

## EUROPEAN UNEMPLOYMENT: AN ASSESSMENT

This review of the evidence suggests that the conventional labor market rigidity explanation of the European unemployment problem is not strongly supported by the data. The preoccupation by economists with labor market rigidity explanations has inhibited research that takes alternative explanations seriously. While the principal aim of this part of the chapter is a critical assessment of the mainstream account, here I briefly outline an alternative, potentially more convincing story.

Since unemployment increased dramatically and nearly universally across developed countries between the mid-1970s and mid 1980s, it is hard to imagine that productivity and energy price shocks did not play central roles. Faced with rising inflation, countries responded with tight fiscal and monetary policies, and most agree that these contributed to the high unemployment of the early 1980s. Relying on a vision of a textbook competitive economy, the standard story is that these shocks temporarily raised the 'natural' rate of unemployment (or NAIRU – the non-accelerating inflation rate of unemployment), which would have returned to its pre-shock levels but for adverse labor market institutions. As Ball puts it, 'the conventional wisdom holds that the NAIRU is unaffected by aggregate demand, and thus that demand does not influence long-run unemployment trends' (Ball, 1999, p. 189). Ball argues to the contrary, that the aggregate demand matters for both short- and long-run movements in the unemployment rate:

In some countries, such as the United States, the rise in unemployment was transitory; in others, including many European countries, the NAIRU rose and unemployment has remained high ever since. I argue that the reactions of policymakers to the early-1980s recessions largely explain these differences. In countries where unemployment rose only temporarily, it did so because of strongly counter-cyclical policy . . . In countries where unemployment rose permanently, it did so because policy remained tight in the face of the 1980s recessions . . . labor market policies are not important causes of the unemployment successes and failures since 1985 (ibid., pp. 190–91).

It is increasingly recognized that, in sharp contrast to US policy, under the leadership of the German Bundesbank and then the European Central Bank an increasingly integrated Europe was saddled with contractionary fiscal and monetary policy for much of the last two decades. Studies by Ball (1999) and Baker and Schmitt (1999) find empirical support for substantial aggregate demand effects on the cross-national pattern of unemployment. While the conventional account relies on adverse labor market institutions to explain the persistence of unemployment since the early 1980s, a more convincing

explanation might point to these policy-induced differences in aggregate demand, supplemented by the adverse timing of employment restructuring across sectors and demographic shifts, and country-specific idiosyncratic factors.

After the productivity and energy price shocks of the 1970s, the developed world experienced de-industrialization in the 1980s, but regions with large shares of agricultural employment (e.g., Spain, Portugal, Ireland, Italy, and France) were also faced with de-ruralization (Esping-Andersen, 1999, p. 102–3). At the same time, they experienced a late demographic bulge from the baby boom. The regression results summarized in Table 7.1 show that a high agricultural share of employment was significantly associated with high unemployment in every test – five of the 20 countries had far higher agricultural shares than the rest: Spain, Portugal, Ireland, Finland, and Italy.

While the demographic variable in these tests – the ratio of the 20–24-year-old population to the 25–59 population – approached statistical significance only for 1989–94 long-term unemployment, it consistently had the right sign (the higher the young adult population share, the higher the unemployment). Part of the reason for its weakness in these tests may be that there is a notable overlap between countries with a high agricultural share of employment and those with a high youth share of the population. In addition, countries with high agricultural shares show relatively small declines in the youth share over this decade: while the ratio of 15–19 to 25–59-year-olds dropped dramatically in the US from 21.2 per cent to 14.6 per cent between 1980 and 1990, Ireland saw a decline from 25.4 per cent (1980) to just 23.4 per cent (1990), Spain's teen ratio fell from 20 per cent to 19.3 per cent, Italy's from 17.8 per cent to 16 per cent, and France's from 17.9 per cent to 16.4 per cent.<sup>7</sup>

In a simple regression for unemployment in 1997 (not shown), three demographic and demand variables accounted for over half (54 per cent) of the unemployment variation across 20 countries: the 1990 young adult share of the population (positive and significant), the 1990–97 real interest rate (positive and significant), and the 1990–97 change in investment spending (negative and significant).<sup>8</sup> No combination of labor market institution variables came close to this explanatory power for the 1997 unemployment rate. An adequate accounting of unemployment levels and changes over time would also have to include country-specific events, such as the economic and political restructuring of Spain after Franco's death, German unification, the Swedish fiscal crisis, and the effects of the Soviet collapse on Finland.

In sum, the empirical evidence surveyed above, coupled with the fact that there has recently been a dramatic decline in unemployment rates across Europe to levels approaching or even below that of the US (Figure 7.2), points to the need to move beyond the simple labor market rigidity story. Of