

The Limits of Special Interest

What Caused Three Decades of High Unemployment in Europe?

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1. Europe's Thirty-Year Unemployment Crisis

For nearly three decades, Europe's economic systems have failed to provide adequate employment opportunities for large segments of the labor force. The unemployment rate in OECD Europe started rising steadily since the early 1970s, and has not dipped below double-digits since the early 1980s. High and persistent unemployment in Europe is arguably the costliest political-economy failure to afflict the Western developed world in the post-war period.

One would only expect that a crisis of this magnitude and duration, affecting some of the world's most developed economies, would have come to some form of resolution three decades after its inception. Although all countries have undertaken some measure of labor-market reforms, unemployment remains the top public-policy issue in the core Continental European economies. Moreover, a disturbing degree of confusion still weighs on the public policy debate. Beyond the usual politically motivated obstacles to clarity, it does seem that intrinsic difficulties in interpreting the evolution of European unemployment have added to the confusion.

The face of unemployment in Europe has been changing over time, and common interpretations of this phenomenon have evolved along with it. The case of France is

¹ MIT, AEI and NBER; DELTA (joint research unit, CNRS – ENS – EHESS) and CEPR; respectively.

prototypical, and will constitute our primary example.² Figures 1 and 2 depict aggregate measures of the fortunes of labor and capital, respectively.³ Panel 1a depicts the well-know progressive increase in European unemployment, from nearly 3 percent in the early seventies to around 12 percent in the mid-nineties. The surge was only interrupted temporarily by the cyclical expansion of the late eighties. Although the steady increase in unemployment throughout this period seems to point to a uniform process, the underlying nature of this phenomenon has been shifting. This is exhibited in the subsequent panels.

[Figure 1: Labor in the French Economy (1967-1995)]

[Figure 2: Capital in the French Economy (1967-1995)]

Two phases appear in the evolution of French unemployment: the first essentially spans the 1970s, and the second spans the subsequent period. As shown in panel 1b, employee compensation grew at a brisk rate in the first phase and at a much slower rate in the second.⁴ The fast growth of wages in the 1970s is all the more striking considering the two recessionary oil shocks that dominated this period. Naturally, wage growth should be compared with the growth of worker productivity. Panel 1c depicts the path of the share of value added that goes to labor. One way to think of this variable is as the ratio of average compensation per worker to average value-added per worker. The evolution of the labor share confirms the stark contrast between the two phases in the progress of employee compensation. It climbs from 68 percent to about 72 percent in the first phase, then falls progressively all the way to 60 percent in the second phase – far below its

² A more extensive discussion of this case, as well as a formal model of the episode, can be found in Caballero and Hammour (1998a).

³ Source: OECD Business Sector Database.

⁴ The growth in employee compensation is adjusted for inflation using the wholesale price index. The contrast in wage growth between the 1970s and 1980s is all the more striking if we look at compensation per hour rather than per employee. From the late 1960s to the late 1970s, average weekly hours per employee fell gradually from around 45 to 40; they dipped to 39 following the official one-hour work-week reduction of 1981. Moreover, a fourth week of paid vacation was introduced in 1969; and a fifth week in 1981.

initial level. The labor share in other continental European economies has experienced a similar pattern; by contrast, it has been essentially flat in the U.S. throughout this period.

Turning to figure 2, the fortunes of capital have been nearly the reverse of what labor experienced. Panel 2a shows that, while employment as a fraction of the labor force was falling, the capital-output ratio was steadily climbing from 2.5 in the early seventies to 2.8 in the early nineties. By comparison, the same ratio in the U.S. has remained essentially flat during the same period.⁵ What appears as a depression from the perspective of employment starting in the 1980s, looks much less so from the point of view of capital -- which grew at a generally sustained rate despite the high real interest rates that prevailed in France in the 1980s and early 1990s. The evolution of the profit rate in panel 2b also exhibits a break between our two phases. While employee compensation was rising in the first phase, profit rates were plummeting. Subsequently, as wage growth slowed down in the second phase, the profit rate recovered to exceptionally high levels by the mid-nineties. Labor and capital seem to have parted company, with the former marred in unemployment and slow wage progression and the latter experiencing a high rate of profitability.

The sharp turn of events around 1980, the persistence of high unemployment over nearly three decades, and the divergent fortunes of capital and labor have proved puzzling to analysts and policy makers. The state of confusion can be easily gauged in the series of labor market studies published by the OECD over this period, which often surveyed the informed debate on the subject. In its 1986 technical report on labor-market flexibility, for example, while agreeing with the view that the increasing gap between wages and labor productivity was responsible for high unemployment in the 1970s, the OECD argued that the disappearance of this gap during the 1980s pointed toward cyclically depressed aggregate demand explanations. But by the early 90s, in face of the persistence of high unemployment despite the recovery in profits -- which undermined the appeal of

⁵ This pattern is particularly pronounced in the manufacturing sector. Looking at the capital/labor ratio over the period 1970-1990, we find that it increased by 122 percent in French manufacturing, versus 88 percent in the U.S. Normalized by the capital/labor ratio in the trade sector, the increase was 25 percent in France versus 8 percent in the U.S.

explanations based on business cycle conditions – the OECD’s comprehensive 1994 *Jobs Study* put the blame on rigid labor market institutions. In the June 1999 *Employment Outlook*, the OECD changed its position once again and concluded that the strictness of labor protection – one of the most visible institutional burdens in European labor markets – seems not to have had a significant impact on unemployment after all.⁶

Far from clouding the debate, the shifting nature of unemployment provides clear evidence for one diagnosis over others – namely the *institutional* source of high unemployment. In what follows, we argue that the two phases that stand out in the data and the gradual parting of company between capital and labor are exactly what one expects to find following an institutional push in favor of labor. The first phase reflects the initial success of the institutional push given that capital in-place has few options in the short run. The second phase reflects the results of the adjustment of capital to the new institutional environment over time, as new investment is needed to replace depreciated capital. This market adjustment weakens the position of labor and takes away much of the advantage gained in the first phase. In the longer term, the institutional push backfires and its cost is essentially born by labor.

The European experience is a special instance of the general proposition – which we also illustrate in the context of the housing crises and OPEC’s attempts to control the oil market – that market forces present the main constraining factor to the politics of special interest. Market forces also constitute the main correction mechanism. In a number of

⁶ The OECD (1999) report surveys a long list of empirical studies that suggest that unemployment and labor protection are not correlated. In our view, the “robustness” of the finding is more apparent than real. To a large extent, most of these studies use the same type of labor protection variables and static methods. On the former, labor protection variables are in all likelihood largely non-comparable across countries, many of which differ widely in relevant institutional detail. On the latter, they exploit little or nothing of the dynamics of institutions – including political interactions – within a country, and pay no attention to the dynamic responses these changes cause. Written laws and regulations do not capture the full determinants of capital-labor relations. In particular, the severity with which an existing labor code is applied is highly responsive to contingent political pressures. The administrative authorization for dismissals in France, for example, involved a visit by a labor inspector who, at that point, had the discretion to apply the full rigor of the labor code to the totality of the firm’s practices and not simply to the case in question. Based on interviews with inspectors, Berger and Piore (1980) report that their actions were highly responsive to the government’s political objectives. It is considerations like this one which bias us toward detailed case

countries where market backlash became too costly – Ireland and the U.K., for example – in-depth reforms have had to be implemented with a significant improvement in employment. Other economies are still struggling to come to grips with the tradeoffs involved, but even there market forces have induced a certain measure of reform.

2. A Tale of Two Factors

Institutions: efficiency and redistribution

Let us take one step back, and think of labor and capital very generally as two factors that need to join forces in order to produce. At this level of abstraction, the mechanisms behind the evolution of European unemployment can be made clearer; and lessons can be drawn that apply to entirely different contexts.

Individually, our two factors come together through market transactions; as organized groups, they interact as unions, lobbies, coalitions that determine the arrangements, contracts, and regulations that constitute the market's *institutional* framework. It is important for what follows to highlight the two functions institutions play: efficiency and redistribution. It is naïve to think that markets can generally function properly without a framework that defines property rights, ensures informational transparency, guarantees the legal enforceability of contracts, limits the scope monopolies, etc. In their efficiency role, the basic principle that determines institutions is that each party ought to get out the social value of what they put in. It is equally naïve to think that such institutions, in part determined in the political arena, will not also be used as an instrument in the politics of redistribution. In their redistribution role, institutions are ideally driven by the principle of communal solidarity, but conflicts are unavoidable when political agents are both judge and party to such redistribution.

In practice, it is often difficult and controversial to determine the fine line between efficiency and redistribution – when it is that the actions of an interest group move

studies, as opposed to the type of cross-sectional analysis with very poorly measured right-hand side variables behind the claims in the most recent OECD labor protection study.

beyond the efficiency-enhancing protection of its rights to a pure attempt at pulling more of the blanket to its side. Undoubtedly, the clearest symptom of the latter arises when markets fight back with a vengeance – through various forms of waste, rationing, stagnation, etc. Market breakdown is not only a symptom of the excessive political exploitation of institutions, but also the heart of the correcting mechanism. If the extent of waste reaches the point where no party is left to gain from the situation, political forces are bound to arise that revert to a less costly outcome. It is in this sense that in markets lie the limits of special interest.

Institutional Push

We start our tale circa 1968. Since the end of the war, Europe had rebuilt and experienced a period of exceptional prosperity – what the French came to know, posthumously, as *les Trente Glorieuses*. There are clear indications that labor had not shared evenly in the fruits of post-war prosperity. In the ten years ending in 1968, wages had grown less than productivity. This gap built tensions that exploded during the revolts and strikes of May 1968. The Grenelle accords concluded on May 27 started a process through which labor gained significantly in terms of union representation, wages, and the work-week. Related events took place in other countries of Europe, most notably in Italy during the Hot Autumn of 1969.

The political momentum of the late sixties' labor movement extended well into the seventies and early eighties. Following the oil shock of 1973, the agenda shifted to the regulatory protection of existing jobs: the 1975 introduction of an administrative authorization for economically-motivated dismissals, more protective unemployment benefits, and early retirement compensation. In France, the labor movement reached its apex following the 1981 presidential election of François Mitterrand, when the *Programme Commun* coalition of Socialists and Communists came to power. Over the next two years, an array of regulations were put in place that covered wage increases, hours reduction, restrictions on temporary work, strengthened employee representation, nationalizations, and the creation of public sector jobs.

Labor's gains during this period materialized in the form of brisk wage growth during the 1970s, ahead of the rate of productivity growth – during a time when the economy was suffering from the impact of the oil shocks of 1973 and 1979. From a disadvantaged situation of sharing insufficiently in productivity improvements, the institutional push in favor of labor had significantly overshot. The heavy burden that was placed on the labor market was progressively revealed in the form of a gradual buildup in unemployment. While unemployment was to be expected as a result of the recessionary shocks of that period, the brisk pace at which wages were growing pointed to a more worrying prognosis.

The events that unfolded in the three decades since 1968 reflect the classic case of an institutional push in favor of one of our factors, that overshot its sustainable level, and was followed by a market backlash. Over the years, the market's response has evolved, changed in nature, and taken new forms.

Withdrawal

The immediate response of a factor that faces an adverse shift in institutions is to withdraw partly from the relationship. If the terms of the relationship are less attractive than previously, the adversely affected factor commits less to it and looks for alternative opportunities. The classic example of this phenomenon is international capital flight in response to threatening news on taxation and the like. This reaction is well understood by politicians. One of the first measures instituted by the new Mitterrand government in 1981 was the introduction of exchange controls, which took as late as 1990 to be fully eliminated.

If the terms of the employment relationship shift against capital, investors turn to investment opportunities abroad or to projects that are less dependent on labor. The withdrawal of capital reduces employment opportunities. The pool of the unemployed in

search of a job increases. Moreover, secondary wage earners and individuals near the retirement age may altogether lose the incentive to remain in the labor force.

The deterioration of prospects for alternative employment ends up weakening the position of labor in the employment relationship, reversing a great part of the advantage that was gained through the institutional shift. The process comes full circle, as labor's weakened position makes investment in new jobs less unattractive and limits the extent to which capital withdraws. The resulting unemployment is, essentially, a response of the economic system that restores equilibrium by taking away from labor part of the advantage it had gained through institutions.

How wasteful is the outcome of this process? It all depends on whether the institutional push goes beyond what is required for transaction efficiency, and overshoots into a pure redistribution game. In that case, one can be sure that job opportunities will be in short supply relative to a healthy economy and unemployed human resources will be wasted.

A clear symptom of an inefficient outcome arises in the form of a *rationing* of available jobs. Individuals with very similar labor-market aptitudes will experience very unequal fortunes in the labor market. Some will find high-paying permanent jobs, while others will spend a prolonged period of time in unemployment. In principle, this type of inequality in labor-market outcomes ought to disappear as the unemployed compete with the employed and offer to work for less favorable conditions. But institutional restrictions block this type of market mechanism. Consider a context where firms are reluctant to create jobs because strong unions, regulatory restrictions on dismissals, or simply high minimum wages. In this situation, an unemployed worker cannot convince the firm to hire him by waiving his right to join the union, to be protected from dismissal, or to be paid the minimum wage. The result is a fracture of the labor force between have's and have-not's. This phenomenon has important implications for the politics of labor-market reform that we will discuss in section 3.

This mechanism of institutional push followed by a withdrawal of capital and a rise in unemployment is, we believe, the main culprit behind the rise of European Unemployment since the 1970s. Other factors, such as economic conditions or the population's demographic structure, do affect the rate of unemployment, but none other are able to account, as we will argue, for the persistence and shifting nature of this phenomenon.

Institutions-driven market breakdown is not unique to the labor market. Very similar phenomena can be observed in very different contexts, as in the case of the housing crises that afflict many developing countries. In response to stress in the housing market, often due to rapid rural migration, many governments have introduced tenant protection and rent control regulations. The consequence has often been a reduction, if not a near disappearance, in new capital commitments to private rental housing projects, which results in an acute shortage of rental housing. Capital withdrawal and shortages in the housing market is a very similar phenomenon to job shortages in the labor market, both being due to an institutional failure. The counterpart of the unemployed is families forced to crowd existing housing, to live in slums, or to squat illegally. Rationing and the inequality of individual outcomes are also a clear symptom of inefficiency in this case – some families find that they benefit from permanent housing at low rents, while others have no hope of accessing such opportunities. Again, this fracture between those who benefit from restrictive institutions and those who suffer from them has important implications for the politics of reform.

Outside Options

A crucial dimension of withdrawal concerns the feasibility and attractiveness of alternative opportunities for capital. Are there restrictions on moving financial capital abroad? How costly is it to disinvest capital goods and sell them? The consequences of an institutional shift against capital depend on the feasibility of such outside options.

When the outside options of capital are limited, withdrawal possibilities will be restricted. Therefore, the number of jobs that were supplied before the institutional push will not diminish greatly and the deterioration in labor-market conditions will be modest. The institutionally induced improvement in the position of labor in the employment relationship does not get much eroded by high unemployment. The end-result is that, overall, the institutional push pays off for labor.

If, on the contrary, capital's outside options are very attractive, it will withdraw from the employment relationship as much as needed to restore the terms of trade that existed before institutions shifted. This means that the end-result for workers who retain their jobs will not be much improved. On the other hand, many workers will lose their jobs and suffer from the costs of unemployment. Indeed, job shortages and rising unemployment are precisely the mechanism by which the terms of trade between capital and labor revert to their initial level. In the case of attractive outside options, the institutional push backfires. Instead of benefiting from a redistribution of income from capital, labor pays the price in the form of wastefully high unemployment.

The dynamics and changing nature of European unemployment have, to a great extent, been driven by the nature of capital's outside options. Following the institutional push, capital's outside possibilities depend on the time horizon considered. In the short run, much of capital in-place is already committed in the form of equipment, machinery, worker training and organization, etc. It is also committed to operating with certain labor requirements. Generally speaking, the possibilities of disinvesting such capital are limited and would result in much of its value being lost. Capital's outside options are therefore very limited. This explains why the institutional push was initially favorable to labor. As can be seen in figure 1, wages grew at a brisk rate during the 1970s – an abnormally high rate considering the two oil shocks and slow productivity growth that characterized that decade. Furthermore, unemployment rose by a modest amount compared to what was to come subsequently. On the other hand, capital's profit rate suffered a large drop.

As time passes, physical and organizational capital depreciates and becomes obsolete. New investment needs to be made to replace it. The capital required for new investment is uncommitted, and therefore has much more flexible choices. It will not be invested in the domestic economy if it can obtain a better return elsewhere. It is in this sense that capital's outside opportunities are more flexible and attractive in the longer term. The result of this greater flexibility can be seen in the deep macroeconomic transformations that took place in the 1980s. As exhibited in figure 1, wage growth during that decade was extremely sluggish. Unemployment, on the other hand, experienced a brisk buildup. Much of labor's gains of the 1970s unraveled in the 1980s through job shortages, high unemployment, a weakened position in the employment relationship, and slow wage growth. On the other hand, capital's profit rate recovered, a phenomenon that highlights the reversal of fortunes between the two factors.

The "Classical" view of unemployment in the 1970s as simply due to excessively high wages, without reference to the underlying institutional factors, was no longer tenable as wage growth slowed down in the 1980s. The new "Keynesian" view of unemployment that became popular then was that unemployment was due to depressed aggregate demand, which in turn was caused by tight monetary and fiscal policies. The problem is that this view cannot account for the different fortunes of labor and capital. Depressed demand should impact both wages and the profit rate. While demand factors have undoubtedly played a role in determining short-term employment fluctuations, they do not seem to provide a viable account for the progressive buildup of unemployment throughout the decade. Only a view that emphasizes the underlying institutional shifts, it seems to us, can successfully account in a unified manner for the dynamics and changing nature of unemployment over the two decades. It is in this sense that the causes of the European unemployment problem can be considered essentially institutional.

The slower wage growth that appeared in the 1980s should not to be interpreted – as many have done – as a sign of reversal in the underlying institutional shift, but as a sign of the response of capital and the nature of factor relations to that shift. Otherwise, the persistence of unemployment since would be quite puzzling. True, reforms have been introduced in European labor markets since the mid-eighties. The 1986 removal of the

administrative authorization for dismissals and the lifting of certain restrictions on temporary employment contracts in France are clear examples. In some economies – such as the UK, Ireland, and the Netherlands – those reforms have been extensive enough that they have significantly reduced the unemployment problem. In others, the problem seems to persist until this day. Not only do reforms seem to have been insufficient, but the latent possibility that those reforms may be reversed is itself a perceived threat. The public debate over the reinstatement of the administrative authorization for dismissal in France following the election of the Jospin government in 1997 is a clear case in point.

An additional development that must have played a role in undermining the position of labor since the 1980s was the progressive opening of goods and financial markets within Europe as well as globally. Globalization offers, so to speak, an international menu of labor-market institutions for capital to choose from and essentially increases the flexibility of its outside options. For economies that suffer from a heavy institutional burden, the result must be higher unemployment and weaker labor. The notion that globalization is incompatible with maintaining the stability of existing labor-market structures has been strongly voiced by Nobel-prize economist Maurice Allais (1994): “It is in the explosive cocktail of those two factors, the liberalization of international trade and the legislation or agreements on minimum wages, that one must see the essential cause of the core trend that inevitably leads all developed countries of the European Community toward increasingly massive unemployment” (p. 194).

Technological Adjustment

A dimension along which capital can adapt that we have not considered yet is technology choice. Instead of responding to the institutional shift by moving abroad, capital can also choose to use a different production technology, or produce a different set of goods, that relies much less on labor. Mechanization and information technology offer a vast array of possibilities to substitute capital investment for labor input in production. This alternative escape route seems to have played an important role in Europe, as can be seen in the increasing ratio of capital to output in figure 2.

The substitution of capital for labor in production constitutes an alternative form of withdrawal. It increases the flexibility of capital's response to the institutional shift, and therefore contributes to its detrimental consequences for labor. Naturally, this type of response is not available in the short run. Capital in-place is typically invested in machinery, equipment, modes of organization that are designed to exploit specific technologies with a fixed range of labor requirements. However, as capital is renewed over time, new technologies can be developed that make capital much less dependent on labor.

The powerful effects of technological inventiveness on the balance of power in market relationships are not unique to the labor market. The evolution of the oil market over the same period constitutes a clear example. Following OPEC's success in coordinating restrictions on oil production in the early seventies, most analysts projected that oil prices would remain at sustained high levels in the foreseeable future. Those projections turned out to be wildly off the mark for a number of reasons, the most notable being underestimation of the possibility, over time, to develop technologies that economize on oil and substitute for it other factors of production.

[Figure 3: Capital-Labor Substitution and Job Protection]

The notion that economies with a heavy institutional burden in the labor market tend to substitute capital for labor find empirical support in cross-country comparisons. Figure 3 plots the average growth rate of the capital-labor ratio across OECD countries over the period 1970-1990 against an index of job protection during that period. The positive correlation between the two measures is clear.

Overall, the sharp contrast between the short and longer term response of the economic system to the institutional push was highlighted in figure 1, which shows the evolution of the labor share of value added. In response to the institutional shift that started in the late 1960s, the labor share initially increased. Higher wages and protected job opportunities

contributed to a redistribution of value added toward labor. Over time, the labor share not only returned to its initial level but strongly overshot in the other direction. Reduced wage growth, a shrinking supply of jobs, and increased substitution of capital for labor all contributed to that phenomenon. Nothing of that nature could be observed for an economy like the United States, which presumably did not experience the same transformation in capital-labor relations as Europe.

3. The Political Dimension

Given that institutions are determined to great extent in the political realm, it is important to analyze the political considerations behind European labor's institutional push. In light of the dire consequences that the European model has had for labor over the medium and long term, why did the institutional push take place? Given that few winners are left at the end – unemployment is high while the gains in wages have dissipated – why has institutional reform not been more vigorous? And, looking ahead, what will it take to integrate the unemployed back into the growth process?

Institutional Push: Expectational Errors and Politics

There are essentially two classes of explanations for the initial institutional push: erroneous expectations and political factors within labor.

As we argued above, the unbalanced sharing of the fruits of sustained growth during the 1950s and 1960s probably justification to the institutional push that took place at the end of that period and carried on to the early 1970s. What is important to note is that the degree of labor protection that is compatible with well-functioning markets depends on firms' productivity and growth prospects. It seems that, in the seventies, labor extrapolated from the post-war growth experience expectations of future recovery and growth that were not fulfilled. The new institutions proved to be excessively burdensome in a world plagued by two oil shocks, disinflationary policies, and the global decline in

productivity growth. While one cannot argue that workers could not have seen deteriorating aggregate conditions, since they were in full display at the time, their extent and persistence may have been underestimated.

Another error in expectations, and central to this article's thesis, is the dramatic underestimation of the ability capital has to find its way around excessive burden over the medium to long run. An important contributor to this underestimation is the rapid process of globalization that has taken place over the last decade, which facilitates capital migration and refocusing. It is fair to say that the extent of this process was underestimated not only by workers but also by analysts, politicians and academics. The other contributor is the lack of foresight of the extent to which technology adapted to the new circumstances. Very similar errors were made by analysts of the oil market around the same time, who grossly underestimated technological substitution possibilities. It is not clear whether labor was alone in underestimating this factor. Academics, for example, insist until today to measure the degree of substitution between capital and labor over the long run using techniques that are highly inappropriate for scenarios where large institutional changes have taken place. As a result, they come out with grossly downward-biased estimates of such substitutability.⁷

As for the second class of explanations, one could take the position that the consequences were foreseen by the workers of the 1970s, but went ahead with their push fully aware that the burden would not be paid by them but by the next generation of workers. We find this type of explanation more relevant for the next question.

Obstacles to Labor-Market Reform

Mistakes happen. What seems obvious now must not have been at the time. More difficult to comprehend is why mistakes can persist for so long. Here we turn around our assessment on the relative contribution of the different factors. While expectational errors

⁷ We are currently writing a technical article on this subject.

have been an ingredient here as well, there is no doubt that the dominant factors are political in nature, mostly within labor itself.

The standard analysis of a situation of this nature is in terms of insiders-outsiders. There is a group of employed insiders who benefit from the status quo at the expense of disenfranchised outsiders. This holds true in our context as well, with one very significant caveat. The situation has turned so unfavorable to labor, that both outsiders *and* insiders are probably worse off relative to a steady-state scenario where institutions are better aligned with the reality of markets.

Such widespread loss across scenarios does not mean, however, that insiders would want to support partial deregulation, as the *transitional* costs for them may outweigh the long-run gains from such collective action. A massive removal of institutional burden would certainly carry significant short-term consequences for those who have gained their leverage through them. It would take a while before investment and the reversal of the accelerated capital-deepening process would restore the current level of well-being of insiders, at least of those who are at an advanced stage of their professional cycle. Demographics probably do not help here either. A two-tier system, that treat incumbents and new hires differently, is an obvious proposal; but this system is typically opposed by insiders, as they fear losing their political clout.

Looking Ahead

Will the market breakdown ultimately be corrected? The answer is, probably yes. While the European experience has turned out to be particularly stubborn, it is quite difficult to stand against efficiency for too long once that diagnostic has been made.⁸ Institutions, while typically slow in responding, have natural tendencies toward efficiency. In the case at hand, it is the deep segmentation within labor that keeps the pressure and will eventually break the ranks. With rare exceptions, of which France is one, there are already many signs of such reversal. Institutional rebalancing has already taken place in

⁸ In this sense, the OECD (1999) report represents a step back.

the U.K., Ireland and the Netherlands, and is showing promising signs among the most acute cases – Spain in particular.

The case of Spain, where unemployment rates around a quarter of the labor force and climbing, led to collective saturation with inflexible labor legislation and a gradual reversal starting in the mid 90s, offers hints of the potential impact of a second promising ingredient: solid growth prospects. Spain was lucky enough to be on the receiving end of competitiveness gains generated by the EMU. While institutional reform is a source of growth in itself, its communion with a direct boost to growth may reduce the transitional costs significantly, and it is perhaps the promise that entrenched insiders need to take the risk.⁹ But even if Maastricht-strapped economies are unable to provide the supplementary boost by themselves, technology may do it as a revival of solid productivity growth seems to be gaining momentum.

The whole problem started with institutional forces and growth prospects crossing in the wrong direction. Both forces seem to be pointing in the right direction at this time, let us hope that they now meet in the middle.¹⁰

⁹ See Caballero and Hammour (1998b) for a formal description of the process of “elastification,” by which we mean the increased sensitivity to shocks brought about by the type of institutional problems that characterize some European economies.

¹⁰ As we write this concluding paragraph, however, Lionel Jospin, the French prime minister, has just pledged to introduce measures to penalize profitable companies that fire employees or employ a high proportion of the workforce on temporary contracts... (FT 09/28/1999).

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Figure 1a: Unemployment

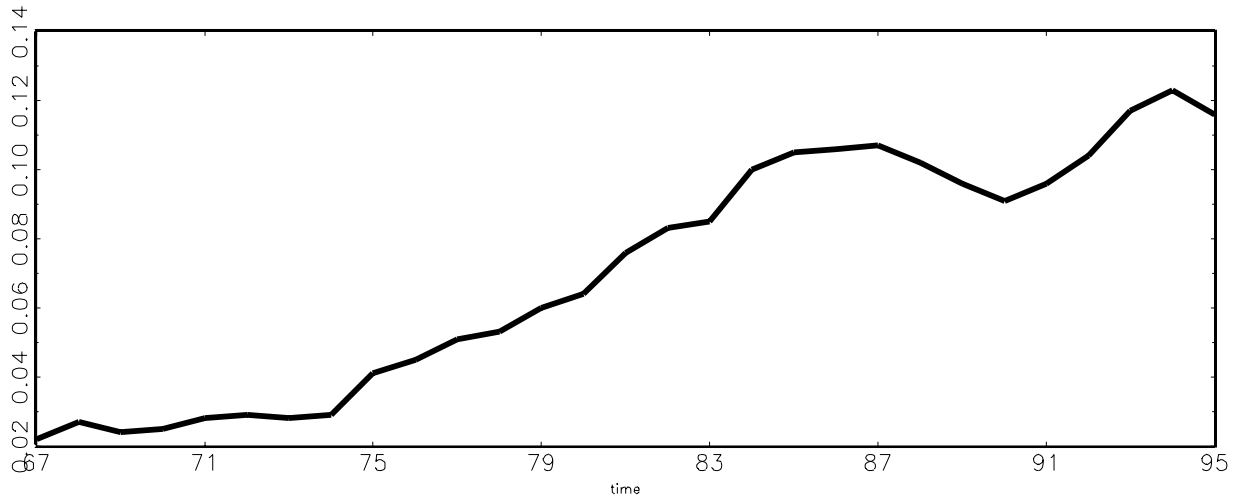


Figure 1b: Inflation Adjusted Compensation per Employee (growth rate)

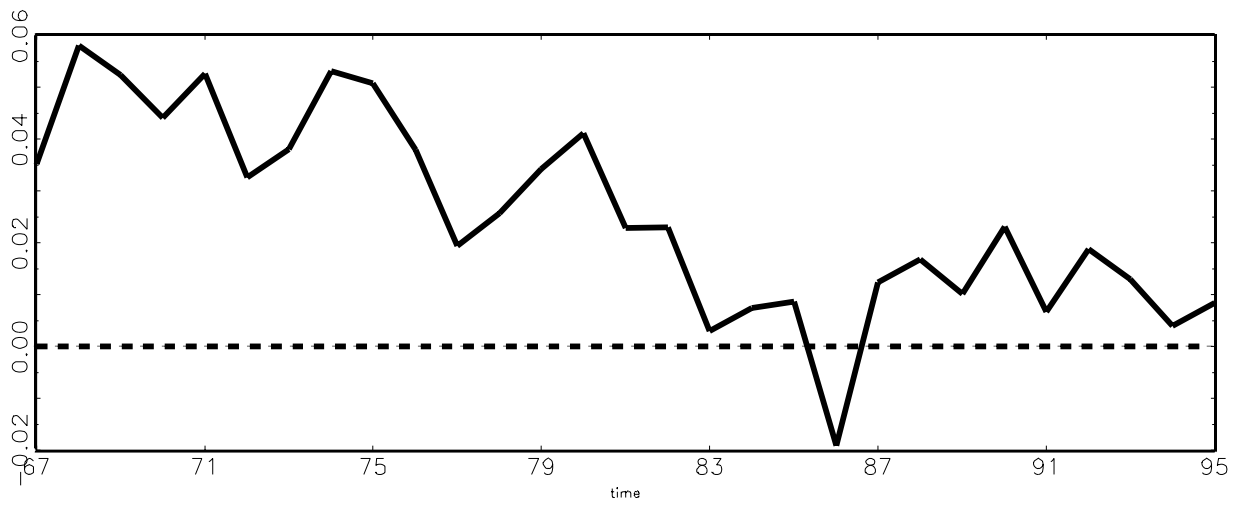


Figure 1c: Labor share

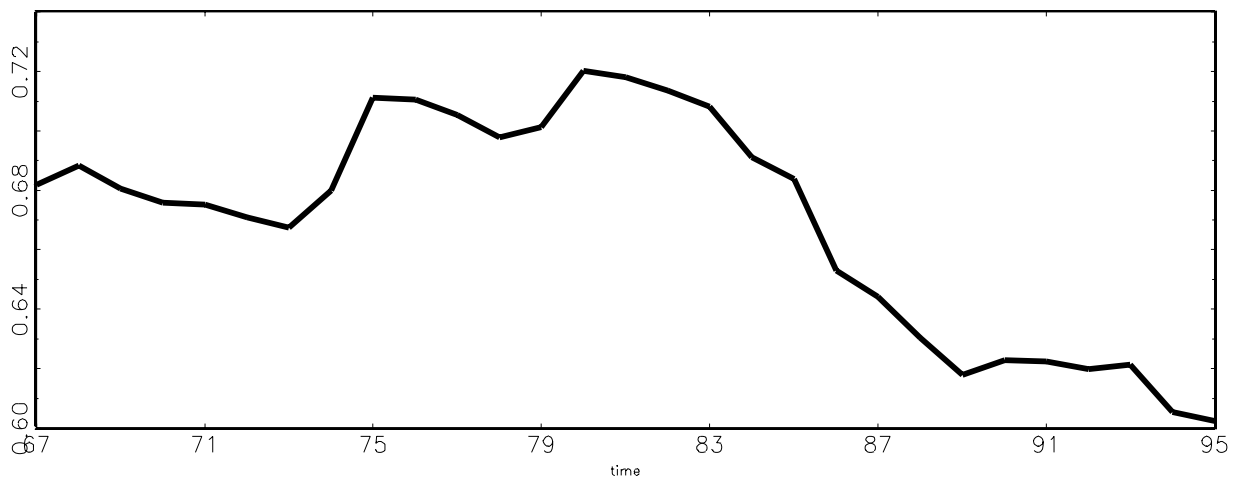


Figure 2a: Capital/Output Ratio

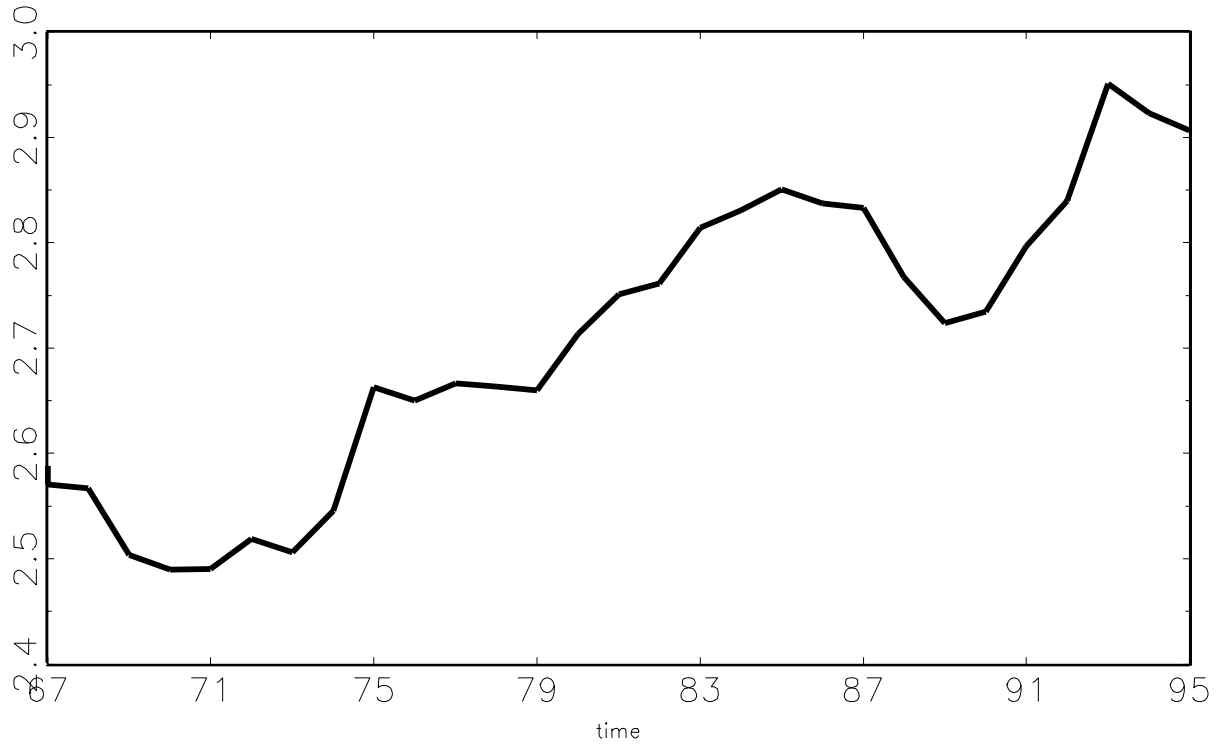


Figure 2b: Profit Rate

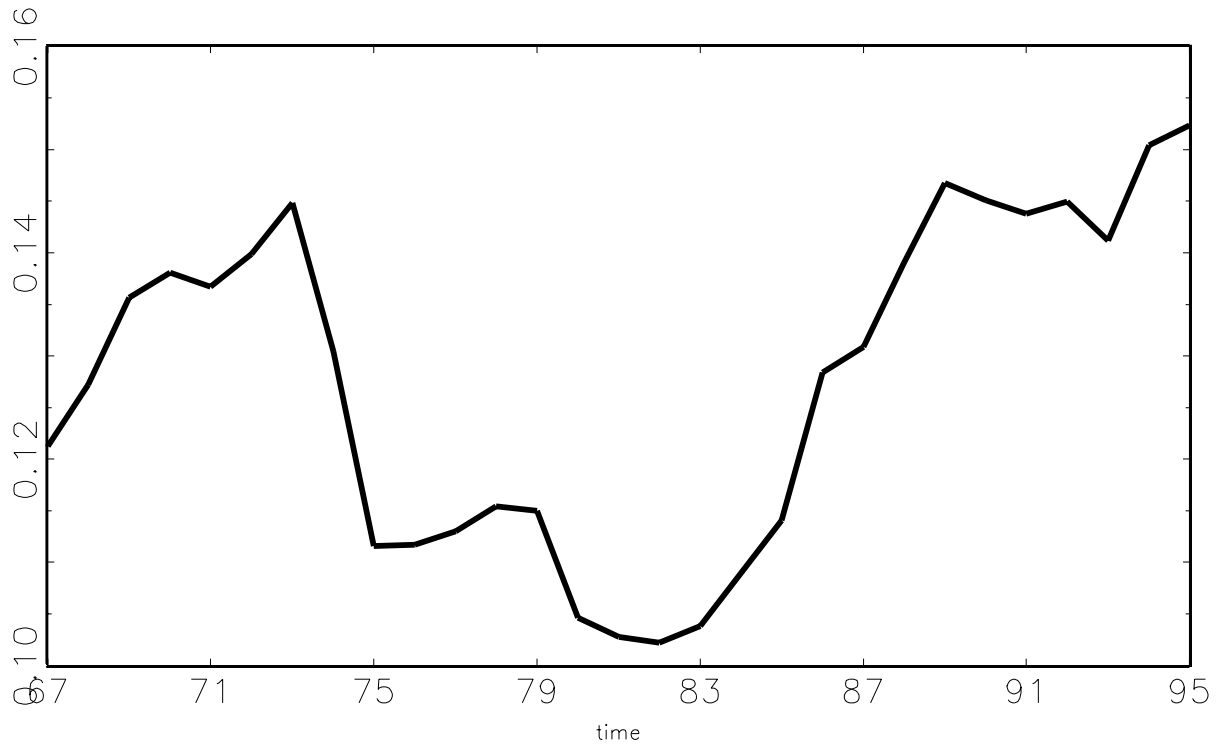


Figure 3: 70-90 K/L Growth and Job Protection

