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# EUROPEAN UNEMPLOYMENT:

## The Insider-Outsider Explanation and its Policy Implications

*Dennis J Snower*

The European unemployment problem has been sufficiently severe and prolonged that many politicians, journalists, and economists appear resigned to it. Many have come to believe that government and public need to adjust to a new status quo. Governments could do so, according to this view, by recognizing that the 1950s and 1960s were exceptional and abandoning their long-held objective of ensuring employment for most people who seek it; the public could do so by learning to accept unemployment as one way of life, by abandoning the traditional view that a job is an entrance ticket to society.

Just as some governments appeared to be accepting this pessimism, unemployment began to fall in the UK, the US, and several Scandinavian countries. This improvement has certainly not been universal. There is little, if any, evidence of it in most European countries: Germany, France, Italy, Ireland, Austria, Spain. The period of high, persistent unemployment in the early 1980s and the selective revival since then have become well known mysteries of modern macroeconomics. Why did the worldwide recession of the late 1970s and early 1980s last so long? Why did the US recover much sooner and faster than Europe? Why has the recovery touched some European countries but not others?

The policy implications of this macroeconomic experience have also been extensively disputed. In Britain, for example, does the recent fall in unemployment create a serious danger of inflation, calling for contractionary monetary and fiscal policies? Or do the still high rates of UK unemployment relative to those in the 1960s and 1970s mean that a revival of inflation is unlikely? If the latter, can unemployment be readily reduced through expansionary macroeconomic policies?

A new approach to these questions is the 'insider-outsider' theory, originally conceived and developed by Assar Lindbeck and myself, and now the focus of extensive research in Europe and the US. It shows how the power of incumbent workers and firms may play an important role in generating high and persistent unemployment. It also seeks to explain the lack of resilience in European labour markets after the worldwide recessions beginning in 1974 and 1979.

### Alternative Explanations of Unemployment

Unemployment in the US, the UK, Germany and France rose rapidly after the 1979 oil price shock, but there has been a dramatic difference between the US and European unemployment experience since the end of 1982, when US unemployment began to

fall. By 1987 it had returned to approximately its 1980 level, and it has since come down significantly more. The level of unemployment in the UK rose steeply in 1981-2, then somewhat more slowly from 1983-6, and has declined since mid-1986. In Germany, however, the post-1979 rise continued sharply to 1983, and has since remained at this level. French unemployment has risen rather steadily throughout the period.

What accounts for these differences? There are several influential diagnoses.

According to the 'natural rate hypothesis', unemployment is at its 'natural' (equilibrium) rate when the public's wage-price expectations are correct, and deviations of unemployment from this natural rate are due to expectational errors. To my mind, it is difficult to understand persistent European, or even American, unemployment in terms of mistaken wage-price expectations (such as when people work less because they have overestimated the product price level).

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### What explains the differences in unemployment experience?

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According to the 'intertemporal substitution hypothesis', workers who believe that real wages are temporarily depressed decide to indulge in more leisure. It is not clear where the intuitive appeal of this argument lies: have European workers in the 1980s expected wages to be depressed more, over a longer period, than American workers?

The predominant Keynesian diagnosis is that the recent unemployment experience in Europe and the US is attributable to adverse product demand shocks, which lead to a decline in labour demand because wages and prices respond sluggishly. This sounds plausible: Europe has indeed been subject to more severe aggregate demand shocks than the US in the 1980s. Whereas both Europe and the US engaged in tight monetary policies early in the decade, fiscal policy was generally more contractionary in Europe. The Keynesian models predicted, however, that the massive European unemployment would be accompanied by a rapid process of disinflation. This did not happen: inflation rates turned out to be much higher than forecast. In particular, the long-term unemployed appear to have exerted little, if any, downward pressure on wage inflation. The Keynesian theory does not explain why the European inflation-unemployment trade-off worsened dramatically in the early 1980s.

The supply-side diagnosis also sounds plausible. Bruno and Sachs have claimed that European unemployment is largely due to adverse supply shocks operating in the face of real wage rigidity. According to this argument, the adverse supply shocks of the late 1970s reduced labour demand and, since real wages refused to fall, unemployment rose. But this theory does not tell us *why* real wages are more rigid in Europe than in the US. Nor does it explain why the effects of the supply shocks have been so persistent. (For example, why has unemployment remained high despite the significant fall in the oil price in the 1980s?) Furthermore, if real wages are rigid, one would have expected European employment to rise in tandem with productivity; but this has not happened. In the period from 1980 to 1987, American employment rose by approximately 15%, whereas European employment fell by about 1%.

Here is another puzzling phenomenon: why has the US been so much more successful than Europe in creating new jobs over the past decade? The differences in the abilities of the industrial sectors and the service sectors to generate employment are well documented. In the European countries since 1980, industrial-sector employment has declined, whereas service-sector employment has expanded steadily (with the partial exception of the UK, where service-sector employment stagnated until 1983 and has risen since then). In the US, however, these sectors performed quite differently: industrial employment fell between the beginning of 1980 and the end of 1982, but has risen since then, and service employment has expanded at a much faster rate than in Europe. Why has the service sector generated more jobs than the industrial sector? Why have both sectors been more successful in the US than in Europe?

### The Insider-Outsider Theory as an Explanation of Unemployment

The insider-outsider theory addresses all these questions in a simple, self-contained way. It suggests that an important source of the European unemployment problem is to be found in the exercise of market power by incumbent workers and firms. The basic idea is simple: incumbent employees ('insiders') have market power due to the existence of labour turnover costs, and they use this power to pursue their own interests, without taking full account of the interests of the newly hired workers ('entrants') or unemployed workers ('outsiders'). Insiders and outsiders play fundamentally different roles in the wage-setting process. Wages are generally the outcome of negotiations between firms and their insiders; outsiders (and particularly the long-term unemployed) have little or no say in these negotiations.

The insiders face only limited competition from the outsiders because of the labour turnover costs facing firms. Some of these costs, such as screening and training costs, are intrinsic to the business of production. Others, such as severance payments or costs arising from strike and work-to-rule actions, are the result of activities whereby insiders create economic rent. The rent-related costs are not incurred to

make the insiders more productive; rather, their primary purpose is to make it expensive for firms to replace incumbent workers, so these costs provide job security for the insiders. They often also discourage firms from hiring new workers, so that the insiders' productive services remain scarce and their remuneration remains correspondingly high.

The rent-related costs give the insiders preferential conditions of employment as well as some power to influence their wages. Consequently, the insiders are able to drive their wages above the competitive level, without running the risk of dismissal. This is a potentially important source of involuntary unemployment.

The exercise of market power by incumbent firms, like that by incumbent workers, may also be responsible for unemployment. Countries with high barriers to entry by new firms may find it difficult to reduce their unemployment pool by creating new jobs. Thus, while existing firms may have little opportunity to expand their workforces due to the rent-creating activities of their insiders, new firms (which do not, of course, have to deal with insiders) find it difficult to penetrate the entry barriers. These entry barriers come in many forms, such as government regulations, credit restrictions, implicit or explicit collusive agreements among incumbent firms, taxes on capital gains and wealth, and even application of union wage agreements (which determine how far new firms must pay insider wages). Evidence that such entry barriers tend to be higher in Europe than in the US may help explain why European countries have been less successful than the US in creating new jobs in the 1980s. Policies designed to reduce entry barriers may have a potentially important contribution to make in reducing European unemployment.

### Other Implications of the Theory

The insider-outsider theory also provides some interesting insights concerning the duration of unemployment. It is frequently asserted that unemployment is a serious social problem, primarily when spells of unemployment last a long time. Perhaps it is only after lengthy unemployment spells that individuals' skills, as well as their attitudes to work, deteriorate. For this reason, the *distribution* of unemployment spells among workers may deserve close attention.

The average duration of unemployment has tended to be significantly longer in Europe than in the US. For example, in the early 1980s, average unemployment spells lasted about three to four months in the US but were close to one year in Europe. Over the past few years, the proportion of the unemployed continuously out of work for more than a year was typically well over 30% in many European countries, but it was well under 15% in the US.

The insider-outsider theory helps explain these differences. When firms face substantial labour turnover costs, the insiders may be able to push wages well above competitive levels while achieving substantial job security. As a result, the insiders' chances of retaining their existing jobs are generally much greater than the outsiders' chances of finding new

jobs, and unemployment becomes distributed unequally among workers.

Furthermore, the short-term unemployed workers are likely to be closer substitutes for the current insiders than are the long-term unemployed. Not only do the short-term unemployed suffer from less skill attrition and obsolescence, but they also have closer personal ties to the current insiders and thus are less likely to bear the brunt of insiders' rent-creating activities. This may be an important reason why the short-term unemployed generally have better chances of gaining employment than the long-term unemployed.

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### Duration of unemployment

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The insider-outsider theory also offers an explanation for the comparatively high unemployment rates among youth, women and various minority groups. The theory predicts that unemployment rates will be comparatively high for people with comparatively little stability in their work records. The frequent job changes by young people may be attributed to their limited information about their own interests and skills and about the available jobs. Women frequently exit from the labour force to care for their children or accompany their husbands on job relocation. Some minority and immigrant workers also exhibit a preference for temporary jobs. Such people become outsiders more frequently than prime-age, indigenous males. Since the chances of employment are much higher for insiders than for outsiders, these people will spend a comparatively long time out of work.

Turning to the different employment developments in the industrial and service sectors, the insider-outsider theory suggests that the service sectors may have expanded faster because they generally face lower labour turnover costs, a lower degree of unionization, and fewer barriers to entry by new firms.

Similarly, the fall in unemployment in the UK over the past two years, in the face of persistent and rising unemployment in other European countries, may perhaps have something to do with the government's protracted efforts to dismantle some of the existing job security legislation, weaken the power of unions, and promote the entry of new firms. These policies may or may not be deemed socially desirable, however: even when they play a significant role in reducing unemployment, they do so at a cost — the outsiders' chances of employment improve, while the insiders' job security falls. It is also important to ask whether these policies are the most effective way of dealing with the European unemployment problem, or whether traditional demand management policies would be more appropriate.

#### Unemployment and Wage Inflation

Consider now the theory's implications for the relationship between wage inflation and unemployment. There is heated debate in the UK and the US about whether the recent fall in unemployment will immi-

nently lead to inflation. In European countries that have not experienced a significant unemployment decline, there is a controversy about whether the mere existence of high unemployment levels means that the prospect of inflation is remote. This question is particularly disturbing when we recall the failure of wage inflation to decline promptly in response to the high unemployment levels of the early 1980s.

In conventional economic thinking, the relation between wage inflation and unemployment (the 'Phillips curve') is seen to reflect conditions *in the labour market overall*. For example, it is commonly held that unemployment mirrors the excess supply of labour in the economy and that wage inflation responds to this excess supply, since the unemployed workers exert downward pressure on wages. By contrast, the insider-outsider theory suggests that the relationship between wage inflation and unemployment is affected by conditions *inside individual firms* — the size of their incumbent workforces, the magnitude of their labour turnover costs, the bargaining strength of their incumbents, the speed with which entrants become insiders, and the speed with which insiders lose their power after leaving employment. This emphasis reflects the theory's basic assumption that the outsiders are disenfranchised in the process of wage determination and that the insiders are concerned primarily with their own wages and job security. The unemployed have an effect on the insider wage only insofar as they are able to influence the insiders' bargaining position within their firms.

In general, the insiders are concerned about their job security regardless of whether unemployment is low or high. In either circumstance, insiders will attempt both to protect their own positions, through rent-creating activities, and to keep outsiders from underbidding in order to gain jobs. In that sense, insiders have an incentive to preserve the status quo: to keep unemployment low when it is already low, and to keep it high when it is already high.

This implies that countries with high unemployment rates are not necessarily free of inflationary prospects. When such countries experience a business upswing, the insiders — pursuing their own interests rather than those of the outsiders — may take the opportunity to improve their wages, so a wage inflation could arise in spite of a large unemployment pool. Of course, when unemployment is high, insiders may face particularly intense competition from the outsiders, so they may have only limited opportunities to raise their wages in an upswing. Furthermore, the low-wage, informal, service sectors of the economy are likely to create more jobs in an upswing, the greater the unemployment pool. The mere existence of high unemployment levels, however, is no guarantee against wage inflation.

#### Explaining Unemployment Persistence

Other theories of unemployment find it difficult to explain the remarkable *persistence* of European unemployment in the wake of the supply- and demand-side shocks of the past decade. The insider-outsider

theory seeks to fill this gap by showing that the exercise of market power by 'insider' workers and firms may help to perpetuate the effects of macroeconomic shocks.

Suppose that some adverse macroeconomic shocks have occurred, such as those which set off the worldwide recession of the early 1980s. As a result, firms lay off some of their insiders. If the shocks are unanticipated and are expected to be transient, then the insiders who have not been laid off may now consider their jobs even more secure than previously. After all, there are now a smaller number of insiders facing a basically unchanged distribution of shocks. As a result, these insiders may now demand higher wages. The unemployed workers, on their part, may be unable to underbid the insiders on account of the labour turnover costs. The new, higher wages will discourage future employment, even after the adverse shocks have passed.

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### Symmetric or asymmetric persistence of shocks?

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If the shocks are anticipated, they may also have persistent effects, because senior workers may cushion their wages in a downswing, but may drive them up in an upswing. In an upswing, the insiders are reasonably certain to retain their jobs even if their wages rise, provided that these wages do not increase by more than their productivity. Then — pursuing their own interests rather than those of the outsiders — the insiders have an incentive to demand higher wages without sacrificing their job security. By contrast, in a downswing, the insiders may face significant uncertainty about retaining their jobs. Generally, their response will not be to reduce their wages sufficiently to preserve job security (the opposite of what they do in an upswing), but rather to accept only a limited real wage reduction together with a reduction in job security. In fact, there may be no real wage reduction at all when there are seniority systems, so the senior insiders can use rent-creating activities to protect themselves from wage underbidding by laid-off workers.

The persistence of shocks may take two forms:

- It may be 'symmetric'. The employment increase from a favourable shock is just as large and lasts just as long as the employment decrease from an unfavourable shock of equal magnitude.
- Alternatively, there may be 'asymmetric persistence'. Here the impacts of upswings and downswings differ. In particular, favourable shocks have a stronger effect on wages and a weaker effect on unemployment than do unfavourable shocks.

Consider the policy choices facing a country with high unemployment. First, it may opt for the traditional tools of demand management — expansionary fiscal and monetary policies. Second, it may choose 'structural' policies to tackle the unemployment problem. These are policies designed to reduce labour turnover costs, weaken labour unions, and generally reduce the power of insiders vis-à-vis out-

siders. Third, it may decide to do nothing at all, in the hope that market prices will bring labour demand back into harmony with labour supply. The UK seems to have relied primarily on the latter two options.

The insider-outsider theory offers a criterion for making such a choice. Strong symmetric persistence of shocks but weak asymmetric persistence suggests the first course of action — expansionary demand-management policies. If these policies have a significant effect on labour demand, they may indeed be much stronger than the traditional Keynesian theory would suggest. For, in that event, these policies do not merely reduce current unemployment, but — due to the exercise of power by incumbent workers and firms — the current reduction in unemployment may lead to a future reduction as well.

Yet if there is strong asymmetric persistence, these policies are unlikely to improve the unemployment problem. Although contractionary shocks may have raised the level of unemployment, the impact of expansionary macroeconomic policies will be dissipated largely in wage increases. In this case, 'structural' policies may be required. By reducing the power of incumbent workers and firms, they can reduce the degree of asymmetric persistence.

Finally, if there is weak symmetric and asymmetric persistence, structural policies are unnecessary and a transient stimulus from demand management policies will have at most a transient effect.

Thus, statistical estimates of the degree of symmetric and asymmetric persistence may be of some policy interest. David Begg, Assar Lindbeck, Chris Martin and I have recently embarked on an econometric study of this phenomenon. Our preliminary results suggest that the US (where unions are comparatively weak) has little persistence of either variety, that the UK and Germany (where unions are decentralized) give evidence of some asymmetric and strong symmetric persistence, and that Austria (with a highly centralized union structure) is characterized predominantly by symmetric persistence.

### Helping the Outsiders

The insider-outsider theory has other policy implications. Beyond policies designed to reduce barriers to entry by new firms, the theory provides a rationale for profit- or revenue-sharing schemes of labour remuneration, whereby workers receive part of their pay as a share of firms' profits or revenues. These schemes could be formulated so as to reward the insiders for allowing outsiders to enter the workforce. Insofar as the insiders are thereby induced to refrain from rent-creating activities, employment could be stimulated. Moreover, vocational training schemes — subsidized or run by the government — might help erode the insiders' advantage over the outsiders and therefore reduce unemployment as well.

There may also be a case for the government to encourage apprenticeship systems. If such employment contracts lengthen the span of time over which workers remain entrants, they will give firms a longer period of time in which to take advantage of the

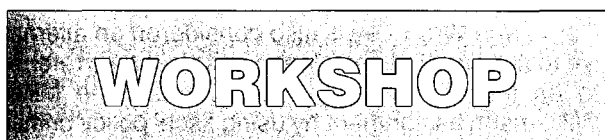
differential between insiders' and entrants' wage claims.

The theory also provides an argument for job-sharing during recessions, provided that the job-sharing schemes are not implemented in such a way as to increase firms' labour costs per hour. These schemes can create a larger number of insiders, all of whom have a vested interest to negotiate their wages with their own job security in mind.

The insider-outsider theory is concerned with equality of opportunity in market economies. It shows that incumbent workers and firms may have incentives to engage in discriminatory activities which rob the outsiders of their opportunity to participate in the labour market on equal terms with the insiders. The discrimination does not arise because the incumbents are malicious or reactionary. On the contrary, they may prefer to welcome the outsiders into the ranks of the employed — provided the incumbents' jobs and incomes are not threatened thereby. But the theory shows that the incumbents may derive considerable economic advantage from keeping the outsiders out, and this is the reason why the discrimination occurs. These ideas may help provide a groundwork for the formulation of government policies to change the incentives which the insiders face and so to create fairer conditions in the labour market.

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## Exchange Rate Target Zones

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### Modelling issues

The target zone proposal was first put forward by John Williamson in 1985 and subsequently extended by him with Marcus Miller. It is a 'blueprint' for the co-ordination of monetary, fiscal and exchange rate policies among the G7 countries. In its extended form, the target zone proposal envisages rules for the conduct of monetary and fiscal policy to stabilize

real exchange rates and nominal demand growth. These rules take the following form. First, countries determine a set of real, 'fundamental equilibrium exchange rates', chosen so as to ensure medium- to longer-run current account equilibrium. They then set targets for the growth of nominal demand, taking into account internal and external policy goals. Interest rate differentials are varied in order to limit the deviation of currencies from their target levels, aiming to keep exchange rates within a given band around the target, while the average level of interest rates across countries is fixed in order to stabilize aggregate growth of nominal demand around the sum of national targets for nominal demand growth. In this context, national fiscal policy is varied with a view to achieving national targets for nominal demand growth.

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### Targets and instruments

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On 13 May, CEPR held a workshop to discuss exchange rate target zones, organized by Marcus Miller, Co-Director of the Centre's International Macroeconomics programme. The meeting was part of a research programme on 'Macroeconomic Interactions and Policy Design in an Interdependent World', with financial support provided by the Ford Foundation and the Alfred P Sloan Foundation.

**George Alogoskoufis** (Birkbeck College, London, and CEPR) began the meeting with his paper 'On Optimal World Stabilization and the Target Zones Proposal'. In the context of a theoretical model, Alogoskoufis compared the performance of optimal policies for world stabilization with a regime of target zones. The model assumed a similar economic structure across different nations and allowed countries to produce both traded and non-traded goods. Nominal wages were imperfectly indexed to the price level, so that, in the absence of an appropriate stabilization policy, unanticipated disturbances may impose welfare losses on the economy. In addition to a standard measure of welfare loss, a Harberger triangle for the labour market, Alogoskoufis also used a 'Bailey money market triangle', which measures the welfare loss induced by deviations of interest rates from their long-run equilibrium due to unanticipated shocks.

When all economies are free to use both monetary and fiscal policy, the analysis suggested that target zones are the optimal arrangement — relatively fixed exchange rates and independent fiscal policies ensure the first-best optimum. If countries are unable to use fiscal policy, however, then a 'second-best' outcome resulted, in which overall welfare is less than the 'first-best' outcome (although the loss is minimized). Thus, in a second-best world, Alogoskoufis argued, the additional exchange rate constraint imposed by the target zone proposal might hinder rather than promote world stabilization. He also showed, however, that if the only economy constrained in its use of fiscal policy is the largest one — the 'Stackelberg leader' — then the use of target zones might in fact reproduce the optimal world monetary arrangement quite closely.