

between 4 and 6 per cent, while Ireland and Spain had rates of about 15 and 19 per cent. Clearly, the European unemployment varies enormously across, and in some cases – for instance, the UK, Germany, and Italy – within countries.

These figures also suggest that the US experience is less distinctive than commonly believed. Several European countries with strong labor market institutions had lower unemployment rates than the United States in both the 1983–88 and the 1989–94 periods. These included Sweden, Austria, West Germany, Switzerland, and Norway. At least through the early 1990s, the US was not the outlier in unemployment the way it was for both real wages (low) and inequality growth (very high).

It is also notable that recent data show a marked convergence in unemployment rates across the developed world. Figure 7.2 compares unemployment rates in 1994 and 2001 for 14 OECD member countries. Apart from Austria (3.8 per cent), the standard measure of unemployment was lowest in the US (6.1 per cent) in 1994. But by the first quarter of 2001, six of the countries shown here shared with the US the distinction of rates below 5 per cent. Indeed, three countries achieved unemployment rates substantially below the 4.5 per cent US rate: Austria (3.7 per cent); Ireland (3.8 per cent); and the Netherlands (2.3 per cent). By late 2001, Sweden's unemployment rate was also below that of the United States.

DO THE DATA SHOW INEQUALITY-UNEMPLOYMENT TRADEOFFS?

In the conventional view, strong egalitarian institutions and social policies produce unemployment by promoting wage rigidity and by reducing incentives for effective job search. Societies can choose more jobs or more equality. But the statistical facts tell a more complicated story. Figure 7.3 shows a plot of the change in earnings inequality (D9/D1, or ninetieth percentile divided by tenth percentile) against the change in unemployment for 16 OECD member countries over the 1979–97 period. These data show no simple tradeoff. There are two high inequality growth countries (the US and UK), two low inequality growth countries (Belgium and Germany), and many countries with little inequality growth but widely varying changes in unemployment. For example, despite similar increases in earnings inequality, the Netherlands experienced declining unemployment, Denmark shows modestly rising unemployment, and France and Sweden experienced relatively high increases in unemployment. To view it from another angle, with substantial declines in earnings inequality, Belgium and Germany experienced smaller increases in unemployment than the UK, Canada,

Austria, and New Zealand, countries with at least some increase in earnings inequality.

Another way to examine the tradeoff hypothesis is to compare earnings inequality with unemployment inequality – the ratio of the unskilled unemployment rate to the skilled rate. Protective labor market institutions that produce wage rigidity and limit the incentives for job search lead to adjustments on the employment side. On the other hand, less skilled workers in flexible labor markets respond to shocks mainly through wage adjustments and should therefore have unemployment rates not greatly dissimilar to those of high skilled workers. Thus, faced with the same shocks, the US should show rising earnings inequality and European welfare states should show rising unemployment inequality. More generally, across countries that vary in labor market rigidity we should observe a tradeoff between relative wage inequality and relative unemployment inequality.

If anything, the data show the reverse. Figure 7.4 shows earnings inequality (D9/D1) and unemployment inequality (the ratio of low to high skill unemployment rates) for male workers in selected years over the 1979–93 period for the eight OECD member countries for which data were available. The US appears in the upper right with the highest earnings inequality and the highest unemployment inequality. Canada experienced comparable levels of earnings inequality but lower unemployment inequality, while France, the UK, Germany, Australia, and Italy were all superior on both dimensions of inequality.

Figure 7.5 also compares these two measures of inequality, but does so for all workers (male and female) using a different measure of unemployment inequality for the early 1990s.² The pattern is similar. Again, the US had the highest levels of both earnings and unemployment inequality, about twice those of Germany and Sweden. Compared to ratios of about 4.5 in the US, the earnings and unemployment ratios in France were far smaller, around 3.4 for earnings and 2.5 for unemployment. *This evidence directly challenges a fundamental tenet of the conventional wisdom; it shows that countries with lower earnings inequality also tend to have lower unemployment inequality.*

EUROPEAN UNEMPLOYMENT AND SKILL-BIASED DEMAND SHIFTS

At the center of the conventional wisdom is a story about a demand shift away from the less skilled of such magnitude that it is frequently referred to as a 'collapse' in the literature. It is also widely recognized that the severity of the unemployment problem in many countries is due to its long-term nature, and the persistence of unemployment may reflect not only wage