The Debate Over Labour-Market Flexibility

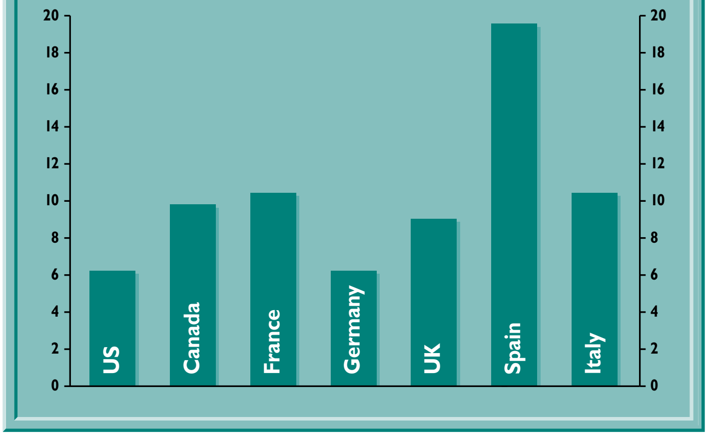
Christopher Ragan

DEBATE CURRENTLY RAGES ABOUT THE best model for labour markets. Should North American labour markets be made more "protective" like those in Europe, or should Europeans strive to make theirs as "flexible" as North America's? Despite the intensity of the debate, this is not a new issue; labour-market flexibility has been extensively studied for the better part of two decades.

With the substantial disinflations and onset of major recessions in both North America and Europe in the early 1980s, unemployment inevitably increased. On either side of the Atlantic, unemployment rates increased by roughly 4 percentage points between 1980 and 1983. As early as 1985, however, it was already clear that labour markets were not functioning the same way in Europe as they were in North America. By that time, unemployment in the United States was almost 3 percentage points below its peak in 1982. In contrast, unemployment in Europe was then 1 percentage point *above* its 1982 value.

Labour economists and macroeconomists on both sides of the Atlantic scrambled to discover the source of the so-called Eurosclerosis and, simultaneously, to unveil the secret of the North American labour-market success. Why were labour markets in North America able to recover so quickly from the 1981-82 recession? And why were labour markets in Europe apparently unable to recover at all?

Editor of World Economic Affairs *and Associate Professor of Economics at McGill University in Montreal, Canada.*



OECD Standardised Unemployment Rates
(percentage of total labour force, 1989-1995 average)

Are Labour-Market Regulations the Culprit?

It did not take long before many economists identified labour-market regulations as an important possible explanation for the different performances of the European and North American labour markets. The widespread view was that most European countries had highly interventionist policies that strongly reduced flexibility in the labour market. In contrast, Canada and the United States, though having many of the same types of policies, applied them much less stringently and thus had more flexible labour markets. This came to be the basis of most explanations for why unemployment from 1986 through 1990 remained between 3 and 4 percentage points higher in Europe than in North America.

One particular set of policies that lies at the core of most discussions of labour-market flexibility may be loosely called "job-security provisions". Such policies include legislated minimum severance payments and minimum advance notice of dismissal. In Europe, such job-security provisions are quite strong; in some, a worker with 10 years of service must be awarded over 12 months of salary in the event of dismissal. In North America, such job-security provisions are either very weak (Canada) or virtually absent (US).

> *Long-term unemployment imposes enormous costs as workers lose their skills and their professional contacts.*

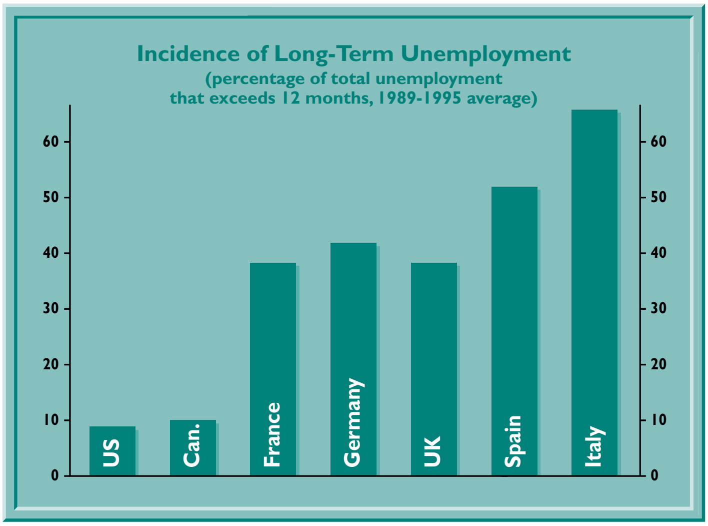
Long-Term Unemployment Is More Telling

As economists progressed in their thinking about unemployment and labour-market flexibility, it became clear that unemployment *rates* were not necessarily the right quantities to be examined. Unemployment exists in all well-functioning economies—especially those undergoing the various adjustments made necessary by internationally mobile goods and capital. As people move between jobs and among industries, and as people leave and re-enter the labour force, they will naturally—even desirably—spend some time unemployed as they search for the appropriate job match. High unemployment rates may therefore simply reflect the fact that, at any particular moment, there are many people involved in such labour-market "turnover". Such "frictional" unemployment should not be viewed as a bad thing as long as individuals are not unemployed for long periods of time.

It is probably more important therefore, and more indicative of the flexibility of particular labour markets, to examine the extent of long-term unemployment. Economies in which a considerable amount of total unemployment is made up of workers who are unemployed for many months are economies in which unemployment is a serious problem. Long-term unemployment imposes enormous costs as workers lose their skills and their professional contacts, to say nothing of individuals' loss of self-esteem and the social costs imposed on society.

The accompanying figure shows that data on unemployment rates and long-term unemployment can tell quite different stories. Averaged over the 1989-95 period, unemployment rates in the major economies of North America and Europe were broadly similar or, at least, there was certainly no obvious ordering of North America and Europe. US and Germany had equally low unemployment; Canada, France and Italy had roughly equal but much higher unemployment. Spain was the only clear outlier.

For long-term unemployment, however, there is a clear ordering. Both Canada and the United States have very little long-term unemployment; this reflects their flexible labour markets in which dismissals may be common, but new jobs are typically easy to find. In contrast, all of the major European countries have much more long-term unemployment, reflecting labour markets in which jobs are extremely difficult to find for those unfortunate enough to be searching. If job-security provisions are responsible for reducing labour-market flexibility, the pattern of long-term unemployment in the lower figure is exactly the one we would expect; Spain and Italy have by far the highest legislated minimum severance requirements of those countries shown.



The Desirability of Mandated Job Security

The *Forum* in this issue addresses the desirability of mandated job security, and whether the relative performances of the European and North American labour markets can sensibly be attributed to the obvious differences in these labour-market regulations.

Seamus Hogan, a labour specialist from New Zealand (a country that has implemented significant labour-market reforms in recent years), currently on staff as an economist at the Bank of Canada, argues that the desirability of job-security policies depends on the effect such policies have on both efficiency and equity. Though legislating the provision of job security is likely to reduce efficiency, he suggests that these effects may be quite small. At this point, many would conclude that with small effects on efficiency such policies must surely be desirable on the grounds that they enhance equity—workers do, after all, express great concern about the security of their jobs. Surprisingly, however, Hogan argues that the real damage done by job-security policies is that they harm exactly the individuals that society ought to care most about—the unemployed. He argues that by reducing the amount of turnover in labour markets, and thus making it difficult for job seekers to find new jobs, job-security policies may harm the currently unemployed workers by more than they benefit the currently employed workers. Hogan's argument goes right to the heart of explaining the figures shown here on the extent of long-term unemployment.

The pressure for reform of the European system of active labour-market regulations will continue at least as long as Europe has significantly higher unemployment than North America.

Marc van Audenrode, a Belgian-born and US-trained economist, currently at Université Laval, provides a partial defence of European-style job-security provisions. He does not provide a strong argument in favour of such policies, but rather argues that they do not appear to do much damage to the flexibility of labour markets. Van Audenrode points out that in Europe the effects of job-security policies actually combine with those of other existing labour-market policies to permit an amount of flexibility similar to that found in North America. European firms adjust less through the number of workers and more through the number of per-worker hours than do their American counterparts; but the overall adjustment is similar in both. Van Audenrode urges economists and policy-makers to think about the effects of policies within the context of the entire collection of existing policies; examining the effects of policies on a piece-meal basis is likely to lead to the wrong conclusion.

The issues surrounding the determinants of labour-market flexibility will be with us for some time. And the pressure for reform of the European system of active labour-market regulations will continue at least as long as Europe has significantly higher unemployment—and higher long-term unemployment—than North America. The debate will not be settled in this issue of *World Economic Affairs*. A careful reading of the *Forum* should, however, lay out the basic issues and provide a framework for thought. ◆