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A Comparative View of the U.S. Labor Market

A new study by NBER Research Associate **Richard Freeman** challenges the widely held view that the U.S. labor market has outperformed the labor markets of other industrialized countries since the early 1970s. Indeed, although the American employment/population ratio was rising and Europe's was falling, U.S. and European gross domestic product per capita grew at the same 1.3 percent annual rate. Freeman comments, "The United States had to pay more for its impressive job performance than is generally recognized. . . . Americans had to work more to obtain the same gains in their standard of living."

In **Labor Market Institutions, Constraints, and Performance** and **Evaluating the European View That the United States Has No Unemployment Problem** (*NBER Working Papers No. 2560* and *2562*), Freeman shows that the American record on employment has been impressive in several respects. For one thing, the United States has created 20 million new jobs since 1975 while employment in Europe has stagnated. The United States also has suffered less unemployment, especially long term, than Europe has. At the same time, there is no sign that the skill structure of U.S. employment is deteriorating.

The key to the rapid growth of U.S. employment has been the flexibility of real wages in response to changes in labor supply and demand, Freeman believes. In the United States, for example, the real wages of baby boomers declined both absolutely and relatively, as they entered the labor market in increasing numbers, so employers in virtually every industry boosted the proportion of young workers on their payrolls. In Europe, on the other hand, the relative wages of young people held steady or increased, and unemployment among younger workers became severe.

> **"Most of the gap between American and European job growth can be explained by lower real wage growth in the United States."**

Wage moderation and job creation were correlated negatively for industrialized countries across the

board during the 1970s and 1980s, Freeman shows. In the United States, Canada, Sweden, and Norway, real wages (and productivity) grew very slowly, while employment soared. By contrast, in the United Kingdom, Belgium, and Spain, pay was rising rapidly, while there was relatively little expansion in employment.

This trade-off between jobs and pay weakens the case for America's superior labor market performance. Indeed, Freeman estimates that most of the gap between American and European job growth can be explained by lower real wage growth in the United States.

On the other hand, differences in real wage growth and employment cannot be attributed reliably to specific labor market structures. The extent of unionization apparently has little effect on performance. Neither large wage differentials nor high job turnover are necessary or sufficient conditions for rapid employment growth. Sweden, where 95 percent of workers belong to unions and where pay differentials are among the lowest in the OECD, had an employment experience very similar to that of the United States in the last 15 years. By contrast, the United Kingdom, which has the most unregulated and diffuse labor market in Europe, saw real wages take off during the 1980s and suffered the resultant unemployment consequences.

Freeman confirms that greater dispersion of wages generally corresponds to a more centralized labor market in which pay adjusts to an industry's specific circumstances. During the 1970s and 1980s, dispersion increased in eight countries with decentralized wage setting, including the United States, Japan, and the United Kingdom. Dispersion decreased greatly in Italy but remained stable in most other countries. Wage dispersion by skill, age, and sex followed similar patterns, Freeman finds.

Some past analyses have found that highly centralized labor markets, such as Austria's, adjusted better to the environment after the oil shock, while other studies have claimed superior performance in countries with decentralized labor markets. Apparently, both conclusions contain some truth. Freeman shows that countries whose labor markets are at either extremes of centralization or decentralization have been more successful in creating jobs than countries whose labor markets have structures somewhere in between the two poles. However, Freeman cautions against overgeneralizing on the basis of one labor market or another. Even countries with similar labor market institutions, such as the United States and the United Kingdom, or Belgium and Denmark, have performed quite differently. SN

Unemployment Insurance and Recalls

In the United States, many workers who are laid off when demand for their employers' products declines eventually are recalled by the same firm. In **Unemployment Insurance, Recall Expectations, and Unemployment Outcomes** (*NBER Working Paper No. 2594*), NBER economists **Lawrence Katz** and **Bruce Meyer** study Pennsylvania and Missouri and find that more than 30 percent of the total weeks of unemployment of the recipients of unemployment insurance (UI) are attributable to such layoff–rehire situations. A further 30 percent of the total weeks of unemployment could be accounted for by workers who expected to be recalled by their former employers but were not.

Individuals who initially expect to be recalled search less intensely for new jobs than other UI recipients do, Katz and Meyer write. Thus, their spells of unemployment tend to be extremely long if they are not actually rehired by their original employer. Moreover, individuals receiving UI, and their former employers, are aware of the time when the benefits expire. As the unemployment spell continues, the workers may begin to consider somewhat less lucrative new positions. Katz and Meyer find that the hourly earnings of those who expected to be recalled but were not were 15 percent less on average at their new jobs. In the case of those who did not expect recall, hourly earnings in their new jobs dropped only 11 percent. Further, individuals who had exhausted their UI benefits before finding a new job took an average cut in hourly pay of 30 percent and their weekly earnings declined even further.

"There is a sharp increase in the rate of escape from unemployment, both through recalls and through new job acceptances, around the time that unemployment insurance benefits are likely to lapse."

Katz and Meyer use a unique dataset drawn from a sample of UI recipients from Missouri and Pennsylvania who began receiving benefits between October 1979 and March 1980. At the time of filing a UI claim, the recipients filled out a questionnaire about their expectations of recall, income previous to unemployment, and some demographic variables. The data

also include administrative records on weekly UI benefits, the number of weeks of benefits for which the individual was eligible, and the timing and number of weeks collected. Follow-up telephone interviews about a year after the initial request for UI asked when a job was found, the weekly wages on the job, whether the job was with the previous employer, and additional information. Most of these UI recipients had blue collar occupations and were previously employed in construction and manufacturing.

In a related study, Katz and Meyer examine the rate at which UI recipients find work. They find that there is a sharp increase in the rate of escape from unemployment, both through recalls and through new job acceptances, around the time that unemployment insurance benefits are likely to lapse. In **The Impact of the Potential Duration of Unemployment Benefits on the Duration of Unemployment** (*NBER Working Paper No. 2471*), the authors report no similar pattern in the escape rate from unemployment for people not receiving UI benefits.

Katz and Meyer estimate that an increase of one week in the potential duration of UI benefits increases the average spell of unemployment by about one day. They also find that for the same predicted impact on the government's UI budget, an increase in the potential *duration* of benefits affects the average length of unemployment by much more than an increase in the *level* of benefits. DF

Budget Deficits and Coalition Governments

According to a recent international study by NBER economists **Nouriel Roubini** and **Jeffrey Sachs,** coalition governments in which two or more political parties share power tend to have larger deficits than governments with only one party in control, especially during periods of adverse economic shocks. In **Political and Economic Determinants of Budget Deficits in the Industrial Democracies** (*NBER Working Paper No. 2682*), Roubini and Sachs examine the ratio of total government debt to gross domestic product (GDP) in 15 developed countries between 1960 and 1986. This ratio increases when the budget deficit is growing faster than GDP. In the United States, this ratio fell from 45 percent in 1960 to 19 percent in 1981 and then rose to 29 percent in 1986. By contrast, the ratio of debt to GDP in 1986 was 22 percent in Germany, 26 percent in Japan, and 99 percent in Italy.

Roubini and Sachs report that this ratio fell in most of the countries in their study between 1960 and 1974. Following the first oil shock in 1973, the ratio of debt to GDP rose in most countries, although not in the United States. In general, the ratio rose even faster after the second oil shock in 1979 and the subsequent worldwide increase in real interest rates.

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Roubini and Sachs find that political factors may affect changes in the debt ratio in certain circumstances. Since the first oil shock in 1973, governments with one party in control, such as the United States during the late 1970s and Japan throughout this period, were most successful at keeping budget deficits under control. Governments with two coalition partners or with different parties in control of the executive and legislative branches, such as the United States since 1981 and France more recently, tend to have higher deficits. Minority governments or governments with three or more coalition partners tend to have the fastest growth in the debt ratio. However, during the period of rapid economic growth that lasted from 1960 to 1973, the number of political parties in government had little effect on the growth of the debt ratio.

Roubini and Sachs suggest that coalition partners are able to reach agreement over tax and spending priorities when the economy is growing satisfactorily. However, when growth declines, as it did after 1973, coalition partners will try to protect their particular part of the budget against austerity measures. Until the conflict among different segments of the society can be resolved, higher budget deficits are the likely outcome.

Roubini and Sachs also estimate that a decrease in GDP growth of one percentage point tends to increase the ratio of debt to GDP by almost half a percentage point. An increase in the real interest rate of one percentage point increases the debt ratio by over three-quarters of a percentage point.

Recent NBER Books

Issues in U.S.-E.C. Trade Relations

Issues in U.S.-E.C. Trade Relations, edited by Robert E. Baldwin, Carl B. Hamilton, and Andre Sapir, is available from the University of Chicago Press for $46.00. This book contains the papers and discussions presented at a joint conference of the NBER and the Centre for European Policy Studies. Among the topics included are: the legal aspects of trade between the two regions; agricultural policies; the use of embargoes to induce change in political actions; the trend toward protectionism and responses to it; and international trade in services. Most of these issues are discussed from both an American and a European perspective.

This volume is particularly timely and will interest economists and anyone else who wishes to keep abreast of economic developments between the United States and the European Community.

Robert E. Baldwin is an NBER research associate and the Hilldale Professor of Economics at the University of Wisconsin, Madison. Carl B. Hamilton is deputy director for the Institute for International Economic Studies, Stockholm. Andre Sapir is a professor of economics at the Free University of Brussels.

Misalignment of Exchange Rates

Misalignment of Exchange Rates: Effects on Trade and Industry, edited by Richard C. Marston, is available from the University of Chicago Press at a cost of $37.50. This volume investigates the causes of misalignment; its effect on employment and production; whether these effects are reversible; and ways to avoid, or at least limit, misalignment through macroeconomic policy.

William H. Branson attributes the misalignment of the dollar in the 1980s to U.S. federal budget deficits. Charles Bean explains the appreciation of the British pound from 1978-81 by the discovery of North Sea oil, rising prices caused by the Iranian revolution, and adverse factors on the supply side. Paul de Grauwe and Guy Verfaille show that misalignment is less of a problem for countries in the European Monetary System. Bonnie Loopesko and Robert Johnson analyze how the Japanese economy is adjusting to the recent fall of the dollar. Joshua Aizenman explains how misalignment can result from monetary shocks through wage adjustment. Louka T. Katseli shows how domestic prices respond differently to small changes in exchange rates versus large-scale devaluation or revaluation. J. David Richardson shows that the U.S. auto industry lost competitiveness because of rising unit labor costs even before the dollar began appreciating in the early 1980s. Branson and James P. Love estimate that changes in real exchange rates resulted in a loss of almost a million jobs in U.S. manufacturing from 1980-5. Finally, Paul R. Krugman proposes that the strong dollar may have an irreversible long-term effect on the U.S. economy.

This NBER Project Report should interest policymakers and students of international economics. Its editor, Richard Marston, is an NBER research associate and the James R. F. Guy Professor of Finance and Economics at the Wharton School, University of Pennsylvania.

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