Comments on Heckman et al.:
"What are the Key Employment Challenges and Policy Priorities For OECD Countries?"

Boosting Jobs and Incomes: Lessons from OECD Country Experiences
Toronto, June 15, 2006

David R. Howell[1]
(howell@newschool.edu)

The Heckman et al. Keynote Address (June 1) offers a sharp critique of the OECD's recent Jobs Report, a major research effort designed to reassess the recommendations of the OECD's highly influential Jobs Strategy (OECD Jobs Study, 1994). The Heckman critique focuses on the OECD's apparent shift in its policy stance towards the view that good employment performance can be achieved with different mixes of labor market institutions.

This recent OECD position reflects evidence that many northern European countries have performed at least as well as the Anglo-Saxon laissez-faire economies on standard indicators of employment – both unemployment and employment rates – and have done so with much lower inequality, much lower incidence of very low wages, much more generous public support for job training and job search, much more job security, and a much stronger social safety net.

The Heckman et al. critique counters that with more appropriate indicators, better microeconometric research along the lines of recent work on Latin America, and a better understanding of basic economics, it will be evident that European countries, even the corporatist northern European ones that *appear* to have been successful, cannot compete with the Anglo-Saxon laissez-faire economies. The path to good economic performance for Europe requires substantial labor market deregulation and the dismantling of the welfare state. To use Richard Freeman's terms, this is a hard core "single-peaked" view of capitalism – only one model really works.

1. The OECD and Recent Research

The OECD has played a leading role in a rapidly growing literature that has aimed to explain the cross-country pattern of unemployment across the OECD mainly by reference to the strength of various labor market institutions. Since the early 1990s the OECD has been central to this research effort, both by developing the best cross-country measures of institutions and policies and by having produced reports and papers that are among the most influential in this literature. Much of this research has been framed by what Keynes termed the "classical" orthodoxy – that labor market rigidity is the dominant, if not only, source of persistent unemployment.

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[1] Professor of Economics, The New School (howell@newschool.edu). Thanks to Andrew Glyn and Paul Swaim for very helpful suggestions. These comments reflect a long collaboration with Dean Baker, Andrew Glyn and John Schmitt on these issues (see fn #2).

In several papers, we (Baker et al.[2]) have called attention to the fragility of the empirical evidence. Much like our critique of this literature, Heckman's Address criticizes the OECD's reliance "on a fragile methodology based on crude indicators of policies applied to highly aggregated and heterogeneous cross-country time series data."

It is particularly important to recognize the fragility of the results in this literature because it is this evidence that is typically cited in support of sweeping policy recommendations. If enacted, these changes in social and economic policy could have substantial effects on worker and community well-being – perhaps positive on balance, perhaps not. What we do know is that there will be losers from any important labor market "reform" so we should be sure our evidence is as solid as possible. If, on the other hand, the real basis for policy recommendations are strongly held theoretical priors, researchers ought to say so.

Given the inherent limitations of this empirical approach, the new OECD research is very impressive: it makes use of the best data available; it builds appropriately on recent advances in specification and methodology in this literature; and it is much more attentive to robustness issues than most previous studies. The OECD's current interpretation of the evidence and its policy recommendations appear significantly more balanced than in previous reports, particularly in recognizing that there may be a variety of paths to high employment and good wages. It is precisely this new "balance," that the Heckman Address criticizes.

In contrast to earlier OECD analyses and most of the literature on unemployment and institutions, the current study finds that <u>the</u> <u>only</u> protective labor market institution significantly associated with unemployment is the benefit replacement rate – neither the strictness of employment protection laws nor union density is found to be statistically associated with the cross country pattern of unemployment. Like nearly all studies, bargaining coordination is associated with better employment performance.

How important is unemployment benefit generosity for labor market performance? The regression evidence on balance shows statistical significance but not necessarily economic importance. This is particularly true if it is acknowledged that some (probably much) of the positive statistical association between benefit generosity and unemployment reflects policy endogeneity. Quite sensibly, policy makers in democratic political systems will sometimes make benefits more generous in harder times: it may be higher unemployment that leads to higher benefits and longer duration at least as much as the reverse. The literature has failed to pay more than cursory attention to this causality issue, and the OECD should be encouraged to explore it much more seriously in future research.

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[2] See Dean Baker, Andrew Glyn, David R. Howell, and John Schmitt, "Labor Market Institutions and Unemployment: A Critical Assessment of the Cross-Country Evidence," chapter 3 of D. R. Howell, ed., *Fighting Unemployment: The Limits of Free Market Orthodoxy*, (Oxford University Press), 2005.

2. Key points in the Heckman Address

Professor Heckman's Address can be boiled down to two main points: that the European welfare state has performed much more poorly than the recent OECD jobs report suggests; and that at least part of the problem is that the OECD has focused too much on the standard unemployment rate.

2.1 On Economic Performance

Professor Heckman asserts that **"**European labor market performance post-1994 has not been particularly strong, especially in comparison with those of the more flexible Anglo-Saxon labor markets, in which incentives more efficiently promote work and human capital formation.**"** At the crux of this poor performance is that the European welfare state fails to provide adequate incentives to work and acquire skills. ***What do the data really show on productivity growth, employment rates, and human capital formation?***

Productivity growth:

Heckman's TFP growth chart actually shows that the EU countries posted consistently superior rates between 1984 and 1997. If the laissez-faire model is so superior, how could this be? Indeed, TFP rates do not fall much below the U.S. until 2002. *Are we to judge alternative economic models just on the basis of the last couple of years?*

If we look at hourly labor productivity in manufacturing, it is true that the U.S. has shown impressive growth. But so has Sweden! According to Heckman's slide, Sweden's public employment share is second only to Norway in the OECD, and is almost twice that of the U.S. But over the decade 1994-2004, Sweden's productivity rose by 91% compared to the U.S. increase of 72%. France increased by 50% compared to the U.K's 30%. By this measure of efficiency, these paragons of the bloated welfare state have out-competed the major Anglo-Saxon laissez-faire economies!

According to the World Economic Forum, 3 of the 4 countries at the top of the global competitiveness list are European welfare states, each with highly regulated labor markets in which 75-90% of the workforce are union members – Finland, Sweden and Denmark. [the 4th is the U.S.]

Employment Performance: Two points:

- Heckman's own figure ("Percent of Population in Full Time Equivalents Engaged in Various Activities") shows that Denmark, Sweden, Norway and Finland had employment rates similar or higher than the U.S. and U.K. in 1999, and Austria and Germany show higher rates than Australia and Ireland. Particularly for women with children, it is not hard to make the case that employment incentives are much higher in the northern European welfare states than in Anglo-Saxon laissez-faire ones.
- The main case against protective labor market institutions on employment performance grounds is that they price low skill workers out of the labor market.

In this case, less-educated workers should be better off relative to more skilled workers in countries that promote downward wage flexibility, like the U.S., since the competitive labor market has priced them into jobs. But the evidence shows no support for this, as noted by Nickell and Layard over a decade ago. According to OECD data for 2003:

- *Unemployment rates:* low education workers in the U.S. have a <u>higher</u> incidence of unemployment relative to more highly educated workers than in the northern European countries or France (U.S.: 9.9 vs 3.4 = 2.9; Sweden: 6.1 vs 3.9 = 1.6; France: 12.1 vs 6.1 = 2).
- *Employment rates:* low education workers in the U.S. have <u>lower</u> employment rates relative to more highly educated workers, despite the very high employment rates of undocumented immigrants and the very high rates of incarceration of the least skilled (U.S.: 57.8 vs 82.2 = .7; Sweden: 67.5 vs 85.8 = .79; France: 59 vs 81.9 = .72).

Human Capital Formation:

This seems to us to be a particularly weak basis on which to attack the European welfare state, at least in comparison to the performance of the U.S.

- A discussion with European and Japanese mfg plant executives about the skill levels they find when venturing into U.S. communities would in all likelihood disabuse even the staunchest advocate of the American Model of the notion that the U.S. system has succeeded in producing world-class workplace skills.
- Heckman makes the case for good early childhood interventions. But this is precisely where the European welfare state excels, at least in comparison to the U.S. With its staggering incarceration and out-of-school jobless rates among youth, does the American Model, with its deregulated labor market and eviscerated welfare state, really offer lessons to the Northern European welfare state?
- As for statistical evidence, human capital formation is better measured by performance than by years of schooling or spending. Take the PISA (Programme for International Student Assessment) international educational achievement test results for 15 year olds in 2003: *How did students in the richest nation in the world perform?*
  - Mathematics: the U.S. came in 24^{th} out of 39, with a score of 483. This compares to an OECD average of 500. Finland gets a score of 544 and NL 438.
  - Science: the U.S. did a little better – 19^{th}, but still fell below the OECD average.

2.2 New Labor Market Indicators?

The Heckman Address argues that the OECD relies too heavily on the standard unemployment and employment rates as measures of labor market performance. This concern appears to be driven by the inconvenient fact that standardized unemployment rates – which seemed adequate just a few years ago when few countries could match low U.S. unemployment rates – now show the U.S. firmly in the middle of the pack of OECD countries in recent years *(since 2000, and also prior to the 1990s).*

He proposes a more broadly defined unemployment rate, one that allocates all those in subsidized employment and training programs to the status of unemployment. It is useful to have alternative labor market indicators, but there are others that would be much more useful as performance measures. As Heckman suggests, we should focus on wage growth and consumer well-being. If we want a really useful measure of disguised unemployment, we should incorporate poorly paid and precariously employed workers.[3]

- According to the OECD, the incidence of low wage employment (less than 2/3 of the median) among full-time workers in the 1980s and 1990s was about 25% for the U.S., compared to 7-15% across OECD Europe.
- Median weekly earnings for full time male workers over age 25 in 2004 dollars reached $760 back in 1986. It then fell substantially, reaching a low of $707 in 1991 and 1992. These weekly earnings did not reach $760 again until 2000. In 2004 male weekly earnings were just $2 dollars higher than in 2000 ($762). (EPI online)

Thus, on wage growth and consumer well-being criteria, the advantage of the laissez-faire model is by no means obvious. It seems fair to ask: Who has benefited most from the much heralded U.S. productivity gains in recent years, and what does this say about the performance of alternative economic models? Is it surprising that European citizens overwhelmingly reject initiatives that would move their societies towards the "American Model"?

3. Conclusion

The Heckman Address contends that it is a mistake for the OECD to shift away from free market orthodoxy towards a recognition that other models of capitalism can perform at least as well. It has done so, according to the Address, because it is "held hostage by an outdated, short-run view of the labor market."

The reverse seems more accurate: the idealization of the Anglo-Saxon laissez-faire model that so often characterizes the discussion of European employment performance reflects an essentially 19th century vision. Efficient 21st century organizations and well-functioning 21st century labor markets require skilled, informed, and motivated workers, which require in turn the information, public goods and infrastructure, and collective safeguards that comes with well-functioning systems of social insurance, redistribution, product and labor market regulation, and collective bargaining. The optimal mix and strength of these institutions is not given by some simple laissez-faire formula, but will differ by country and region, depending on historical experience and prevailing social norms: what works for Peru may not work for France, and vice-versa. The OECD should be applauded for this recognition. A balanced interpretation of the evidence does not support the superiority of simple free market solutions.

[3] *Some initial work in this area can be found on the New School's Schwartz Center for Economic Policy Analysis web site.*