

## **LABOR MARKETS: FACTORS DRIVING UNEMPLOYMENT RATES IN INDUSTRIAL NATIONS**

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### **ABSTRACT**

Different labor market institutions and policy exist in the US compared to major European nations. Recently US unemployment rates have been lower than those in Europe, and this paper will explore the reasons for this difference.

### **INTRODUCTION**

During this decade and the last, the US has experienced a healthy labor market. Unemployment rates have been low by historical standards. In contrast the labor markets in Europe have suffered higher unemployment rates. This paper will apply economic theory to analyze some of the causes for this difference in macroeconomic outcomes.

Economic theory suggests that efficient markets require flexible prices and relative freedom for supply and demand to be reflected in the decisions made by buyers and sellers in the market. In labor markets we see that nations have adopted different policies in terms of wage flexibility, severance pay, unemployment compensation policy, termination prerogative, strength of union contracts, and the political role of organized labor. Theory would suggest that nations adopting more restrictive policies in these areas will experience higher unemployment rates and less efficient labor markets.

This paper will present data from OECD industrialized nations to describe their labor market policies and the results. We will test the hypothesis that more restrictive labor market policies tend to be associated with higher unemployment rates.

### **THE CONVENTIONAL WISDOM**

For many years analysts have noticed that unemployment rates in the US and other “free market” nations have been lower than the same rates in nations with perceived labor market rigidities. Economists usually advocate free markets, and lower unemployment and a higher level of labor market efficiency are expected where arbitrary rigidities are not imposed by governments.

Government policy toward the labor markets is different in most of Europe than in the US. Most nations offer more generous unemployment compensation for longer terms than in the US, which reduces the supply of labor. Employers in Europe face more onerous requirements before implementing large layoffs, which reduces the demand for labor (and may shift some demand for labor overseas). Mandatory

vacation time is higher in many areas of Europe than the US, which discourages hiring and increases labor costs. Social insurance taxes are generally higher in Europe, discouraging hiring. Government labor market policies in terms of re-training and adjustment payments are more common in Europe, reducing the incentive for workers to take the first job offered. Each of these factors seems to make European labor markets less competitive and more inefficient compared the US markets. In addition, labor unions are stronger in Europe, and often have specific political power and position. Last year French youth rioted in the streets to force the government to reverse a policy that would have made it slightly easier for firms to discharge unneeded workers under age 25 without cause. The government had proposed this policy change to encourage firms to hire young workers and reduce the high unemployment rate among this group.

Given that labor market policy differs in the US and Europe, it is instructive to compare the resulting unemployment rates and other measures of labor market efficiency in these areas. This topic is interesting in light of the evolution of the European Community, the integration of some of the former USSR-controlled nations into the EU, the re-unification of Germany, and the massive emigration of people from southern and eastern Europe, North Africa Asia, and other places into Europe over the past 25 years.

### TRENDS IN UNEMPLOYMENT RATES

Since 1960 we see a divergence in the unemployment rates of the US and Europe. It is important to note that the data on unemployment are collected differently in each nation, and the shifting of national boundaries since 1960 makes it difficult to identify trends that are comparable.

Table 1 presents data comparing unemployment in the US and Europe since 1960. Here we see a trend in the US of unemployment remaining within the band of 5%-7%, while during the same period in the Europe G4 (France, Germany, United Kingdom, and Italy) the rate drifted up from 2.6% in the 1960-73 period to 9.4% over the period of 1990-2000. Since that time US unemployment rates have come down as low as 4% and G4 rates have increased.

**TABLE 1  
COMPARATIVE UNEMPLOYMENT RATES: US AND EUROPE G4**

Country	1960-73	1973-90	1990-2000
USA	4.9%	6.9%	5.6%
Europe G4	2.6%	6.8%	9.4%
France	2.0%	7.4%	11.1%
Germany	0.7%	4.6%	7.9%
United Kingdom	2.9%	7.9%	8.0%
Italy	4.7%	7.2%	10.5%

Source: Bureau of Labor Statistics, US Department of Labor, "Comparative Civilian Labor Force Statistics, Ten Countries, 1959-2001", March 25, 2002.

This finding of a divergence between unemployment rates in the US and Europe and the perception of relatively more labor market rigidities in Europe suggests a link worthy of study. However we also should consider alternative explanations. One is the changing mix of job and industrial sectors in each area. For example, in the US over the 1960-2000 period, service sector employment increased 2.5% per year. In

Europe G4 the figure was 1.7% per year. In goods-producing industries, the US growth rate was 0.8% per year, while in Europe G4 the comparable employment declines at a rate of 0.6% per year. In agriculture, US employment declined 1.2% annually, while Europe G4 agricultural employment dropped 3.7% annually. We will not pursue analysis of the sector mix of employment in this paper. (See Bureau of Labor Statistics, 1992).

### **MEASURES OF LABOR MARKET RIGIDITY**

Analysis of unemployment across the nations of Europe is difficult because national data are collected in different ways, and some nations do not have long term time series that are consistent in terms of coverage or definitions. Several political events over the past 40 years have made it difficult to trace accurate trends. Nevertheless many scholars have attempted to combine existing data and develop innovative measures of labor market dynamics. Some of the measures developed are listed in Table II.

**TABLE 2  
MEASURES OF LABOR MARKET PERFORMANCE AND RIGIDITY**

Measure	Source
Unemployment rate 2004	OECD, 2005a
Employment rate, 2004	OECD, 2005a
Employment protection laws, 2003	OECD, 2004
Unemployment benefit, net replacement rate	OECD, 2005a
Trade union density (% of employees)	OECD, 2005a
Collective Bargaining coverage (% of employees)	OECD, 2005a
Co-ordination of bargaining (index)	OECD, 2005a
Active labor market policy spending (% of GDP)	OECD, 2005b

The derivation of these measures is described by Howell (2006). In analyzing these measures, we see many differences across the 24 nations of the OECD. While almost all European nations do have labor market rigidities more pronounced than in the US, they have very different results in terms of published unemployment rates. We can group the OECD nations into two groups that exhibit very different unemployment performance but similar labor market rigidity. Table III shows these results for three subsets of OECD nations: the US and similar free market states, European high unemployment states, and European low unemployment states.

### **CONCLUSIONS**

It appears from this organization of the data that there are more variables and conditions that need to be understood to explain unemployment. These measures of labor market rigidity do not necessarily define a specific unemployment outcome. For example we see that in the “low unemployment” group of European nations they have rigid labor markets and low unemployment (like the US and other free market nations). In the “high unemployment” group of European nations they also have more rigid labor markets but much higher unemployment than the US and other free market economies. More research is needed to fully explore the causes of unemployment and the role of government policy toward labor markets.

**TABLE 3**  
**MEASURES OF LABOR MARKET PERFORMANCE**

Nation Group Nations	Free Markets US, UK, IRE, Australia, NZ Canada	Low Unem Aust, Den, Neth, Nor, Swz	High Unem Germ, Fr, It, Spain, Fin, Bel
<b>Measure</b>			
Unemployment rate, 2004	5.2%	5.0%	9.1%
Employ rate, 2004	70.8%	73.7%	62.6%
Employ protection laws, 2003 index	1.2	2.2	2.6
Unemployment benefit, net repl rate	52%	77%	72%
Trade union density (% of employees)	26%	47%	36%
Collective Bargaining coverage (% of employees)	36%	76%	83%
Co-ordination of bargaining (index)	1.7	3.9	3.8
Active labor market policy spending (% of GDP)	0.5%	1.2%	1.0%

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