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No Easy Answers: Comparative Labor Market Problems
in the United States Versus Europe

by

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Over the last two decades, virtually every western European nation has faced high and persistent unemployment. In frustration, many Europeans have looked to the United States, with its lower unemployment rates, as a model of labor market flexibility. The U.S. model has become less attractive, however, as analysts have come to recognize the extent of rising wage inequality in the United States over the past two decades, including sharp declines in wages among the less skilled. In short, both European countries and the United States have faced serious labor market problems in recent years.

This article discusses some of the ways in which these labor market problems on either side of the Atlantic reflect different institutional responses to related economic problems. Both the U.S. and the European experiences demonstrate that there are no easy answers about how to operate a labor market which generates plenty of jobs for younger and less-skilled workers and which also offers these workers the opportunity to earn enough to support a family. Good policy choices will require mixing some of the best aspects of labor market flexibility with well-run activist labor market and social protection policies.

This is not just an economic concern. The labor market problems experienced on both sides of the Atlantic have had a number of social and political ramifications. These labor market changes test a country's social cohesion and its sense of community. Those who have lost economically over the past few decades -- either because of extended unemployment or because of falling wages -- are likely to be more conservative and less willing to take risks. Rising opposition to immigrants and various forms of right-wing violence is on the rise in both the United States and Europe. Many countries are experiencing difficulties in maintaining a sense of community and civic conversation between those who are angry at their losses and those who

have maintained (or gained in) relative economic status over the past decade. While the sources of this discontent may not be solely economic, the employment problems faced by specific groups of workers in all these countries are one potentially important source of anger.

The Story in Europe

Concurrent with the OPEC oil price shocks and a world-wide recession, European nations experienced sharp rises in unemployment and a slow-down in growth in the mid-1970s. Rather than recovering in the 1980s, in many European nations things got worse. Unemployment was higher by 1990 than it had been in 1980 for most countries, and these high unemployment rates continue to persist, as figure 1 indicates. Rates of long-term unemployment (the share of the unemployed out of work 12 months or more) soared to between 30 and 50 percent in many nations, while part-time employment also rose.¹ Problems were especially severe among younger workers.

Initial attempts to explain this high unemployment focused on the lack of labor market flexibility in Europe, due to extensive labor market regulation and generous social assistance programs. Despite an uncertain economy, it was argued, wages stayed high because of protective legislation and rigid union rules. Employers refused to hire these high-cost workers, especially since extensive severance protection made it costly or impossible to lay them off. Workers, in turn, were content to remain out of the work force because they received generous and long-term unemployment compensation and other assistance.²

¹ See Table 2 of Blank (1995).

² For example, see the collections of articles in Bean et. al. (1987) or Lawrence and Schultze (1987).

As high unemployment persisted through the 1980s, these stories about economic inflexibility were buttressed with other explanations that focused on the persistence of such problems. Insider/outsider models suggested that the workers who remained employed had no incentive to allow flexible wages and severance rules, hence “insiders” (the employed) kept firms from adjusting in ways that would allow them to hire “outsiders” (the unemployed.) Similarly, various so-called “hysteresis” models tried to explain how the European nations moved from a low-unemployment to a high-unemployment equilibrium because of a series of sustained economic shocks in the 1970s and early 1980s.³

Over the 1980s, many European nations tried to create greater flexibility in their labor markets by weakening protective legislation, in the hope this would bring unemployment rates down. For instance, Germany, France, the United Kingdom and Belgium weakened their dismissal laws. Spain, the United Kingdom, and the Netherlands decentralized wage bargaining. Italy eliminated automatic wage indexation.⁴ The full list of such efforts is long.

Surprisingly, as researchers studied these changes they found remarkably few effects. Certainly aggregate unemployment rates did not fall noticeably. In 1991-93, I headed a research project sponsored by the Ford Foundation and the National Bureau of Economic Research that commissioned a group of U.S. and European authors to study the effect of European changes in labor market regulation and social protection on labor market flexibility.⁵ This research indicated

³ For instance, see the discussion in Lindbeck and Snower (1990) or Blanchard’s article in Dreze and Bean (1990).

⁴ Organization for Economic Cooperation and Development (1990.)

⁵ Blank (1994).

that the effects of these changes were small. For instance, changes in severance laws or in public sector bargaining, created no bursts of job growth or worker mobility. These results are consistent with work by other researchers, who at best find very small effects from the efforts of European nations to free up labor market constraints.⁶

It is possible that the legislative changes enacted by European nations in the 1980s were too small to make a difference, and that larger more dramatic changes are necessary. For instance, rather than limiting severance pay and making it easier to fire workers, perhaps nations need to abolish all such laws entirely. But the small effect of efforts by European countries to create more flexible labor markets suggests that the problems facing Europe's labor markets go beyond the institutional structures and rules that exist within these countries.

The Story in the United States

Through the mid-1980s, the much less regulated labor markets in the United States appeared to provide a successful alternative model. While unemployment continued to rise in Europe through the 1980s, it fell dramatically in the United States. By the late 1980s, it was at a low and sustained rate of around 5-1/2 percent, as figure 1 shows. The mild recession of 1990-91 pushed unemployment up, but it fell quickly to its previous low levels by the mid-1990s.

By the late 1980s, however, a number of economic observers began to suggest that focusing only on unemployment missed an important piece of the U.S. picture. While unemployment seemed stable at fairly low levels, wage inequality was rising rapidly. Real wages of less-skilled workers have fallen steadily since the early 1970s. Between 1979 and 1993, real

⁶ For instance, see Blanchflower and Freeman (1993), Atkinson and Mogensen (1993), or Buechtemann (1993).

wages (wages adjusted for inflation) among men working full-time without a high school degree fell 22 percent, while full-time working men with a high school degree experienced a 12 percent decline in their wages. Over these same years, full-time male workers with a college degree saw their wages rise by 10 percent. Female workers have also seen dramatic increases in wage inequality, although the actual declines among the least skilled are not as extreme (not a very reassuring statement given how low wages for less-skilled women have always been.)⁷

The slow realization of these wage trends underscores the effect of data on the public policy discussion. The unemployment rate is reported monthly in many countries, and it is widely discussed and accepted as a measure of economic pain. In contrast, distributional issues are rarely measured nor reported in official government statistics. While average wage and income levels are frequently reported, distributional changes around that average are not. Hence, it was not until the early 1990s that these wage trends became known and accepted. Only after a number of studies by different researchers with different data sets all produced similar evidence of declining wages at the bottom and rising wages at the top, did this rise in inequality become an accepted fact within the academic community. By the time the wage inequality information became widely accepted, the claim that flexible American labor markets were obviously superior to Eurosclerotic labor markets had become so imbedded in the public discussion, that few people stopped to reassess whether that flexibility came at too high a price.

In short, while the less-regulated U.S. labor markets appear to have avoided serious unemployment problems, they instead experienced major declines in wages for some groups of

⁷ The data on wage changes are from Blank (1997). For discussion of the changes in wage inequality, see Levy and Murnane (1992) or Danziger and Gottschalk (1995).

workers. The bottom line is that both the United States and Europe have faced major and problematic labor market changes over the past two decades. Although the trends in U.S. wage inequality were much less immediately visible and only became apparent over time, the problems that they create for less-skilled workers may be as severe as the problems faced by European workers who experience long spells of unemployment.

A “Unified Theory” of Links Between U.S. and European Labor Market Problems?

Increasingly, researchers are looking at the potential links between rising inequality in the United States and high unemployment in Europe. The same changing global economic forces are impacting both the United States and Europe. For instance, changing patterns of international trade and changing technologies will increase the demand for some groups (especially more skilled workers), while decreasing the demand for other groups (especially less skilled workers) in all industrialized nations. In the more open U.S. labor markets, it is not be surprising if these changes produce shifts in relative wages. The more regulated European labor markets have historically maintained more rigid wage structures, forcing employers to adjust to these economic changes by changing their hiring and firing behavior, leading to increased unemployment. A priori, it is not clear whether the United States or the European model is preferable. They are simply different, adjusting to these international economic changes in different ways, with different effects on various groups of workers.

Let's call this story the “unified theory,” since it suggests both the European and U.S. labor market problems are the result of the same fundamental changes in global economic forces. The best evidence in support of this theory is simply the timing of events. Continuing high unemployment in Europe became a puzzle as the world economy started to recover in the late

1970s.⁸ This is exactly the same time that wage inequality started to rise rapidly in the United States. Both sets of problems appeared to emerge at about the same time, although the wage inequality problems in the United States were not widely recognized until almost a decade later.

But other empirical evidence for the unified theory is admittedly mixed. The careful cross-national research needed to fully explore this issue is only beginning. The theory implies a trade-off between wage inequality and high unemployment, where countries with the most inflexible labor markets experience the highest unemployment rates but show little evidence of rising wage inequality, and vice versa. At best, the reverse correlation between these two problems across countries appears mild. The United States has experienced the strongest increase in wage inequality, and little long-term increase in unemployment rates over the past 15 years, consistent with the theory. Similarly, some European countries with high unemployment show no change in wage inequality. But, some European countries have experienced both problems, most notably the United Kingdom.⁹

Further evidence might be found by investigating which group of workers are experiencing the biggest decline in relative wages in the United States, and asking whether this same group of workers is most affected by rising unemployment in European countries. In the United States, it is clearly the less skilled who have seen the biggest wage declines, although wage inequality is rising within skill categories as well. In Europe, unemployment rates are highest among the least skilled, but it is not clear that the relative unemployment rate of low-skilled workers has risen over

⁸ Wood (1994) makes this argument.

⁹ For evidence on comparative changes in wage inequality within the OECD, see Freeman and Katz (1995).

time. In fact, only France, Italy and Norway show big rises in unemployment among the least skilled relative to more skilled workers.¹⁰ In other countries, unemployment among all groups has risen, so relative unemployment rates by skill remain largely constant. In general, European unemployment seems more focused by age than by skill level. Younger workers have experienced the biggest increases in unemployment. But this does not necessarily contradict the unified theory. Labor market protections that make it harder to fire older workers in Europe may have pushed an undue burden of unemployment onto younger workers of all skill levels, as companies try to cope with changing competition and changing product demand.

Finally, a growing body of research has tried to directly test the extent to which direct changes in trade or technology feed through to the labor market.¹¹ At present, this literature is more extensive for the United States than for Europe, and there is a need to do more cross-national comparative work on these topics. The evidence seems to suggest that changing technology has played a larger role than changing trade, although there remain serious problems in correctly characterizing technological change and in developing a fully satisfying model of how trade changes flow through the entire labor market.

While there is much we still don't understand about the extent to which U.S. and European labor market changes are linked together, there appear to have been a series of demand shifts that have affected many of the most industrialized nations. Differences in how labor markets in these nations have responded depends upon their institutional structure. Less

¹⁰ Nickell and Bell (1995).

¹¹ Recent contributions to this literature include Allen (1996) and Berman, Bound and Griliches (1994).

regulated labor markets, particularly the United States and the United Kingdom, have experienced much greater changes in relative wages.¹² (It is worth noting that only in the United States have there been actual declines in real wages among workers. In other countries where inequality has grown, it is because the wages of more skilled workers have risen faster than the wages of those at the bottom of the wage distribution.) Countries with centralized labor bargaining have been most effective in maintaining an unchanged relative wage structure, but a number of these economies have instead faced very high and sustained unemployment problems.

The demographics of different nations also appear to matter for these labor market changes. Some of the labor market differences across countries can be explained by different age patterns in the population, as well as by different patterns of labor force entry and exit among younger and older workers, as well as among female workers.

Social protection programs have played a key role in offsetting the effect of labor market changes on workers' income and well-being. Countries with more redistributive programs have spread the economic costs of these changes more broadly within the economy. In fact, there is some evidence that countries with more extensive social assistance programs are exactly those countries where the increases in unemployment are also spread more broadly across workers of different skill levels. This suggests that these countries may have distributional norms that affect corporate and public behavior, beyond the explicit transfer systems that are in place. (One small piece of evidence in support of this is the rising level of CEO salaries relative to other workers within the firm in the United States over the 1980s, a pattern that is not mirrored in European firms.) Within the United States, the costs of these economic changes have been much more

¹² Freeman and Katz (1994) make this argument.

highly concentrated on a particular group of workers, with less relief provided by public transfer programs.

I don't want to oversell the "unified theory" approach to understanding the unemployment or wage situation in any one country. Every industrialized country has clearly faced its own unique set of economic and social forces over the past two decades, which have shaped the economic reality of its workers. For instance, some countries have chosen to pursue strong macroeconomic and monetary policies to fight inflation, and this has affected their unemployment rates and their wage rates. Other countries have faced significant immigration issues, which has affected unemployment and changed the distribution of jobs and wages. Each country has its own peculiar history. But it remains a useful exercise to stop asking what is different about the U.S. and the various European experiences, and to instead asking what is similar about them. When this question is asked, it becomes clear that there are related labor market problems facing both U.S. and European policy makers.

Policy Implications

In all countries, changing labor markets have present major challenges to policy-makers. All countries have faced increasing demands on their public assistance programs, from workers facing either deteriorating wages or long-term unemployment. This means greater demands on public budgets. Countries with extensive social welfare states have been most challenged, as the burden of supporting generous redistributive programs rises when the number of people accessing those programs grows. Sweden is only the most dramatic example of a European country that is being forced to make significant cuts in its social assistance programs, due to the economic problems of providing traditional levels of support to a large number of unemployed workers.

There are many responses to both the labor market problems and the public budget problems that countries have experienced. The initial approach taken by many nations was simply to hope that these problems would go away and things would return to “normal.” Unfortunately, but not surprisingly, this approach failed. The fundamental economic changes underlying these economic problems are unlikely to reverse themselves and will probably continue in the foreseeable future. To the extent that part of the problem is due to growing global economic competition (particularly increasing competition from rapidly developing nations), this competition will only continue and may even accelerate in certain markets. To the extent that part of the problem is due to the growth of “smart” technologies that privilege more skilled workers, most observers believe these technological shifts are still underway in most industries.

A second possible response is to try and insulate a country’s economies from these economic changes, through higher trade barriers or by trying to regulate labor market changes and slow down the adoption of new technologies. Fortunately, few countries have chosen this route, although a vocal political minority in all industrialized countries continue to advocate this. As economists are famous for pointing out (often with annoying frequency), creating barrier to trade and barriers to economic change can produce very negative long-run effects, limiting economic growth and job creation and creating long run costs that are much greater than the benefits that such policies might produce in the short run.

This leaves only one good alternative: For governments to confront these problems head-on, recognize that they have no quick and easy solution, and plan in the long run for how to offset and reduce their labor market effects. There is no single “silver bullet” to do this, and each country must find an approach that works within its own particular set of political and economic

institutions. The best answers, I believe, lie in utilizing a mix of ideas from both the U.S. and the European experience.

On the one hand, those who admire the flexibility of the U.S. labor market have some good arguments in their favor. Extensive limits on employee hiring and firing can seriously limit an economy's ability to adapt to changing economic forces. In economies with extensive historical labor regulations, easing severance restrictions and increasing the ability of firms to hire part-time or temporary labor are almost surely necessary changes.

On the other hand, along with flexibility must come a greater willingness to redistribute the costs of that flexibility throughout the economy, rather than forcing it to be borne by particular groups of workers facing extended unemployment or falling wages. U.S. policy makers have been far too ready to shrug and say "That's just the result of the market," in the face of massive loss of earning power among less-skilled workers. There are two ways in which countries need to offset the costs of ongoing labor market changes.

First, there are a variety of active labor market policies designed to subsidize or raise wages or which bring unemployed workers back into jobs. Many countries have at least experimented with expanded job placement and training programs, subsidies and tax incentives for hiring disadvantaged workers, and public sector job creation, particularly for the long-term unemployed and for younger workers who may have dropped out of the labor market entirely.

Such programs directly address some of the problems of low skills or inadequate access to jobs. Thus, they promise to "right" that which is wrong. They also operate to redistribute some of the gains by "winners" (those who maintain their jobs and/or experience rising wages) to the "losers" (those who become unemployed or face declining wages.) There is plenty of evidence

that these programs can have positive effects.¹³

But it is important to recognize that such effects are typically small. Rarely do training or job placement programs lead to large increases in future income, according to most evaluations of these programs. In addition, such programs make significant demands on the public sector. Not only are they typically quite costly, per participant served, but they also require substantial management expertise. Someone must actually run these programs, locating jobs, monitoring employers' use of tax credits, identifying public sector job placements, and so on. In many cases, such policies may be best operated by the government, in conjunction with substantial private sector involvement (where management expertise is often greater.) Traditionally, such programs have worked best when run on a small scale for clearly targeted groups.

All of this suggests that some mix of active labor market policies are an important policy component in most countries, but they are rarely adequate as by themselves. They must be combined with some on-going redistribution of income, supplementing the wages of low-wage workers or providing income support for those who remain unemployed. Active labor market policies must be the first line of attack -- workers should be pushed into job training, job search and public job programs as quickly as the size of these programs will allow. But given the realistic limits on active labor market policies, a reasonable social safety net needs to remain in place. If this does not happen, countries will face very real long-term consequences, such as increases in the size of their underground economies, increasing crime, drug use, and family fragmentation -- frequent outcomes when a share of the population is excluded from mainstream labor markets, and increasing civic disconnection and disorder.

¹³ For a summary of the U.S. evidence, see U.S. Department of Labor (1995)

Such income supplementation can occur through traditional unemployment and public assistance subsidies, or can occur in more novel ways. The Earned Income Tax Credit in the United States subsidizes wages of low wage workers and has been shown to increase labor force participation among those initially out of the labor market.¹⁴ Public sector job programs are a way of supplementing income while still encouraging labor market activity. Part-time unemployment subsidies are used in some European countries, and subsidize involuntary part-time workers with partial unemployment payments.

The appropriate level of such subsidies is always a contentious issue. Because of perceived overwhelming demand on their unemployment and public assistance budgets, most industrialized countries have cut income transfers to some extent in recent years. The United States has been in the midst of a debate about whether its social assistance programs are too generous (particularly in the face of high and sustained caseloads over the early 1990s) for several years. Other countries have implemented major changes in the unemployment benefit systems (which traditionally provide far more income support and redistribution in European countries than in the United States), as well as some of their social assistance programs.

Setting limits on access to cash support may be a fiscal necessity, but if at all possible, those limits should coincide with the provision of active labor market policies. Time limits on unemployment insurance may usefully coincide with involvement in job search and training. Time limits on public assistance with no guarantee of employment, as have been recently enacted in the United States, amounts to no more than wishful-thinking public policy. Given the realities of low-wage labor markets, many less skilled parents will face unemployment and low wages that

¹⁴ Eissa and Lehman (1996).

make economic survival extremely difficult without some ongoing external support.

The economic changes in U.S. and European labor markets have created difficult problems for these countries. The link between these problems of declining wages and high unemployment and changes in global economic forces suggest that there is little reason to believe these problems will reverse themselves at any point in the decade ahead. Declining wages and/or high unemployment are going to be continuing problems within the foreseeable future. Nations will also continue to face difficult choices between active labor market policies, redistributive programs and government budget costs.

At present, the United States appears to be in the process of choosing a route whereby low-income families are cut off even further from government assistance, in the name of deficit reduction and budget balancing. The recent welfare reforms aimed at low-income families emphasize that the labor market is the only way out of poverty, even as falling wages make full-time work less and less useful as an escape from poverty. The long-term consequences of such policy changes, when combined with the trends in wages, are unknown. They have the potential to lead to increases in class conflict, in poverty, and in a lost sense of opportunity via mainstream employment.

While many European countries are cutting their safety nets, most still maintain far greater assistance and redistribution than the United States. Given a longer and stronger commitment to public redistribution in the past, how far they will follow the United States in cutting back social assistance in the long term is unclear. Because the problem of long-term unemployment -- particularly among younger workers -- has been evident for many years in these countries, there is perhaps more recognition of the long-term costs of this problem, as youth simply drop out, seeing

no reason to make any effort to prepare for or look for work. Unfortunately, Europe has found no effective ways to lower youth unemployment rates, just as the United States has found no effective ways to prevent wage declines among the less skilled.

There are no obvious answers to these problems in the short-run, only ways to soften their effects. Those who favor U.S. labor markets as models of flexibility, adjusting quickly to economic changes and thereby providing the incentives for workers to invest in new skills or change jobs and relocate, must also indicate how they propose to deal with the substantial segment of the American working population that is facing permanently lower wages and reduced incentives to participate in mainstream labor markets. Those who favor the European model that provides more job protection and greater wage equality must indicate how they propose to deal with the large number of long-term unemployed in these countries. A better response is not view policy as a choice between two opposing models, but to try and meld some of the best parts of the flexible U.S. private labor market with an effective set of active labor market and social protection policies.

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Figure 1

