

David R. Howell (howell@newschool.edu)
OECD Forum on the New Jobs Strategy
Toronto, June 15, 2006

Roundtable Remarks

The New OECD Jobs Report: More Reliable Evidence and More Balanced Assessments

Thanks to the OECD for this opportunity to make a few brief remarks. My written response to Professor Heckman's Keynote Address is available here and online, so I will take advantage of these few minutes to comment on the OECD's new research on employment performance, and will focus on the Bassanini-Duval working paper and the EO Chapter 7 summary of it (I did not have access to Chapters 1-6).

Before making some critical – constructively critical – remarks, I want to start by saying that the Bassanini-Duval research is a big step forward in this field. Given the inherent limitations of the data, the new OECD macroeconomic 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 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.

That said, I will take this opportunity to 1) make some comments about the interaction between theory and evidence in recent research on cross-country patterns of unemployment, and 2) offer three examples that highlight the need for still more skepticism, caution, and balance in the interpretation of macroeconomic results.

As Professor Lindbeck notes in his Address, there is a very strong *consensus* among economists about the centrality of supply-side factors. This is the notion that the rigidities imposed by labor market institutions are at the root of persistent high unemployment.

In his work on methodology, Mark Blaug (1992) strongly criticizes mainstream empirical research for its focus on confirmation of researchers' own strongly held theoretical priors. This contrasts he argues with confronting these priors with the data - trying to establish what is left after we put on our hat of scientific skepticism and put the prevailing wisdom through the wringer of challenging empirical tests that include comparing them to what alternative models would suggest. This is an especially appropriate objective for the OECD – a taxpayer supported institution.

The last two decades of macroeconomic research on unemployment and institutions offers a good illustration of empirical work that in my view quite clearly fails Blaug's methodological test. In cross country studies with small numbers of countries and relatively poor institutional measures, fragile results are cited in support of the orthodox

labor market rigidity account, and worse, these unrobust cross-country regression coefficients have then become the basis for sweeping policy pronouncements instructing specific countries on the kinds of reforms they should adopt.

Again, the recent OECD research shows much more balance and caution. But I will give three examples of the need for *still more caution and skepticism*.

1. First, free market orthodoxy has become so pervasive that evidence often takes a back seat. Thus, even with data and empirical tests that are designed with the expectation that EPL strictness will help account for poor employment performance, the results generally fail to produce the predicted result (as in most recent B-D regressions). Still, the stylized fact that EPL strictness lies at the root of the unemployment problem remains.

Take a look, for example, at the OECD's 2005 economic surveys for France and the NL, which call for reforms in employment protection without reference to any evidence of its harmful effects. Similarly, in his address today, Professor Lindbeck states flatly that since the mid 1970s "high firing and hiring costs instead contributed to prolong the high unemployment level that then emerged". He cites no evidence. This is the orthodox prediction and is widely believed, but without compelling empirical support it remains just that, a belief.

2. Second, despite the greater caution and attention to robustness in the OECD's research, there is a sense that an important objective continues to be the marshalling of evidence in support of the essential correctness of the original 10 commandments – the major recommendations of the 1994 Jobs Strategy. In nearly the same language as we've seen in OECD reports since at least 1999, it is claimed (editorial, 2006 EO) that "the record shows that those countries which implemented its (1994) recommendations outperformed those that did not."

Now there is some evidence that could be interpreted to support this claim, but there is also much that challenges it. To assess this claim, we would need to know which recommendations are being counted, how they're weighted, and how we can be confident that the reforms "caused" improved performance (to be considered in more detail below in point #3). Little convincing work along these lines has been produced (including chapter 7's Figure 7.3, the limitations of which we will describe in a forthcoming paper).

And if we are to know who "outperformed" whom, we need to know what the yardstick of performance is. If it is unemployment, it would be interesting to know which recommendations adopted by Spain and Ireland could possibly explain the spectacular drop in unemployment in those two countries, and which could account for the rise in German unemployment? Even the cases of Denmark and the Netherlands do not provide unambiguous evidence that the timing of labor market reforms can explain their declines in unemployment.

And if the yardstick is unemployment, we need to be careful not to put too much weight on the standard measure of unemployment – for entirely different reasons than those

advanced by Heckman and Lindbeck. The unemployment rate reflects those who are not employed but are actively looking for work. But what it means to be “employed” differs dramatically across countries. To take an extreme example, according to the OECD, Mexico’s unemployment rate was just 3.1% in 2004. This compares to a U.S. rate of 5.6%. According to the BLS, using “U.S. methods” Mexican and U.S. rates have been about the same for the last decade. As recently as the late 1990s, Spain’s unemployment was around 20%. Who would claim that Mexican and U.S. labor market performance was about the same in the late 1990s, but Spain’s was 4-5 times worse than Mexico’s? The level of unemployment is often not a very good guide to labor market performance, and too much weight should not be placed on differences between countries.

But the change in unemployment may also not be a very good guide to changes in labor market performance. For example, the work by Bassanini-Duval that appears in Figure 7.3 (EO, Chapter 7) shows Switzerland with the highest change in observed unemployment in their set of OECD countries – about 4 percentage points. But this reflects the fact that in 1982, Swiss unemployment was measured with employment service data, not household-based survey data, and shows an impossibly low rate of .04%! The household survey rate for 2003 was just over 4%, and this is how they get the huge jump in unemployment that appears in the Figure. Austria is another country for which household survey data is not available before the 1990s, and yet it appears in the tests as well.

But far worse offenders are the prominent studies that have tried to explain changes in unemployment since the early 1960s – the time series for nearly all countries involve using registered rates in the 1960s and 1970s and survey-based rates in the 1980s and 1990s, but there is no discussion by the authors of the meaningfulness of changes based on such data (e.g., Nickell et al., 2003; 2005).

3. My third example refers to the need for caution in the interpretation of regression coefficients, and I will focus here on the causality problem. Two of the four variables B-D found to be strong and robust were benefit generosity and the tax wedge. Both raise questions about causality.

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 (our Granger tests suggest that for most countries showing a relationship, it is from unemployment to benefits). Quite sensibly, policy makers in democratic political systems will sometimes make benefits more generous in harder times: that is, it may be higher unemployment that leads to higher benefits and longer benefit 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.

All three addresses today underscore the critical negative role played by the tax wedge, and B-D found this to be one of the key robust results. But the empirical literature shows mixed results, and theoretical expectations on the effects on employment are not so clear. The effects depend, on the demand side, on labor costs, and this in turn depends on who bears the burden of the tax. As a result, as Blanchard, Nickell, and many others have repeatedly said, there is no clear prediction on theoretical grounds (except perhaps for low wage workers in a labor market with a high minimum wage...). It's really an empirical question.

On the supply side, the predicted effects are also not perfectly clear. The response of workers to the burden of taxes depends on social norms, and in contrast to Prescott's view (for example), surveys consistently show that northern European citizens are much more tolerant towards taxes than U.S. citizens. Despite high taxes, employment rates are higher in many northern European countries than in the U.S.

But my main point here is about causality. American cities like Philadelphia and Newark have weak local economies and, with little tax base, have had to impose very high tax rates as a result. Taxes are used to raise revenues, and if revenue levels are to be maintained (and budget deficits limited), tax rates must be adjusted accordingly. The upshot is that countries with poor macro performance may have to impose high tax rates. If this is so, in these countries both tax rates and unemployment rates will tend to be high, but that doesn't mean that changes in the tax wedge caused changes in unemployment.

So the question really is what part of any association that is found between taxes and unemployment, and between unemployment benefit generosity and unemployment, is causal: running from taxes and benefits to unemployment? Why do we simply assume that it is 100%, and what role is played by ideology – the current dominance of free market orthodoxy?

In sum, this new OECD research represents a big step forward. But there remains a concern that the “default” position in the research and in the interpretation of the findings is consistency with the conventional wisdom -- that labor market rigidities are at the root of poor employment performance. This is a hypothesis, not a fact, and following Blaug, the OECD should aim in future work to more self-consciously confront the conventional wisdom with the evidence, not simply aim to confirm it.