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Must we choose? European unemployment, American inequality, and the impact of education and labor market institutions

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Abstract

In the last 15 years, two equilibria have arisen in the advanced world. On the one hand, wage dispersion has widened in those countries where unemployment has remained low (with cyclical variations). On the other hand, wherever income inequality has remained unchanged, unemployment has shot upwards. To account for these distinct patterns, we develop a political–economic model showing that, controlling for the skills of the population, the effects of technological and trade shocks (that have affected OECD nations) that are contingent on the institutional rules in place. Economies with generous unemployment allowances adjust through subsidized unemployment. By contrast, low levels of social protection lead to less unemployment but wider wage dispersion. The level of qualifications of the labor force determines the extent of the adjustment for a given institutional arrangement. We derive, in turn, the institutional structure of each country from the political conditions in place at the time of the shock. The empirical part successfully tests the model for the sample of European regions and US states.

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1. Introduction

Since the mid-1970s, most advanced nations have moved toward two distinct economic equilibria. In continental Europe, unemployment has followed a steady upward trend, encompassing, by the early 1990s, nearly 10% of the labor force. Meanwhile, in the US, the unemployment rate, although subject to substantial fluctuations, has remained close to its postwar level of 5% (see Table 1). These different trajectories in the labor market have been associated with distinct patterns in the evolution of wage distribution. As shown in Table 2, which reproduces the evolution during the last decade of the ratio between the wage earned by a male worker in the ninth decile and the wage earned by a male worker in the first decile in several OECD countries, in countries where unemployment rates have remained low (or highly cyclical), wage dispersion has risen — the US, UK, and Japan. By contrast, in countries suffering from increasingly sticky unemployment, wage inequality has remained unchanged or has even declined — France, Germany, and Italy.

Two competing sets of theories have been developed to shed light on these facts. On the one hand, two structural approaches have explained differences in employment trends as a result of recent exogenous shocks on the developed economies. A first line of analysis has emphasized trade and the effects of growing competition from low labor-costs countries (Borjas and Ramey, 1993; Wood, 1994). The massive introduction of standardized goods from less developed countries (LDCs) would have lowered international prices and reduced demand for the least qualified workers in developed economies. Unable to keep up with higher labor costs in the wake of fierce external competition, employers in those sectors would have either cut wages (the American scenario) or stop hiring (the European case). A second line of research (within the structural approach) has stressed, instead, the impact of fast technological change. The introduction of new technologies that are more skill demanding would have lowered the demand of low skilled workers and widened the income distribution by rewarding high skills (Freeman and Katz, 1994; Krugman, 1994).[1]

On the other hand, institutional models have focused on the impact of domestic institutional frameworks, such as labor laws or specific patterns of collective bargaining, to account for a growing cross-national variation in the evolution of employment patterns. According to insider–outsider models, the unemployed, who are generally non-unionized, are unable to exert downward pressure on wages since only organized employees, keen on maximizing their income level, sit at the bargaining table (Lindbeck and Snower, 1988). In this institutional context,

[1] Davis and Haltiwanger (1991), Bound and Johnson (1992), and Berman et al. (1994) also favor this hypothesis. As Bertola and Ichino (1995) point out, some researchers jointly model trade and technology shocks (Sachs and Shatz, 1994; Leamer, 1994).