Introduction

DOES THE WELFARE STATE HURT EMPLOYMENT?

The employment performance of European economies has not fared particularly well in recent years. In most countries unemployment has risen to historically unprecedented levels, in some cases surpassing in relative terms the level of unemployment experienced during the Great Depression. In addition to unemployment, other labor market indicators also show signs of troublesome deterioration. Labor force participation rates of elderly workers have continued to decline in many countries despite policy makers' efforts to reverse the trend toward "early exit" from the labor market. Young workers and first-time job seekers have experienced disproportionately high levels of unemployment, and most policy efforts to integrate this group into the labor market have remained unsuccessful. Long-term unemployment as a percentage of total unemployment has been on the rise in many countries, transforming the long-term unemployed into a group permanently excluded from the labor market. In addition, overall labor force participation rates have stagnated or declined in several economies, despite an increase in the labor force participation rates of women.

In troubled times such as these, it can be hard to distinguish good news from bad news. Even sudden economic recoveries in the midst of decade-long recessions have frequently been characterized by jobless growth. The slow real growth experienced in the mid-1990s did not result in increased employment; unemployment levels continued to rise after each economic recovery. Thus, in the first decade of a new century, it appears that current levels of high unemployment are here to stay.

The political will to address these troubling problems is not in short supply. Labor market reforms and efforts to change the financing of social insurance occupy a prominent place on the policy agendas of European governments. Most reforms initiated in recent years respond to the growing political perception that high levels of income and payroll taxes are one of the causes of the economic malaise experienced by European economies during the last two decades. The diagnosis that high levels of nonwage labor costs are an obstacle to employment growth is now being accepted by many governments in Europe, and even by social democratic governments, the traditional defenders of the welfare state (Leisering 1999; Clasen 2001: 652–3). Consider the following examples: In the past decade, both left- and right-wing governments in France have introduced more than 40 policy measures that have lowered social charges of employers, exempting a number of sectors from social security contributions to family or sickness insurance (Bourguignon and Bureau 1999; De Foucauld 1995; Dehez and Fitoussi 1992; Piketty 1998; Assouline 1998). In recent years, the Belgian and Dutch governments have enacted policies reducing payroll taxes on employers in the manufacturing and service sectors. In Germany, the Red-Green coalition government is considering a broad reform in the mode of financing the social insurance system that would involve a partial shift to taxes that are not employment based, such as ecological taxes, as well as various *Kombilohn* proposals, that is, fiscal transfers that compensate social insurance contributions at low-income levels (Schelkle 2000; Bofinger and Fasshauer 1998; Wanger 1999).

Why were European economies able to reconcile the simultaneous pursuit of full employment and welfare state expansion during the first three decades of the postwar period, and why did this virtuous relationship break down in recent decades? What factors account for the deterioration of employment performance experienced by European economies in recent decades? This book develops a theoretical framework that provides an answer to these questions. The explanation advanced in this study seeks to account for both cross-national and intertemporal variation in the employment performance of advanced industrialized economies. The first part of the question is familiar to students of comparative political economy. What are the most salient factors that account for cross-national differences in the levels of unemployment experienced by European economies? Can we identify systematic differences in institutions and policies that can account for these differences? I also examine changes over time in the employment performance of these economies. Why have most European societies experienced a steady rise in the level of unemployment? What countries have experienced a stronger deterioration of their labor markets and why?

In its simplest form, the book's argument can be formulated as follows: In the first decades of the postwar period, welfare state expansion was premised on a political exchange between unions and governments, whereby governments of all partisan orientations guaranteed increases in social services and transfers while unions delivered wage restraint. The significant wage moderation exercised by unions in exchange for advances in social protection explains how most economies were able to reconcile welfare state expansion with full employment over a long period of time.

The process of welfare state growth and maturation, however, has undermined the effectiveness of this political exchange. We can distinguish two political mechanisms by which the growth of welfare state commitments has constrained the effectiveness of policies of wage moderation in restoring high levels of employment. The first is through a change in the composition of social policy transfers. In recent decades most European economies have experienced sharp increases in their numbers of "labor market outsiders." This heterogeneous category includes persons who enter the labor market only intermittently, the long-term unemployed, workers who retire early, and other labor market groups whose members do not belong to unions. The growth in social policy transfers going to labor market outsiders has reduced the net social policy transfers and services received by union members. This reduction, in turn, lowered unions' willingness to deliver sustained wage moderation. The second mechanism is a consequence of the rise in taxes necessary to finance existing social policy commitments. A higher part of the wage bill is now committed in the form of income or payroll taxes. As a result, the "room for action" of unions' wage policies is severely curtailed. As wages represent a small fraction of total compensation, even high pay cuts accepted by unions are likely to have only a modest impact on lowering employment. In other words, as the fiscal burden rises, the sensitivity of employment to wages declines. The net effect of these political developments is the sharpening of the trade-off between the pursuit of full employment and the commitment to welfare state expansion. The process of welfare state maturation has undermined the effectiveness of a critical political exchange that underpinned social policy expansion in the first decades of the postwar period.

Developments in European Labor Markets: Two Theoretical Perspectives

This book seeks to provide a unified approach that accounts for cross-sectional as well as temporal variations in the employment performance of European economies. For most studies this has remained, so far, an elusive goal. Most political science studies have been relatively successful in explaining cross-sectional variation in a broad range of economic outcomes across European economies. However, they have been unable to provide an answer to the question of why the employment performance of these economies has deteriorated so sharply over time. In contrast, economic approaches have focused on the extensive regulation of European labor markets as an important factor accounting for the rise in the level of unemployment. While these explanations attempt to account for intertemporal changes in the employment performance of advanced industrialized economies, they fail to provide an explanation for cross-national variation. The goal of this section is to identify the most significant limitations of the existing research.

Broadly speaking, we can identify two competing perspectives examining the sources of cross-national variation in the employment performance of advanced industrial democracies. Each of these approaches encompasses internal divergences and disagreements that will be analyzed in more detail in Chapter 1. The first of these perspectives is the neoclassical approach, which derives its conclusions from an extension of competitive labor market models. Most scholars working within this perspective contend that the regulation of labor markets and the dense networks of policies and practices that prevent the "flexible" deployment of labor by firms are at the root of the European unemployment problem. The second theoretical perspective, the corporatist approach, has been elaborated in a vast literature examining the economic consequences of different institutions of wage bargaining. These studies have shown that competitive labor markets do not always produce the best employment performance. Under some conditions, economies characterized by encompassing institutions of wage bargaining have produced employment outcomes superior to those of decentralized labor markets.

Neoclassical approaches contend that extensive measures protecting the employment security of workers are the main factor accounting for the poor employment performance of European economies in recent decades and for the contrast between "sclerotic" European economies and that of the dynamic, employment-generating United States (OECD 1994; Scarpetta 1996; Siebert 1997; IMF 2003). Their studies focus on several institutional features of the European labor market as labor market rigidities and causes for high levels of unemployment. The first is employment security regulations, or rules governing the hiring and firing of workers. These rules are regarded as a barrier to employment creation because they impede the flexible employment adjustment of firms in response to changes in demand.

Because firms operating under these rules can lay off workers only with great difficulty, they are also more reluctant to hire new workers during economic upswings. Other studies also point to the generosity of social policy benefits as a factor that raises the reservation wage of workers and lowers the likelihood that an unemployed worker will accept a job. As a recent report of the International Monetary Fund (IMF) succinctly characterizes the policy implications of this analysis, "countries with high unemployment are urged to undertake comprehensive structural reforms to reduce 'labor market rigidities' such as generous unemployment insurance schemes, high employment protection, high firing costs, high minimum wages, noncompetitive wage-setting mechanisms; and severe tax distortions" (IMF 2003: 125).

These arguments have both theoretical and empirical limitations. Critics of the theoretical logic underpinning this approach have pointed out that the "employment-security-regulations-as-rigidity" hypothesis discounts the positive externalities of these institutions for firms (Estevez-Abe, Iversen, and Soskice 2001; Wood 1998, 2001). Protective employment security regulations increase the long-term horizon of firms and workers and strengthen the incentives of these actors to invest in skills. Similarly, firms in economies with significant provision of training might also favor social policies with generous earnings-related benefits (Mares 2003; Manow 2000). Such benefits raise the reservation wage of high-skilled workers relative to low-skilled workers and further contribute to the incentive for these workers to invest in skills (Manow 2001; Mares 2003). As a result of the institutional linkages between systems of skill protection and social policies, employment security regulations are not always a source of rigidity for firms. In many economies with well-established systems of social protection, employers have embraced policy proposals to deregulate labor markets only reluctantly (Wood 1998, 2001; Thelen 2000, 2001). Most surprisingly, in some countries, such as Germany, firms have not changed their employment practices even after legislation weakening the stringency of employment security regulations has been enacted (Buechtemann 1991, 1993). In recent years, reports of the Organization for Economic Cooperation and Development (OECD) have incorporated these challenges to the neoliberal orthodoxy and have begun to advocate for a more selective reform of European labor markets.

On empirical grounds, the neoclassical perspective fails to account for the divergent employment performance of European economies. Figure 0.1 maps the correlation between a measure of the stringency of employment

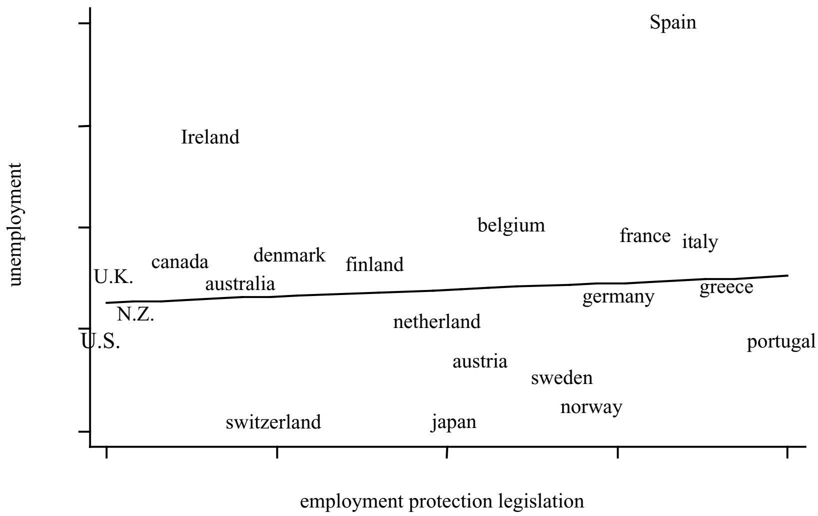

Figure 0.1. Impact of employment protection legislation on unemployment. (*Source:* OECD 1999b: Table 2.5.)

protection legislation developed by the OECD and unemployment in a number of European countries averaged over the period between 1990 and 1999. The employment security regulation index takes values between 1 and 26, with 26 being the economy with the most rigid labor markets. The measure takes into account regulations concerning hiring (such as rules favoring disadvantaged groups, conditions for using temporary labor, or fixed-term contracts) and regulations concerning dismissals (such as procedures for redundancy, mandated prenotification periods, and requirements for collective dismissal) (OECD 1999b: 50). While the correlation between this index and average unemployment rates is positive, the relationship is rather weak. Several countries with stringent employment security regulations, such as Sweden and Norway, have experienced relatively low levels of unemployment. Portugal is an interesting outlier here: It has the most stringent employment security regulations in the sample (the OECD score is 26), yet its average level of unemployment in this period was 6 percent, 3.5 percent below the average for western European economies. In other countries, such as Ireland, the unemployment level has been very high (14.8 percent) despite relatively weak levels of employment protection. The bivariate correlation shown here is, of course, illustrative. However, a number of studies that use more sophisticated estimation methods,

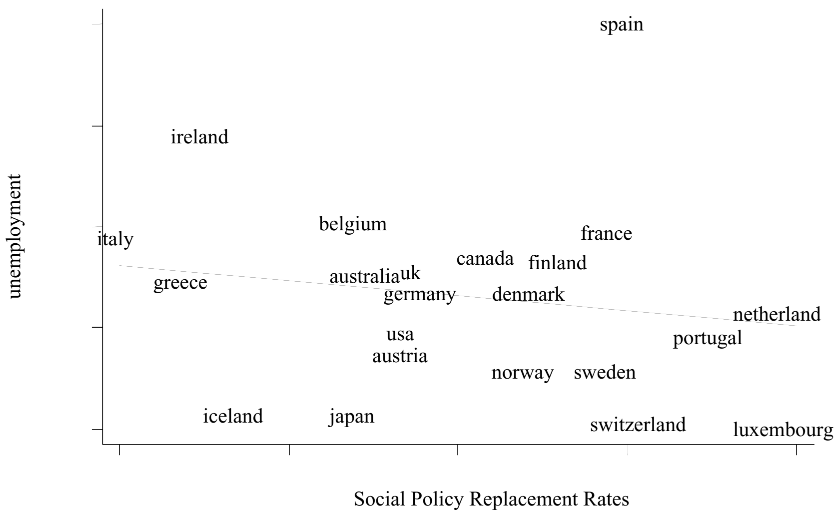

Figure 0.2. Relationship between generosity of social policy benefits and unemployment. (*Source:* OECD 1999b: Table 3.2.)

such as time series or panel data, have reached similar conclusions. It appears that employment security regulations have no effect on unemployment levels (Bertola 1990; Blanchard 1990; Blanchard and Wolfers 2000; Jackman, Layard, and Nickell 1996; Esping-Andersen 2000) and only a modest effect on the *composition* of unemployment.[1] It is important to point out that this explanation also faces difficulties in accounting for temporal change in unemployment. Despite the weakening of employment security regulations and the deregulation introduced by many European governments in recent decades under pressure from international organizations, unemployment has continued to rise.

Figure 0.2 examines the plausibility of a second hypothesis advanced by neoclassical scholars that the generosity of social policy benefits is the primary factor accounting for cross-national differences in unemployment

[1] In contrast to these studies, Elmeskov, Martin, and Scarpetta (2000) find that employment protection regulation has a positive impact on structural unemployment. Using 1993 unemployment data for 18 countries, Esping-Andersen (2000) finds that employment protection has a quadratic effect on unemployment. The unemployment level of young workers and of women is high when employment security regulations are either very rigid or very flexible. Other studies, such as Grubb and Wells (1993), find that stringent employment protection legislation increases the percentage of part-time workers.

levels. The horizontal axis of Figure 0.2 maps the net replacement rates of social policy benefits for a married couple working at an average wage. The values for this variable have been computed by the OECD as part of its benefit systems database and include unemployment, family, and housing benefits in the first month of benefit receipt. The surprising result in this case is that while the correlation between replacement rates and unemployment is rather weak, its sign is negative, suggesting that countries with more generous levels of benefits experience lower rates of unemployment. Sweden, Switzerland, and Norway are again outliers, with very high replacement rates and very low levels of unemployment. Switzerland, for example, has an average replacement rate of 78 percent, but its unemployment average during this period was 2.2 percent, 7 percentage points lower than the European average. These findings disconfirm the second hypothesis of neoclassical studies, which regards generosity in the level of social policy benefits as the main cause for high levels of unemployment.

The corporatist perspective has informed a vast political science literature exploring cross-national variation in the economic performance of OECD economies (Schmitter 1979, 1981; Cameron 1984; Goldthorpe 1984; Iversen 1999; Garrett and Lange 1995; Garrett 1998). In contrast to neoclassical scholars, corporatist studies argue that labor market regulations and strong and encompassing trade unions are not always a source of rigidity and a cause of high unemployment levels. The central theoretical proposition of the corporatist approach is that institutional differences among wage bargaining institutions – more specifically, differences in the level of centralization of the wage bargaining authority – explain cross-national variation in a variety of economic outcomes, such as levels of inflation, growth, and unemployment. As will be shown in Chapter 1, corporatist scholars differ in the specification of the functional form of the relationship between labor market institutions and labor market outcomes. One set of studies argues that the relationship is monotonic, where the performance of economies with centralized labor market institutions is strictly superior to the performance of economies with more fragmented institutions of wage bargaining (Cameron 1984; Crouch 1985; Lange 1984). Other scholars argue that the relationship between the centralization of the wage bargaining system and unemployment follows a "hump-shaped" pattern (Calmfors and Driffill 1988; Calmfors 1993). According to these studies, employment performance in economies in which wages are set at the industry level is inferior to employment performance in economies with *either* highly centralized *or* highly decentralized labor market institutions. The theoretical

Table 0.1. *Average unemployment in European political economies*

	Unemployment categorized by wage bargaining system		
Period	Decentralized*	Intermediately centralized†	Highly centralized ‡
1960–1975	3.04	3.135	1.49
1976–1995	6.986	8.4616	3.166

Notes:
See Chapter 2 for a description of the wage bargaining centralization measure used here (computed as an average of existing indices).
* Decentralized economies include those with a wage bargaining centralization score greater than 10: Britain, the United States, and France.
† Intermediately centralized economies include those with a wage bargaining centralization score greater than 4 and less than 10: Belgium, Denmark, Finland, Germany, Italy, The Netherlands, and Switzerland.
‡ Highly centralized economies include those with a wage bargaining centralization score lower than 4: Austria, Norway, and Sweden.

claim common to both approaches is that unions in economies characterized by encompassing institutions of wage bargaining face an incentive to internalize some of the externalities of their wage demands. As a result, the overall level of unemployment will be lower in these economies than in economies with fragmented labor market institutions.

The corporatist approach is more successful than the neoclassical studies in explaining cross-national variation in European economies' employment performance. Its most important limitation is its inability to account for the deterioration in the labor market performance of European economies over the last two decades. To illustrate these trends, consider Table 0.1, which classifies economies into those with "decentralized," "intermediately centralized," and "highly centralized" labor market institutions and computes the average level of unemployment for each type of economy over the periods 1960–1975 and 1976–1999. This presentation of the data reveals the presence of a hump-shaped relationship between labor market institutions and unemployment, as hypothesized by Lars Calmfors and John Driffill (1988) as well as other scholars (Iversen 1999). Economies with intermediate-level centralization of the wage bargaining system, in which wages are set by industry-level unions, have an employment performance inferior to economies with either highly centralized or highly decentralized labor market institutions. The data presented in Table 0.1 suggest that unemployment has risen in all economies over time irrespective of the structure of their labor market institutions. However, in the 1976–1995 period, economies with intermediately centralized wage bargaining systems exhibited the worst employment performance, and the deterioration of their employment performance has been sharper than in economies with either centralized or decentralized labor market institutions. Why has the employment performance of European economies deteriorated so sharply during recent decades? This question, which has received little attention from corporatist studies, is the main object of study of this book.

The Argument

The central theoretical argument of this book explores the conditions under which unions are willing to deliver wage restraint in exchange for the provision of social services and transfers; it also considers the policy constraints on unions' wage moderation that are a consequence of the process of welfare state maturation. In Chapter 1, I develop a formal model of the optimal wage choice of trade unions in different macroeconomic environments and in welfare states characterized by different levels of taxes and transfers. A critical assumption made in this study is that unions care about the provision of social policy benefits and services received by their members. In other words, unions' utility comprises a component that denotes their concern for social policy services and transfers going to union members. This assumption distinguishes my model from the majority of "union monopoly," or bargaining, models, which generally assume "utilitarian" preferences – that is, that unions want to maximize the real wages of their members and minimize unemployment (Farber 1986).

The analysis developed in Chapter 1 explores the employment consequences that follow from unions' choices and the ways in which the various institutional parameters of a political economy magnify or decrease the impact of these choices on the equilibrium level of employment. I examine the effect of three policy parameters: the structure of labor market institutions; the impact of monetary policy; and the influence of existing welfare state arrangements. Let me discuss the impact of these institutions in turn.

In exploring how labor market institutions affect the equilibrium level of employment, my analysis builds on existing corporatist studies. The key results of my model are in agreement with the theoretical results of the Calmfors and Driffill (1988) analysis. More specifically, I show that unemployment is highest in economies with industry-level wage bargaining systems. In this particular setting, the effects of unions' monopoly power