hypothesize that explicit or implicit “full employment guarantees” during the early post-World War II decades made price and wage setters assume that the authorities would accommodate faster cost and price increases by nominal demand expansion, and that each agent expected others to have similar expectations. If we subscribe to this view, then sooner or later, the authorities would have been forced to shift to a more anti-inflationary policy stance because of well-known disadvantages, and unpopularity, of high and rising inflation. An increase in unemployment would then be difficult to avoid. In this sense, the full-employment policy stance actually taken during the first decades after World War II bore the seeds of its own destruction.

Figure 1. Unemployment, 1960-1995

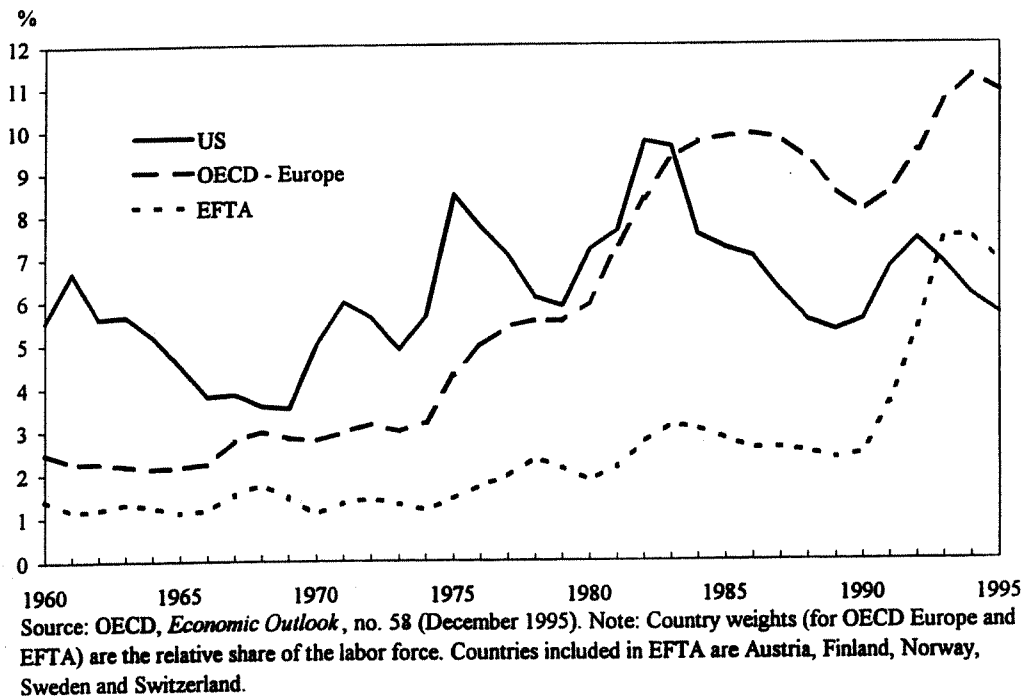
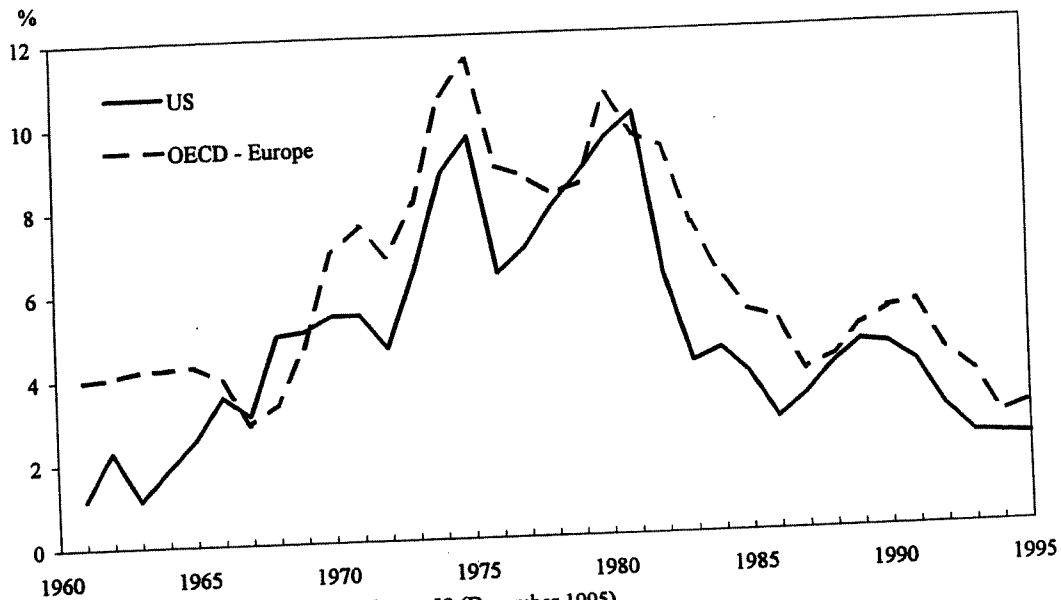


Figure 2. Inflation, 1961-1995



Source: OECD, *Economic Outlook*, no. 58 (December 1995).

Note: Weights calculated at current gross domestic product (GDP) and 1990 exchange rates. Inflation is defined as the year-to-year percentage change in the GDP deflator. Turkey is excluded from OECD - Europe.

This does not explain the timing, abruptness and synchronization among countries of the collapse of full employment in three steps in the mid-1970s, early 1980s and early 1990s (Figure 1). It is rather generally agreed, however, that the two oil-price shocks contributed to the first two stepwise increases in unemployment: as the cost-push impulses of these shocks were not fully accommodated by nominal demand expansion, an abrupt rise in unemployment was unavoidable.¹ The role of aggregate-demand restraints was even more obvious in the case of the third stepwise increase in unemployment in the early 1990s. This is reflected in the rise of real interest rates in Germany during the process of political reunification, and the high interest rate policies in other West European countries in order to maintain fixed exchange rates against the D-mark.

¹ Accommodation was particularly limited in conjunction with the second oil-price hike in 1979/1980; see various issues of OECD *Economic Outlook*, and a summary in ILO (1996).

By raising the input price of energy, the two oil-price hikes also operated as negative productivity shocks for firms outside the oil-producing industries, thereby accentuating the fall in long-term productivity growth from about the same time. Unchanged employment would, therefore, have required downward adjustments of the "real product wage", i.e., the real wage paid by firms (including payroll taxes), or at least its rate of change.² Such adjustments clearly did not happen in Western Europe in connection with the first oil-price hike: real product wages continued to rise at about the same rate as during the immediately preceding years, i.e., by over 3 percent per year during the period 1973-79 (Table 1, column 5).³ The subsequent abrupt increases in unemployment in Western Europe in the early 1980s and again the early 1990s cannot, however, be blamed on the behavior of real product wages.⁴

² This (reasonable) point has been pressed, in particular, by OECD Economic Outlook (July, 1977) and Bruno and Sachs (1985). Among individual West European countries, however, it is difficult to detect a clear correlation between short-term changes in real product wages and the unemployment rate in cross-country statistics (Gordon, 1988).

³ Wage-earners in Western Europe, aided by their unions, were even able to "compensate" themselves for the price increase of consumer goods initiated by the oil-price shock: the average "real consumption wage", i.e., the real (after-tax) wage as perceived by the consumer, increased by more than 2 percent per year during the period 1973-1979; see Table 1, column 4. (The real product wage and the real consumer wage rate are defined algebraically in Section III.)

⁴ The unemployment rate increased about as much in the aftermath of the second oil-price shock as it had after the first shock, even though the real product wage, in particular its rate of increase, actually did adjust downwards this time (Table 1, column 5). Moreover, real product wages were basically flat in the early 1990s.

The experience of the EFTA countries is consistent with these assertions that demand factors played a crucial role for the three stepwise increases in unemployment in Western Europe from the mid-1970s. Immediately after the two oil-price shocks, real product wages developed in about the same way in the EFTA countries as in Western Europe as a whole, but unemployment increased only modestly (Figure 1). The reason is probably that several EFTA countries pursued rather accommodating, or even expansionary, demand management policies. It is also important to note that full employment broke down in several EFTA countries when the accommodating policy stance was subsequently, and rather unexpectedly, discontinued -- in Norway in the mid-1980s, and in Sweden and Finland in the early 1990s.

TABLE 1.

AVERAGE ANNUAL GROWTH RATES OF GNP, EMPLOYMENT, LABOR PRODUCTIVITY, REAL CONSUMPTION WAGE AND REAL PRODUCT WAGE

	(1)	(2)	(3)	(4)	(5)
	GNP	EMPLOYMENT	LABOR PRODUCTIVITY (PER EMPLOYED)	REAL CONSUMPTION WAGE (PER HOUR)	REAL PRODUCT WAGE (PER HOUR)
US					
1973-1979	2.5 %	2.5 %	0.0 %	0.6 %	1.2 %
1979-1985	2.0 %	1.3 %	0.6 %	-0.2 %	0.0 %
1985-1990	2.7 %	1.9 %	0.8 %	-1.7 %	-1.5 %
1990-1995	2.4 %	1.2 %	1.1 %	-0.2 %	0.3 %
1973-1995	2.4 %	1.8 %	0.6 %	-0.3 %	0.1 %
WESTERN EUROPE					
1973-1979	2.7 %	0.7 %	2.0 %	2.2 %	3.3 %
1979-1985	2.0 %	0.4 %	1.6 %	0.3 %	0.7 %
1985-1990	3.2 %	1.3 %	2.0 %	1.9 %	2.2 %
1990-1995	1.7 %	0.0 %	1.7 %	0.8 %	1.0 %
1973-1995	2.4 %	0.6 %	1.8 %	1.3 %	1.8 %

Note: Western Europe is equivalent to OECD Europe for the GNP, employment and productivity figures. Greece, Iceland, Ireland, Luxembourg, Portugal, Spain and Turkey are excluded in the wage figures.

Sources: For GNP and employment figures: OECD Economic Outlook, June 1995.
For wage figures: Wages and total labour costs for workers, Swedish Employers' Federation, March 1995.

These observations and interpretations regarding the "proximate causes" of the emergence of high unemployment in Western Europe do not mean that the unemployment problem today can be reduced to an issue of demand management. As will be argued below, once high unemployment has emerged, basic structures and mechanisms in West European societies tend to perpetuate it. Attempts to fight unemployment therefore have to include *both* policy measures that avoid sudden increases in unemployment *and* reforms of the structures and mechanisms that tend to prolong it.

II. Prolonged unemployment

A glance at Figure 1 suggests that the most characteristic feature of the unemployment experience in Western Europe, in particular as compared to the United States, is not the *initial* employment response to various supply and demand shocks, but

rather the inability of unemployment to return to the pre-shock level.⁵ This is also reflected in the long-term paths of the employment share of the working-age population. For individuals in the age group 15-64, this share fell from 66 percent in 1970 to 59 percent in 1993 in Western Europe (Figure 3). By comparison, it increased from 63 to 73 percent in the United States during the same period.⁶ This information is important because poor employment performance is usually reflected not only in high unemployment but also in low labor-force participation.

The proximate reason for prolonged heavy unemployment in Western Europe is the weak net hiring of labor in business upswings. This comes out clearly in Figure 4. Aggregate employment has been rather similar during recessions in Western Europe and the United States -- usually falling by about one percent per year. But the difference is noticeable during booms: while aggregate employment has usually risen by 2-4 percent per year during business upswings in the United States, the corresponding figure is usually only one percent in Western Europe. The yearly net hiring rate was somewhat higher during the long cyclical upswing in the second half of the 1980s, after the "countershock" of oil prices and the relaxation of monetary policy worldwide after the abrupt fall in stock-market prices in 1987. This suggests that a favorable combination of supply and demand shocks can to some extent overcome various obstacles to net job creation in Western Europe. In other words various institutions in Western Europe of great importance for employment growth appear to have been erected for "fair weather" rather than for "storms".

The difference in unemployment performance between the United States and Western Europe is further highlighted by the "Phillips loops" in the two regions (Figures 5 and 6). Such a comparison, in fact, suggests two "different worlds" in terms of the functioning of the labor market. While the loops are rather "closed" in the United States, they have so far been "open" in the EU. (In 1995 the United States was back to where it started in 1962.) After periods of restrictive demand management and disinflation, the

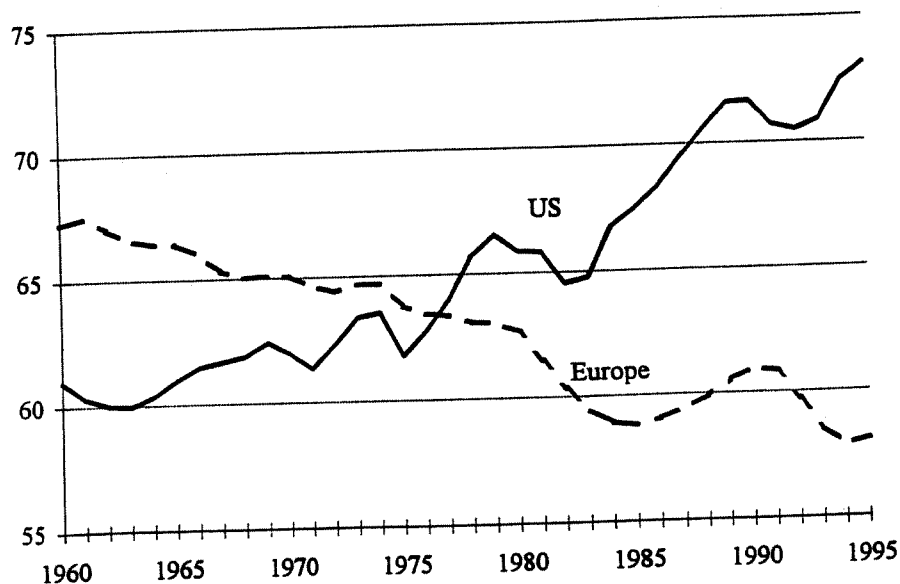
⁵ This is certainly not an original view; see, for instance, Layard, Nickell and Jackman (1991) and Bean (1994).

⁶ Figure 3 shows that this divergent development started even earlier; see also European Commission (1995).

unemployment rate is much more resistant to coming down again in Western Europe than in the United States.

Prolonged aggregate unemployment in Western Europe is also reflected in long unemployment spells for individuals. It is well known that some 40-50 percent of the unemployed in Western Europe have been unemployed for more than a year, in contrast to only about ten percent in the United States (OECD, 1994). The outward flow from the unemployment pool (as well as the flow into the pool) is much smaller in most West European countries than in the United States. This information, of course, is quite consistent with aggregate statistics on weak net hiring in business upswings. While the unemployment pool is usually a place for a "temporary stay" in the United States, it is more like an absorbing state, i.e., a "trap", in Western Europe. There is probably general agreement that European-type long-term unemployment is a more serious social problem than US-type "circulating" unemployment, even though the same individuals in the United States often experience several consecutive short-term spells of unemployment.⁷

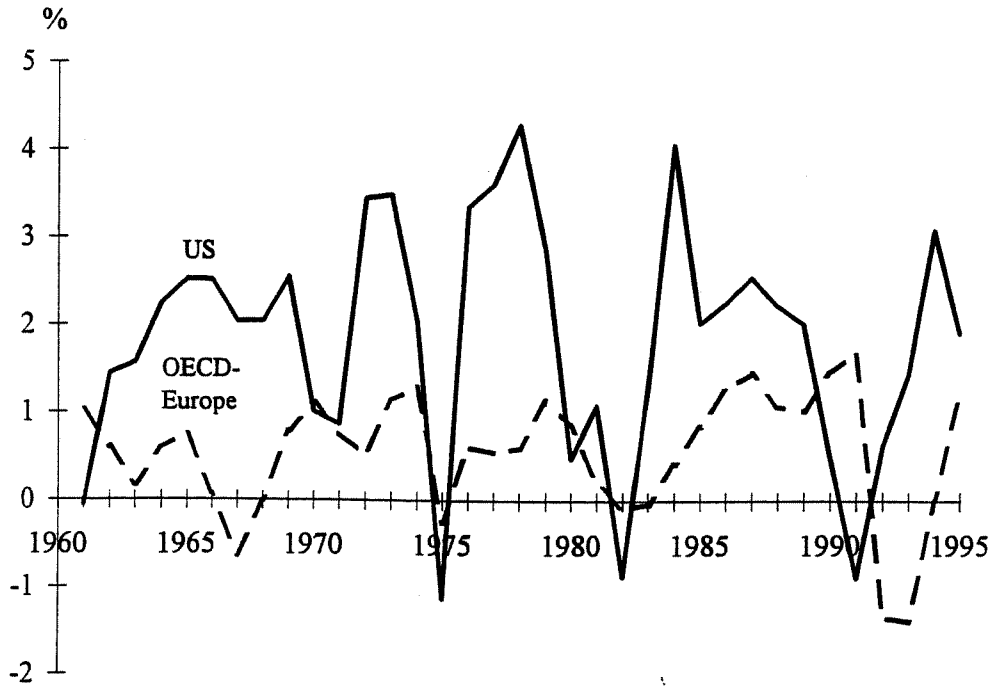
Figure 3. Total employment as a percentage of population aged 15-64 years, 1960 - 1995



Source: OECD, Economic Outlook, June 1995

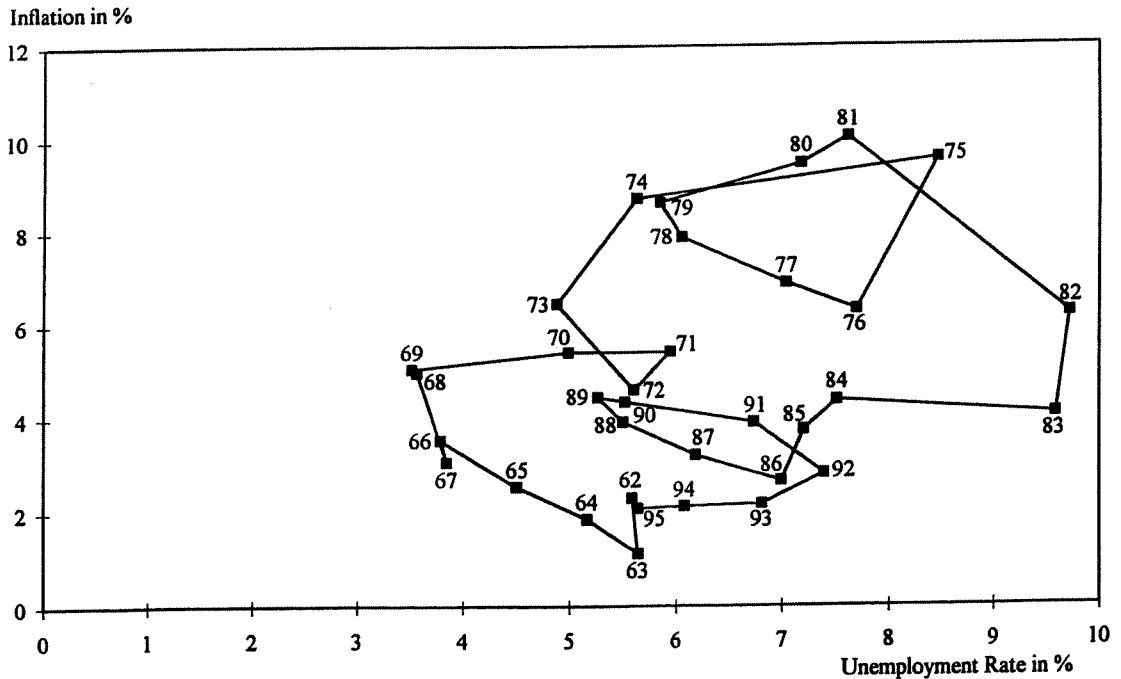
⁷ This difference partly reflects the fact that job changes in Western Europe mainly take place directly from one job to another, while in the United States they often occur via the unemployment pool (Alogoskofis et al., 1995, pp. 20-22; and OECD, various studies). To some extent, this helps explain why *average* unemployment spells are longer in Western Europe than in the United States. But it does not explain why *so many* individuals experience long unemployment spells in Western Europe.

Figure 4. Yearly changes in employment in the US and Western Europe, 1961 - 1995.



Source: OECD, Economic Outlook, June 1995.

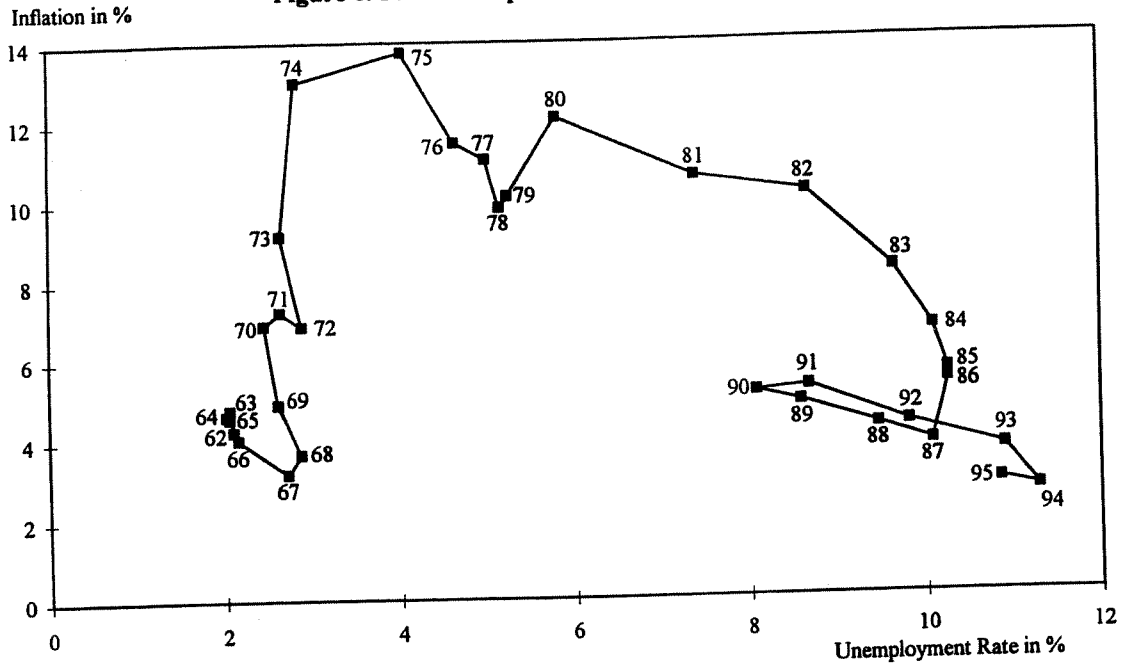
Figure 5. Price-Phillips Curve for the United States, 1962 - 1995



Source: OECD, Economic Outlook, No. 57, 1995.

Note: Inflation is defined as the percentage change in the GDP deflator.

Figure 6. Price-Phillips Curve for the EU, 1962 - 1995



Source: OECD, Economic Outlook, No. 57, 1995.

Note: Inflation in each country is defined as the percentage change in the GDP deflator. The weights used for aggregate inflation are the countries' relative share of total GDP at 1990 prices and US dollars. The weights used for aggregate unemployment are the countries' relative share of total employment.

(One and the same individual in Western Europe often experiences several long-term unemployment spells instead.) The main employment problem in the United States is instead the large group of "working poor".

III. Mechanisms prolonging unemployment

Why, then, is the hiring of workers so weak in business upswings, and unemployment so prolonged, in Western Europe? *Restrictive demand management* is certainly one important factor, often motivated to bring down inflation, limit budget deficits and support a fixed exchange rate. Thus, restrictive demand management policies have often contributed to keeping the actual unemployment rate above the long-term equilibrium rate. It is quite clear, however, that there are also two other "villains": institutional changes during the 1960s and 1970s that raised the *equilibrium unemployment rate* itself, and mechanisms of *unemployment persistence* that make the

actual unemployment rate fall very slowly whenever it winds up above the equilibrium rate.

Unfortunately, these two “villains” are difficult to disentangle. They are influenced by rather similar factors, including labor-market institutions, government regulations and various welfare-state arrangements. They are also difficult to distinguish empirically; *statistically calculated* equilibrium unemployment rates tend to “shadow” the actual unemployment rate because estimates of the former also tend to reflect unemployment persistence. There is an important difference, however. While the equilibrium rate is determined by exogenous institutional factors, relevant persistence mechanisms operate, as explained below, via various endogenous variables.

1. Real and relative wages and labor-turnover costs

When discussing various mechanisms behind prolonged unemployment, it is useful to start with wage formation. Even though the real product wage has not been a major factor underlying the *initiation* of high unemployment in Western Europe, the possibility remains that its long-term path has contributed to unemployment persistence. Casual support for this view is that the real product wage increased by 1.8 percent per year in Western Europe during the period 1973-1995, while the corresponding increase was only 0.1 percent in the United States (according to Table 1, column 5). This is just about the reverse of the paths of aggregate employment growth in the two areas: 0.6 percent per year in Western Europe as compared to 1.8 percent in the United States.⁸

An obvious objection to this reasoning is that several countries in Western Europe could afford a faster increase in real product wages than the United States, without generating high and prolonged unemployment, because of their more rapid rate of labor productivity growth. Indeed, real product wages in Western Europe seem to have increased at about the same rate as labor productivity during the last two decades, i.e., since the early 1970s (Table 1, columns 3 and 5).⁹ Such *ex post* comparisons of the

⁸ A negative statistical relation between long-term changes in the real product wage and aggregate private employment may also be detected in cross-country statistics from a larger set of OECD countries. The relation is rather weak, however, and (as always in bivariate relations) hazardous to interpret.

⁹ There is still a difference, though, as compared to the United States, where real product wages seem to have *fallen* by about 0.5 percent per year relative to labor productivity growth.

growth rates of labor productivity and real product wages seem too mechanical, however, to be very informative. The relatively fast rate of labor productivity growth in Western Europe is partly a *result* of rapidly rising real product wages. The brisk increase in real product wages in Western Europe has favored both capital-intensive sectors and the use of capital-intensive technologies within various sectors. The rapid rise in real product wages has also forced low-productivity plants and firms out of business -- indeed, faster than other firms have been able to re-employ "redundant" workers. In a medium-term perspective, these developments have not only boosted aggregate productivity growth, but also contributed to the slow expansion of aggregate employment. The mirror image in the United States is that stagnating real product wages have retarded productivity growth and contributed to expanding aggregate employment.

An eclectic conclusion could well be that employees in the United States have *to some extent* "paid" for successful long-term employment performance with stagnating real wages, while the unemployed in Western Europe have *to some extent* "paid" for the brisk increase in real wages of those who were fortunate enough to have jobs.¹⁰ This reasoning assumes, realistically, that there is an "autonomous" element in the path of real product wages in the short and medium term, so that these wages do not simply reflect what happens to (exogenously determined) labor productivity growth.

In a world with recurrent shifts in the composition of the demand for and supply of different types of labor, it is also natural to blame high levels of unemployment on rigid *relative wages*. In particular, many observers have referred to demand shifts to the disadvantage of low-skilled and non-versatile workers as an explanation for the particularly large rise in unemployment rates for these groups in several nations in Western Europe -- regardless of whether these demand shifts are the result of technological changes disfavoring low-skilled workers, increased international competition for labor-intensive products, or reorganizations within firms that favor skilled and versatile workers.¹¹ Similar demand shifts are then asserted to explain the

¹⁰ Some of the long-term consequences via capital formation are discussed in Gordon (1995).

¹¹ According to Alogoskoufis et al. (1995, p.50), the ratio of the unemployment rates of unskilled to skilled workers increased from 1.9 to 3.5 in France from the early 1980s to the early 1990s, from 2.9 to 3.4 in Germany, from 0.8 to 1.3 in Italy, from 2.2 to 3.8 in the United Kingdom, but only from 3.1 to 3.2 in the United States. See also OECD (1994, pp. 28-41) and Nickell and Bell (1996). The relatively unfavorable employment trend for low-paid

huge increase in the dispersion of relative wages in the United States, where relative wages are assumed to be more flexible; see, for instance, Krugman (1994).

As in the case of other plausible explanations for high unemployment in Western Europe, such as the long-term path of the average real product wage, it is difficult to test this theory statistically. The influence of other factors, which are often correlated with the structure of relative wages, makes it difficult to isolate the impact of relative wages. For instance, we should not expect a close statistical correlation in cross-country data between the development of relative wages and either aggregate unemployment rates or relative unemployment rates for different groups of workers. The consequences of shifts in the composition of the demand for different types of labor depend not only on simultaneous changes in the composition of labor supply. They also depend on the distribution of the *initial stock* of human capital in the national economy; see OECD (1995) and Nickell and Bell (1996). If there is an ample supply of semi-skilled workers who are good substitutes for high-skilled labor, increased demand for the latter is not likely to generate a drastic increase in either the dispersion of wages (in countries with flexible relative wages) or relative unemployment rates (in countries with rigid relative wages). This condition is probably fulfilled in some countries on the European continent, where the distribution of human capital (skills) is much more even than in the United States (Björklund and Freeman, 1996; Nickell and Bell, 1996).

Granted that the paths of average real product wages and relative wages are part of the explanation for high and prolonged unemployment in Western Europe, how do we then *explain* the actual behavior of wages? One explanation is that real wages are pushed up, in particular in business upswings, by those who already have a job, the so-called "insiders" in the labor market (Lindbeck and Snower, 1988). This wage behavior then limits net hiring of workers. Insiders have market powers to behave this way because of various costs and inconveniences to firms of firing insiders and replacing them with "outsiders", i.e., jobless workers. The time path of the real product wage in Western Europe is consistent with this interpretation: considerable increases in the real product wage have taken place during business upswings in spite of high rates of unemployment.

workers on the European continent is even more pronounced if we look at *employment rates* in the private sector rather than at the unemployment rates for the economy as a whole.

High labor-turnover costs for workers arise partly because insiders can refuse to cooperate with outsiders who threaten to underbid existing wages. Insiders can also threaten to harass underbidders. Social norms against underbidding of prevailing wages certainly also exist, and these norms are upheld by the market powers of insiders and unions if these are more interested in the welfare of insiders than outsiders. In several countries in Western Europe high labor-turnover costs are also a result of job-security legislation and legal, or de facto, extensions of collective wage agreements to unorganized workers, thereby accentuating the market powers of insiders and unions in some countries. So do the legal rights of unions to strike without the approval of their members, as well as to take action (such as blockades) against firms that are not involved in wage-bargaining conflicts. These types of legislation were boosted during the 1960s and 1970s in several West European countries; some subsequent retreats have usually not led to more than marginal modifications of this legislation. Moreover, relative wages are made less responsive to market forces by minimum-wage legislation and wage bargaining at national or industry levels, rather than at the level of individual firms or plants.

Labor-turnover costs also contribute *directly* to employment and/or unemployment persistence simply by making it more expensive for firms to change their workforce.¹² More specifically, high labor-turnover costs tend to stabilize aggregate employment at the initial level -- whatever it happens to be. The resulting employment inertia may be regarded as an advantage if aggregate employment is initially high, as it was in the 1950s and 1960s. But such inertia is a disadvantage if *unemployment* is initially high, as has been the case since the late 1970s in Western Europe. In the latter situation, it is high unemployment rather than high employment that is stabilized by high labor-turnover costs. This illustrates how an institutional feature -- in this case job-security legislation -- that is favorable, or at least "innocent", under certain circumstances may become a serious problem under other circumstances. From this point of view it is surprising that some economists have minimized the role of job-security legislation in the West

¹² Attempted econometric tests of the role of hiring and firing costs catch, in principle, both the direct and indirect effects (via wage formation) on labor demand. This makes it difficult to disentangle the relative importance of the insider-outsider effect, which emphasizes the role of wage formation, and the direct influence of hiring and firing costs. It is also difficult to rank labor-turnover costs among countries, even those associated with job-security legislation. So far, it has not been possible to isolate the effects of labor-turnover costs from other factors, partly because of various interaction effects.

European unemployment problem by the observation that we do not know if high labor-turnover costs tend to increase or reduce the *average* employment level over the business cycle. Such arguments are quite irrelevant for countries that have been stuck in permanently high unemployment for one or two decades. The consequences today of high labor turnover costs, including tight job-security legislation, have to be evaluated in terms of their effects on the existent employment situation, rather than their average effects over ordinary business cycles.

The general conclusion is that job-security institutions and legislation in Western Europe tend to raise the equilibrium unemployment rate *and* to accentuate unemployment persistence.

2. Tax wedges

Do the wide *tax wedges* for labor in several countries in Western Europe also contribute to prolonged aggregate unemployment? To highlight the issue, it is useful to provide algebraic definitions of the real product wage and the real consumption wage, respectively: $w = W(1+t_w)/P$ for the real product wage, and $w_c = W(1-t_i)/P(1+t_c)$ for the real consumption wage, where W is the nominal wage rate, t_w the wage tax rate, P the product price, t_i the income tax rate and t_c the consumer good tax rate. The tax wedge between these two real wage rates is then defined as $w/w_c = (1+t_w)(1+t_c)/(1-t_i)$. This illustrates the fact that all taxes on labor enter symmetrically into the definition of the tax wedge.

The consequences of wider tax wedges for aggregate employment and unemployment depend basically on how the taxes are shifted and, in particular, on the extent to which wages adjust to higher tax rates. If the nominal wage rate does *not* adjust downward in proportion to a rise in the payroll-tax factor (i.e., $1 + t_w$), or the product price does not increase proportionally, the real wage costs of firms will rise, and some private production and labor demand are priced out of the market. When higher income taxes or consumption taxes (t_i or t_c , respectively) are shifted to higher wages, the consequences for labor demand are, in principle, the same.

In these examples, the employer "pays" the tax. This is likely to occur to a considerable extent in the short run, in particular in the case of increased payroll taxes -- regardless of whether higher taxes finance increased government spending or are

designed to reduce the budget deficit. The reason is that wage contracts, usually expressed in nominal terms, often cover several years. In a *long-run* perspective it is more likely that employees will have to “pay” the tax. A basic reason is that the required return on capital is tied to its international return. Thus, we should *not* expect wider tax wedges to result in a permanent rise in the real product wage for most wage-earners, and hence in a permanent reduction in demand for these workers, though the general demand for labor may fall during a period of transition, before full adjustments have taken place.

The situation is different for low-productivity workers. If such workers were to “pay” for a tax increase with lower wage rates, and hence a reduction in their real consumption wage (w_c), then w_c may fall below the reservation wage. These workers will then withdraw from the labor force or move to the underground economy. If minimum wages prevent such a fall in the real consumption wage, then wage costs would instead increase for such workers. Thus, in the case of some low-productivity workers, wide tax wedges will -- also in a long-term perspective -- result in either higher unemployment or withdrawal from the official labor market.

Most likely, wide tax wedges create more serious employment problems for the production of household services than for manufacturing. Few individuals choose to produce their Mercedes cars in their own garages because of wide tax wedges between the costs of purchasing a car in the market and of producing it at home. But people can wash their own cars. They are also able to repair and paint their houses, clean their apartments, work in their gardens, mind their children, cook their food at home rather than eat at a restaurant, etc. In other words, the elasticity of substitution between purchases in the market and home production would be expected to be much higher for a number of household services than for most manufactured products.

In some countries in Western Europe today, the total marginal tax wedges are about half to two-thirds of the gross wage for *both* the buyer *and* the seller of household services, after all explicit and implicit tax wedges are taken into account. As a consequence, the buyer of a service has to earn 4-9 times as much before tax as the seller of the service receives after tax. This is bound to reduce the attractiveness of buying household services in the official market using earned money, rather than producing the services oneself. Thus, “Baumol’s law”, according to which the demand for labor-intensive services is impeded by gradually rising relative prices, is accentuated. As a

result of all this, increased unemployment, withdrawals from the labor force or shifts to the black market are particularly likely in the private-service sector.

3. Job search, discouraged workers and social norms

Dwindling job search by the individual during periods of high unemployment, and as an extreme case “discouraged workers”, represent another celebrated mechanism of unemployment, and non-employment, persistence. Various benefit systems accentuate this type of persistence mechanisms. The most obvious example is perhaps generous unemployment benefits with long duration and lax administration (thus without strict “work-force” requirements). Other benefit systems, however, may often have similar effects on employment rates. Today, for instance, the number of citizens with a disability pension (in many cases with very vague symptoms) and subsidized early retirement is often about as large as the number of unemployed (OECD, 1996). As the downward pressure on wages is reduced by generous benefit systems, this mechanism interacts with persistence mechanisms in relation to wage formation. It is well documented that the generosity of various benefit systems increased considerably in Western Europe during the 1960s and 1970s, though some retreat has recently occurred (Burda, 1988; OECD, 1996).

Empirical studies, including panel data from several countries, give some support to the hypothesis that search intensity declines with longer unemployment spells (Pedersen and Westergaard-Nielsen, 1993). Moreover, higher vacancy rates have lately tended to be associated with a given unemployment rate; the “Beveridge curve” has shifted outwards in a number of countries (Elmeskov and MacFarlan, 1993). Thus, in recent years, vacancies seem to have been filled less easily than before.

A more “sociological” version of these mechanisms is that *habits* and *social norms* in favor of work (“work ethic”) may be weakened when major macroeconomic shocks hit societies with generous benefit systems (Lindbeck, 1995). Such shocks tend to throw more individuals onto various safety nets, and the hesitation to live on various types of benefits would be expected to fall by the number of individuals who are financed this way. Induced changes in habits and social norms will then contribute to persistent unemployment and non-employment, and perhaps also to a higher equilibrium unemployment rate.

Habits and social norms among individuals may often be connected more with the values of *subgroups* in society than with the values of the population as a whole. This means that "unemployment cultures" may develop within groups of interacting individuals who share similar unemployment experiences.

Prolonged periods of high aggregate unemployment are also likely to increase the tolerance among politicians and public-sector administrators for letting individuals live on various benefit systems. Politicians may lengthen the periods during which individuals are allowed to live on benefits, and administrators are likely to soften the requirements regarding active job search -- at least until the government runs into serious financial problems. Moreover, the costs and difficulties of monitoring the unemployed probably increase along with their number, which also tends to accentuate unemployment persistence (Ljungqvist and Sargent, 1996).

4. Physical and human capital shortage

There is empirical evidence to the effect that physical and human capital shortage contributes to unemployment persistence after prolonged recessions. An indication of the empirical relevance of physical capital shortage is that rather high utilization of physical capital stock has been attained during recent business upswings at ever higher levels of unemployment (Elmeskov and MacFarlan, 1993). Moreover, during the last couple of decades, a shortage of skilled workers has also been reported at rather high levels of aggregate unemployment, which is an indication of human capital shortage.

These explanations of unemployment persistence are incomplete, however, in the sense that a sufficiently large reduction of real product wages, or sufficiently large investments in physical or human capital, could overcome the problem -- as indeed seems to have been the case in the United States. The problem may also be mitigated by more shift work, which is more costly as compared to ordinary working hours. Thus, when trying to explain unemployment persistence by physical or human capital shortage, it is also necessary to assume downward rigidity of real product wages, or sluggish investment in business upswings ("investment persistence", as suggested by Wyplosz, 1994). This illustrates, again, the interactive nature of various persistence mechanisms.

5. *Multiple equilibria?*

Most of the mechanisms discussed above help explain not only why unemployment persistence *exists*, but also why it is stronger in Western Europe than in the United States: job-security legislation is stricter; insider and union power is usually stronger; and unemployment benefits are more generous and can be obtained for longer periods. There are probably also stronger obstacles to the entry and growth of small firms in Western Europe than in the United States, which contributes to capital shortage.

Persistence mechanisms imply that unemployment at a given point in time is partly a result of unemployment in the past, i.e., unemployment is history dependent.¹³ Is this an example of multiple equilibria? I would say “no”, as the operation of various persistence mechanisms simply means that a number of initial stock variables change *endogenously* over time in response to the actual unemployment situation. Obvious examples are the number of firms, insiders and discouraged workers; the stock of physical and human capital; and probably also the strength of social norms against living on various benefit systems, as well as the existence of specific “unemployment cultures”.

IV. Policy options

1. *Counteracting shocks*

Granted that unemployment persistence is the major employment problem in Western Europe, it is tempting to advise governments to counteract demand and supply shocks immediately, before various persistence mechanisms have had a chance to start operating.¹⁴ A well-known problem with such “fine-tuning” policy is that it may destabilize rather than stabilize the national economy because of various time lags inherent in policy actions, combined with our limited ability to make good forecasts. This problem is less severe, of course, if policy actions are reserved for situations of either deep recessions or strongly overheated booms, i.e., if governments conduct “coarse-tuning” rather than fine-tuning. But with such a policy strategy, various persistence

¹³ This reasoning predicts that countries with periods of strong and lengthy disinflation will suffer from particularly large unemployment persistence. Ball (1996) presents some empirical evidence supporting this prediction.

¹⁴ Such a policy is analyzed theoretically in considerable detail in Lindbeck (1963).

mechanisms may have already created serious long-term unemployment problems before policy actions are taken, or the main effects have occurred.

All this does not mean that discretionary stabilization policy action is a hopeless task. But it is not easy for policymakers to find an appropriate "window of opportunity" for discretionary policy actions. It is important to take policy actions early enough to avoid serious problems of unemployment persistence, but late enough to make the policy authorities confident that a major macroeconomic disturbance has, in fact, occurred.

It should be added, however, that expansionary demand management is potentially useful even if policymakers have missed this window of opportunity in the sense that high and persistent unemployment, above the equilibrium rate, has already emerged. Then, however, great care has to be exercised to avoid wage explosions and possibly also human and real capital shortage.

Expansionary demand-management policies during the last decade have often been politically paralyzed by huge budget deficits. Indeed, even the automatic fiscal stabilizer becomes problematic if public-sector debt explodes during long and deep recessions, as this may undermine private agents' confidence in the viability of the financial position of the government. One predicted consequence is that the interest rates on government debt will increase. Another likely effect is growing uncertainty about various welfare-state entitlements, which would be expected to result in a rise in the financial saving rate of households in the midst of recessions. Such developments may turn the traditional automatic fiscal stabilizer into an "automatic destabilizer".

A specific difficulty with demand-management policies in the highly integrated nations in Western Europe is that a considerable fraction of domestic demand management "leaks" to other countries. As aggregate import to Western Europe as a whole is only about 10 percent of the area GNP, this specific problem could, theoretically, be mitigated by so-called "global Keynesianism" within Europe, i.e., *coordinated* demand management by all (or most) West European countries. But the risks of destabilizing policy actions are probably even greater in the case of coordinated policy actions than in the case of isolated national policies, due to the difficulties in reaching well-timed agreements between governments. Indeed, if several countries act in unison, poorly timed policy actions will be particularly damaging for all. A recent example is the high-interest policies in the late 1980s and early 1990s, pursued to support the ERM

exchange rate regime. Another example is the possibility that governments will generate a downward “Maastricht spiral“ in the West European economies in their joint attempts to qualify for the contemplated monetary union. This should not imply that all types of coordination of national stabilization policy are useless. An obvious example of potentially useful cooperation is concerted actions to avoid “beggar-thy-neighbor policies” in the form of protectionism, aggressive devaluations, or selective subsidies in the tradables sector. Concerted actions to avoid instability of exchange rates is another example.

2. Mitigating unemployment persistence and reducing the equilibrium unemployment rate

The difficulties of counteracting macroeconomic shocks underline the importance of mitigating unemployment persistence. Some policy actions with that purpose may also, as we shall see, reduce the long-term equilibrium rate of unemployment. What I want to emphasize is the *interactive* nature, including various complementarities, of different mechanisms and policy actions. For instance, while certain policy actions may not have much effect in isolation, important effects may be achieved when several such actions are taken together.¹⁵

Let me start with some rather non-controversial, and in some cases even popular, policy options. *Infrastructure investment* often raises the marginal product of labor in private firms. The hiring of labor may be stimulated not only during the construction period, but also after the infrastructure is in place. From this point of view, it is interesting to note that infrastructure investment was very high (often close to five percent of GNP) during the 1950s and 1960s when productivity growth was fast and unemployment low. Positive long-run employment effects require, however, that product wages do not rise in proportion to the marginal product, which points to the importance of reforming the system of wage formation at the same time.

Investment in human capital, including training programs in the context of so-called “active” labor market policy, is another policy action that hardly needs any

¹⁵ The importance of complementarities of different measures of economic policy is emphasized in, for instance, Lindbeck et al. (1994) and Freeman (1995). For a formal analysis of the role of complementarities, see Coe and Snower (1996).

recommendation today. One reason why such a policy action can contribute to lower unemployment is that it may reduce "mismatches" between demand and supply in various submarkets for labor. Another reason is that it can raise the productivity of workers who are currently priced out of the market by wage rates above their productivities. As in the case of infrastructure investment, positive effects on aggregate employment then require, of course, that wages do not increase in proportion to improved productivity. Other obvious requirements are that a considerable number of vacancies exist, and that the incentives are sufficiently strong for workers to search and accept offered jobs, i.e., that work is regarded as more rewarding than various types of benefits.

It is also important to be on guard against temptations among politicians to use active labor market policy -- such as retraining and public works programs -- merely to improve unemployment *statistics*. Indeed, some governments seem to regard neat unemployment statistics as politically more important than the reality which such statistics were originally designed to measure. Metaphorically speaking, open unemployment could, from a purely statistical point of view, be abolished immediately by putting a book in the hands of every unemployed worker, classifying him (her) as a student! Active labor market policy, as conducted or planned today in several countries, runs the risk of making this metaphor a reality.

Radical deregulations in *product and capital markets* are also likely to be important for mitigating unemployment. Obvious examples are removal of various types of government-imposed restrictions on the entry and expansion of small firms; discontinuing restrictions on opening hours of stores; eliminating the discrimination of small firms in the tax, subsidy and regulatory systems; removal of various distortions in the markets for credit and equity capital, etc. More systematically implemented anti-cartel legislation may also help. Thus, general improvement in the conditions for entrepreneurship is probably important for expanding employment at wages on which people can support themselves.

Reduced payroll taxes (or higher employment subsidies) make up another common suggestion for reducing unemployment. At given government spending, other taxes would then, of course, have to be raised. Such tax-switching cannot result in a fall in the real product wage unless *either* workers are not compensated by higher wages *or* some of the tax burden is shifted from labor to other groups, such as pensioners or owners of

capital. The latter could, in principle, be achieved by combining lower payroll taxes with higher value-added taxes or environmental taxes (possibly also higher taxes on capital, although the international nature of the capital market makes this difficult).

As suggested in my discussion of tax wedges, a *selective* reduction in payroll taxes (or selective employment subsidies) for low-productivity workers, particularly in household-service production, can certainly improve the employment situation for this special group. A general problem with this method, however, is that it functions as a tax on investment in human capital. The reason is, of course, that the subsidies are reduced if workers acquire more skills, and hence become capable of earning a higher wage.¹⁶ This specific difficulty can be avoided if the long-term unemployed are instead allowed to transform their unemployment benefits into job vouchers that can be used either to “buy jobs” (Snower, 1994), or to finance the start of a new firm (or to become self-employed). An obvious difficulty, though, with such arrangements is that the unemployed are then induced to postpone job search until they become eligible to receive the vouchers.

A special type of employment subsidy, highly prevalent in some Scandinavian countries, is a temporary or permanent increase in public-sector employment. There is no question that open unemployment can be reduced in the short run by such measures. Indeed, a plausible explanation for the low unemployment rate in Sweden in the late 1970s is the drastic increase in public-sector employment during this period. It is equally clear, however, that some “regular” employment is crowded out.¹⁷ Moreover, we would expect aggregate employment to be kept down only temporarily, as the long-term equilibrium unemployment rate would be independent of the composition of aggregate employment between sectors.

There is also an argument for increased *flexibility of working hours* over the business cycle. From a distributional point of view, the obvious advantage is that the burden of higher aggregate unemployment is then shared among many wage-earners, rather than falling on a small minority of workers. Flexible working hours also mean a smaller rise in the number of outsiders, who have relatively little influence on wage formation. Upward pressure on wages is, therefore, reduced and unemployment persistence is mitigated.

¹⁶ This problem may not arise for workers receiving statutory minimum wages.

¹⁷ For evidence of such crowding-out effects, see Calmfors (1994).

Increased flexibility of hours of work over the business cycle is, of course, a very different story than a *permanent* cut in working hours. While the latter may sometimes bring about a better (preferred) trade-off between income and leisure for individuals, it is not obvious why it would reduce the unemployment rate in a long-term perspective. The “equilibrium” unemployment rate would be expected to be tied to the number of unemployed (relative to the labor force) rather than to the number of working hours of each worker.¹⁸ The situation is different in a short-run perspective. Provided hourly wages are not raised in connection with a cut in hours of work, there is certainly a possibility that the number of unemployed could fall *temporarily*, before wages and capital formation have adjusted to the new situation. Such short-term improvements in the employment situation do have some value. A problem, though, is that this kind of reform reduces the tax base in the long run, as compared to policies that boost aggregate employment without permanent work-sharing arrangements; the welfare state would then be more difficult to finance.

So far I have mainly addressed what may be called “lenient” policies, even if deregulations in product markets would certainly create opposition among groups that regard themselves as losers from such policy actions. It is time to shift to more unpopular, or “harsh”, policy options.¹⁹ *Deregulations of the labor market and less generous welfare-state benefits* are obvious examples. It is clear from the discussion above, as well as from the general policy debate in various countries, what types of harsh policy actions may help reduce unemployment: less generous and more strictly administrated unemployment benefits, liberalization of job-security legislation, policy actions that reduce the market powers of insiders and unions, etc. It is well-known that greater use of temporary workers, as an isolated reform, tends to increase the market powers of those with permanent contracts, i.e., the “true” insiders (Bentolila and Dolado (1994)). It is therefore important to combine such a reform with other actions that reduce the market powers of insiders. Another potentially useful, but also politically difficult, reform is to increase the actuarial elements in the unemployment benefit system. The

¹⁸ As a casual empiricism, the combination of long working hours and relatively low unemployment rates in the United States and Japan indicates that short working hours are, at least not a prerequisite for relatively low unemployment rates.

¹⁹ The distinction between “lenient” and “harsh” policy actions was used in Wyplosz (1994).

technique is, in principle, to let employees themselves pay industry-specific unemployment-benefit fees, rather than having general tax-payers finance the bulk of unemployment benefits. The purpose would be to internalize some of the society-wide costs of unemployment-generating wage increases. Such reforms are, of course, not meant to dismantle the welfare state, but rather to make it more compatible with a smoothly functioning market system, including lower aggregate unemployment.

Reforms of the system of *wage formation* are another important example of what many individuals would call “harsh” policies. In the case of the private sector, measures that reduce the powers of insiders and unions are obvious examples. In the public sector there is also a case for “creating” a demand curve for public-sector employees by imposing fixed cash limits on wage payments. (Indeed, if such a limit were fixed in money terms, the labor demand curve would be a rectangular hyperbola.) The hope is, of course, that union wage demands in the public sector would then be more modest, as the trade-off between real wages and employment would be more apparent than it is today. Restrictions on the right to strike in (parts of) the public sector would also strengthen the bargaining position of the employer side in this sector.

If we believe, as I happen to do, that decentralized wage bargaining is conducive to full employment in the long run, there is also a case for shifting wage bargaining to the level of individual firms. A more radical reform would be to guarantee workers and firms the *right* to make individual contracts. In such cases union officials would become consultants to individual workers rather than parties that sign collective contracts.

These and similar reforms of the wage-bargaining system, and related reductions in the market powers of insiders and unions, are basically designed to restrain real product wages during periods of heavy unemployment, and to make relative wages more conformable to market conditions. Such reforms, however, are not likely to reduce unemployment much if they are not combined with policies that boost aggregate product demand, reduce labor-turnover costs and induce workers to search for and accept job offers.

VI. Complementary distributional adjustments

Many institutional reforms designed to make the West European economies generate lower unemployment are bound to have distributional consequences that are

generally regarded as unfavorable. This is probably the case, in particular, for deregulations of the labor market, the imposition of less generous benefit systems, and more decentralized wage bargaining. The seriousness of such distributional consequences differs, however, among countries depending on the initial conditions. Trivial examples are that reductions in minimum wages or unemployment benefits create less serious distributional problems in countries where their levels are initially rather high. A less trivial example is that a shift to more decentralized wage bargaining is not likely to result in an equally uneven distribution of wages in Western Europe as in the United States, because of the more even distribution of human capital. The fundamental deficiency of policies on these matters in the United States is, from this point of view, not that the labor market is relatively unregulated, but that so little has been done to improve knowledge and skills among the lower deciles of the wage distribution.

There are, nevertheless, strong social and political reasons for combining deregulations and welfare-state reforms with policy actions that mitigate unfavorable distributional consequences. The most obvious technique perhaps involves a reduction, or even the removal, of income taxes for low-income groups. An alternative method is cash transfers to low-income groups, so-called "in-work cash benefits", such as the Family Credit in the UK and the Earned-Income Tax Credit in the US. A disadvantage of all such compensating policies is, of course, that tax rates then have to be raised for other groups. But such drawbacks should be compared with the disadvantage of instead having to accept undesirable distributional consequences, or not being able to undertake employment-enhancing institutional reforms to begin with. Another potentially useful way to combine employment-enhancing reforms with distributional concerns is to restore some kind of apprenticeship system (though not necessarily in line with the details of the present German system). Low entrance wages can then be combined with expectations of higher wages in the future when the productivity-enhancing effects of such systems have emerged.

Deregulations of *other* markets than the labor market are less likely to result in serious distributional consequences. There may nevertheless be political obstacles. It may, for instance, be difficult to find strong political support for reforms that facilitate the entry of firms. There are no interest groups for not-yet-existing firms and products! Another example is that the removal of rent control, so as to improve the geographical

mobility of labor, usually encounters political problems similar to those created by the liberalization of job-security legislation: there are “insiders” in the housing market, too, namely tenants with rent-controlled contracts.

VII. The Upshot

The serious unemployment problem in Western Europe has been described in this paper as the consequence of (i) temporary supply and demand shocks with (ii) strong persistence effects added to (iii) a rising trend of equilibrium unemployment.

A recurrent theme in my presentation is that *isolated* reforms and policy actions are not likely to improve the employment situation to any considerable extent in Western Europe. *Comprehensive* and probably also radical deregulations of markets as well as reforms of existing benefit systems are also likely to be necessary. Such actions, however, have to be combined with macroeconomic policies that prevent labor demand from becoming seriously constrained by limited product demand. There is a risk that politicians and the mass media instead concentrate their attention so much on selective measures *directly* designed to reduce unemployment that they forget the essence of employment-enhancing policies which is to improve the *general conditions* for entrepreneurship, production and employment. In particular, a market economy cannot function well if one of the most important markets, that for labor, is not allowed to function simply as a *market*, rather than as a tightly regulated administrative system. Unemployment, i.e., excess supply of labor, in connection with labor market regulations and collective wage bargaining, is no more surprising than surpluses of agricultural products as a result of agricultural price regulations, or a housing shortage as the result of rent control.

The main reasons for emphasizing comprehensive reforms in this paper may be summarized as follows.

(i) The interactive, indeed often complementary, nature of many mechanisms and policy instruments makes it important to combine measures that (a) stimulate *labor demand* (by contributing to expanding product demand, encouraging the entry of firms, facilitating wage moderation and market-conformable relative wages, and narrowing tax wedges) with (b) policy actions that stimulate *labor supply and jobs search* (such as lower taxes or higher benefits for the working poor, better functioning labor-exchange

systems and in some countries also less generous and more strictly administrated benefit systems of various types, and (c) *improved education and training* for low-productivity workers.

(ii) Another reason for using several policy tools simultaneously is that different policies have their main effects in *different time perspectives*. It is artificial to single out, for instance, education and training, which operate mainly in a long-term perspective, against more flexible relative wages, less generous unemployment benefits, or liberalized job security legislation, i.e., measures with speedier effects. Measures with both fast and long-term effects are needed.

(iii) *Uncertainty* about the effects of individual policy actions is another well-known reason for choosing a "portfolio" of policy measures rather than relying on a large dose of one or a few measures (Brainard, 1971). Uncertainty regarding the effects of separate policy actions makes different policy tools complementary in the same way as assets in a portfolio with different risk characteristics are complementary.

This paper, then, winds up recommending a *package approach* to fight unemployment. We cannot afford the "luxury" of not using a great number of potentially useful policy instruments. It is a serious mistake -- which many economists commit today -- to argue against various types of "harsh" policy actions on the grounds that we cannot be sure about the effects of *each* action. It is the "package" that is supposed to help reduce unemployment, and we cannot know in advance (perhaps not even afterwards) to what extent some specific actions contribute to the end result. Such a package approach also has *political* advantages, as most citizens would personally experience both advantages and disadvantages of separate measures. If most citizens gain from certain policy measures and lose from others, it is difficult to summon resistance against the entire package, as such resistance is most easily organized around single issues that hit specific groups of citizens.

It is, however, important to realize that serious distributional problems exist also if comprehensive and radical reforms are *not* implemented. One reason is that unemployment in itself is a serious distributional problem. Another is that existing welfare-state arrangements may be financially undermined if the employment problem is not solved. This may very well be a more serious threat to the welfare state than increased wage dispersion, which also increases the pressure on the welfare state. Moreover, the

longer we wait to take comprehensive actions, the harsher they will have to be. It is important that this is understood also by the most ardent advocates of existing regulations and welfare-state arrangements.

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