

What are the Key Employment Challenges and Policy Priorities For OECD Countries?

James J. Heckman,

University of Chicago, and American Bar Foundation

Martin Ljunge,

University of Chicago, and University of Copenhagen

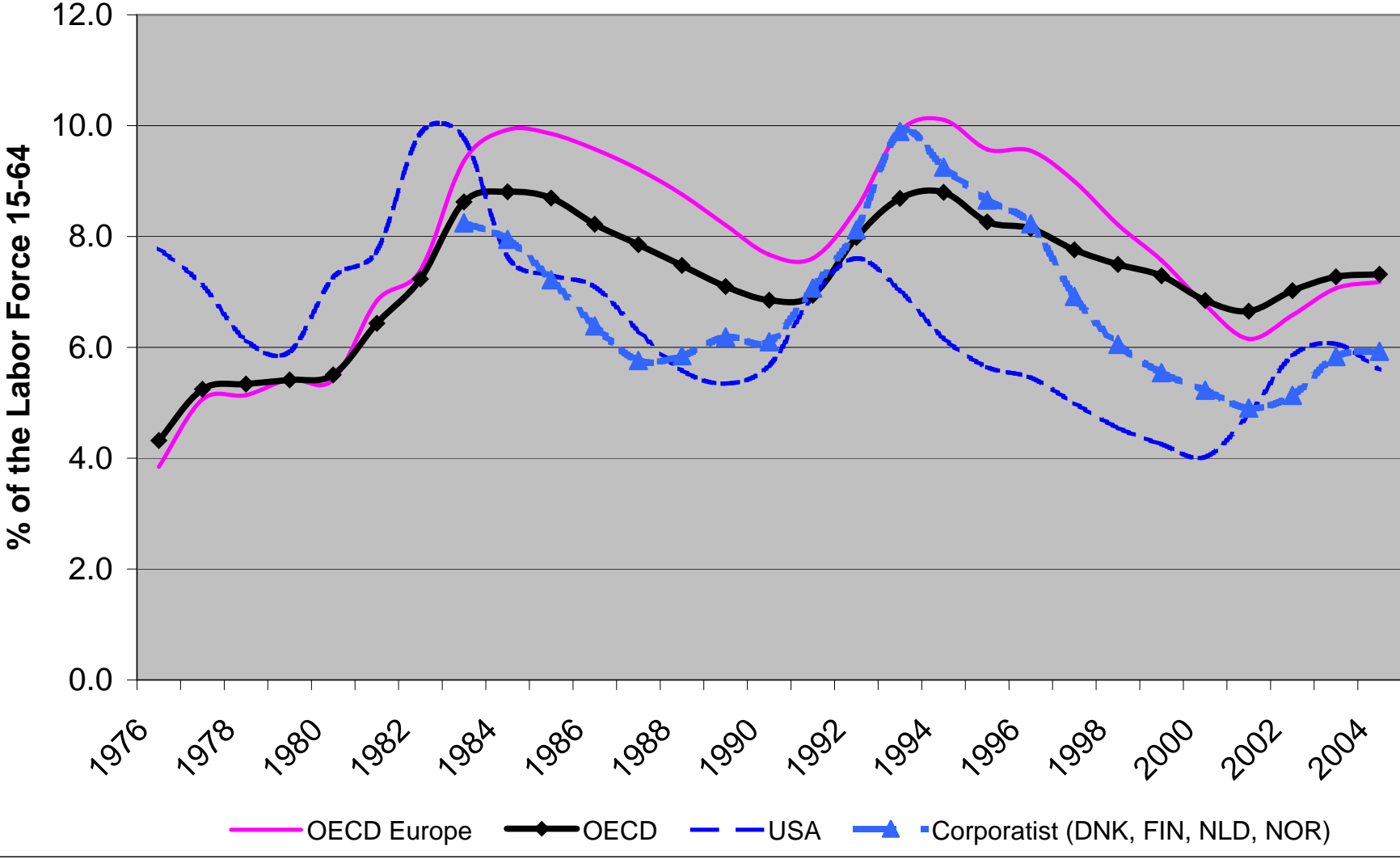
Kelly Ragan,

University of Chicago, and Stockholm School of Economics

Boosting Jobs and Incomes: Toronto, June 15, 2006

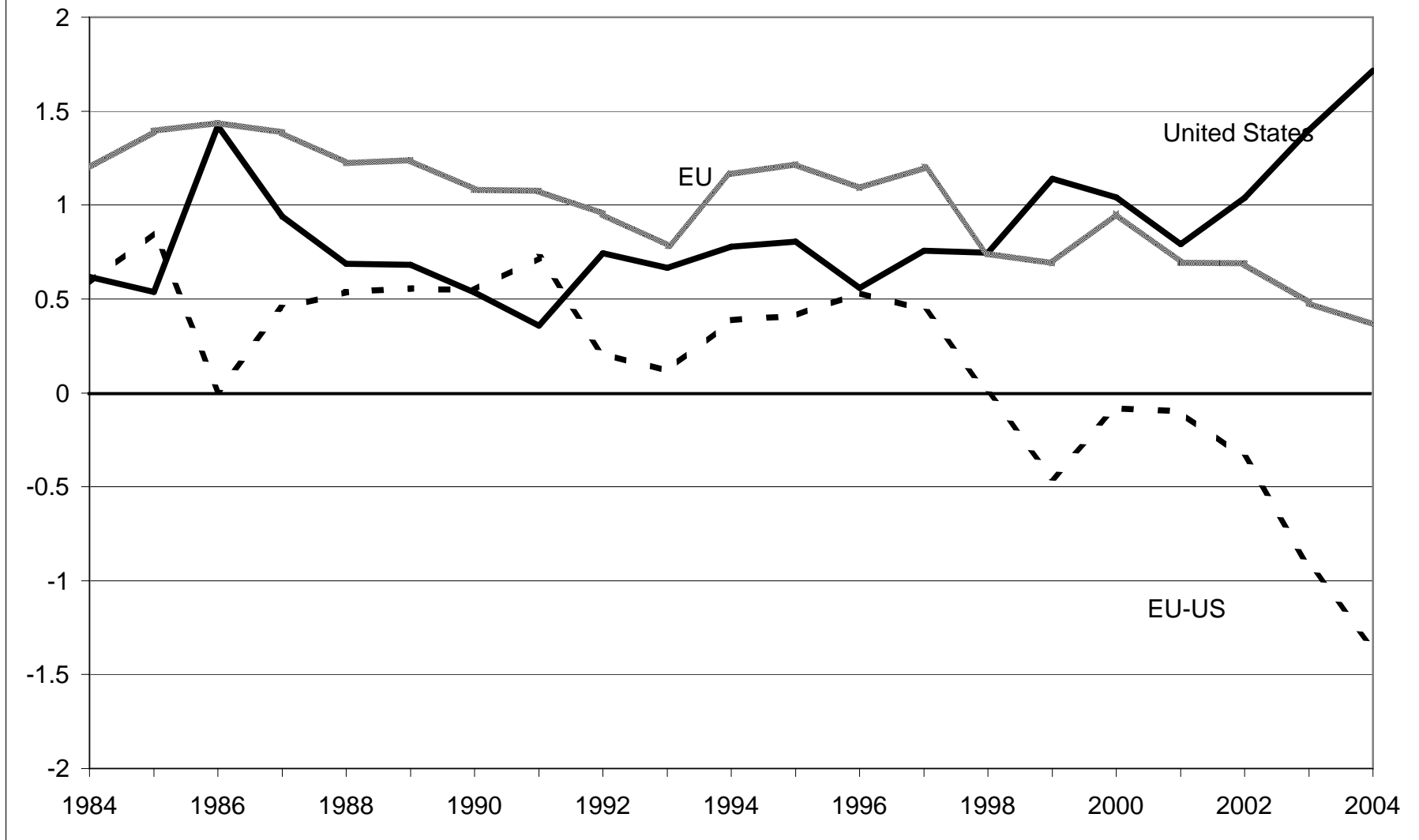
- The new OECD Jobs report documents that some of the reforms suggested in the 1994 Jobs report have been implemented and they partially account for the improved state of European labor markets.
- European unemployment rates post-1994 are lower but they are still very high.
- Apparently they are much lower in corporatist Europe.

Open Unemployment Rates in the OECD



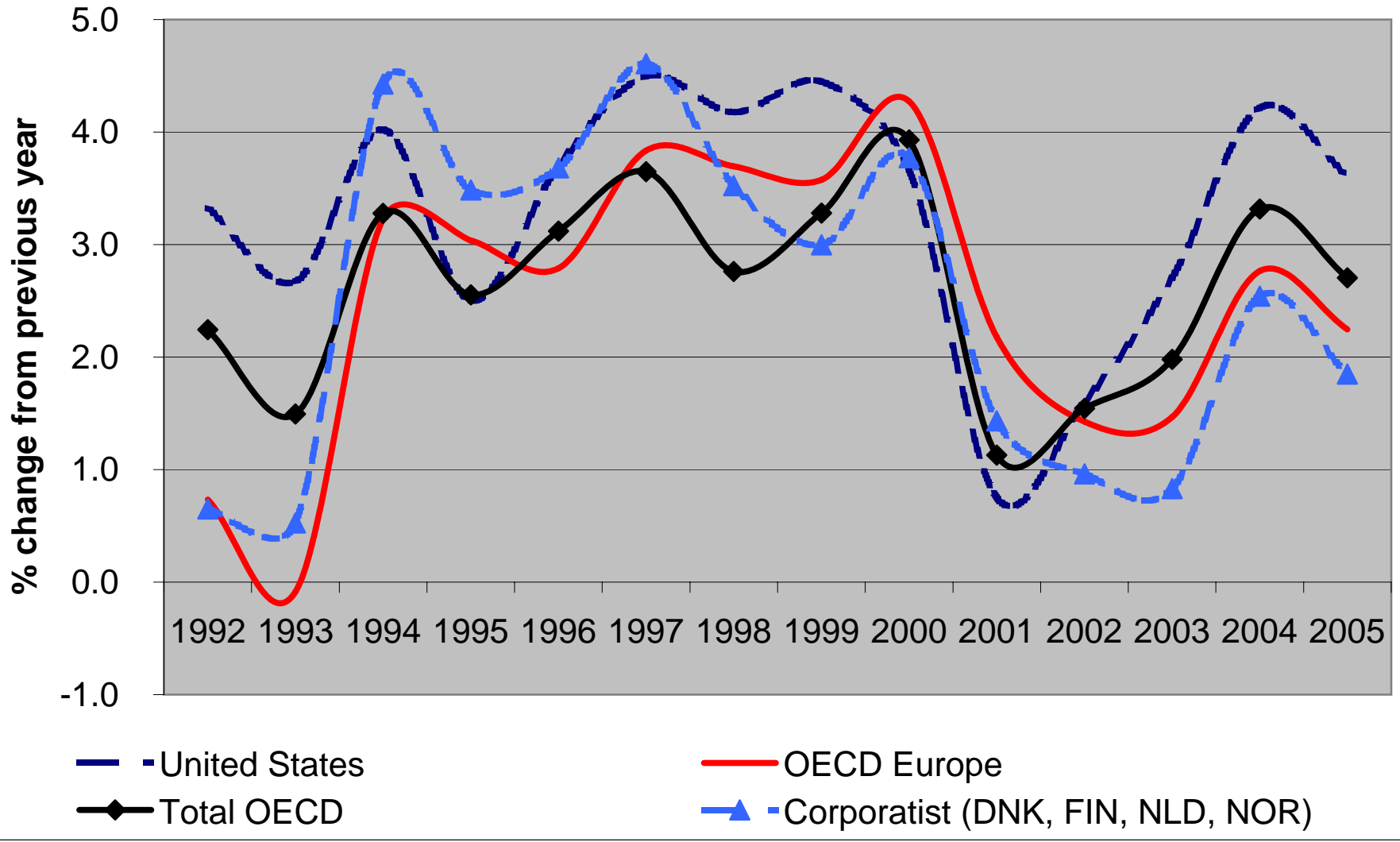
- However, average productivity growth is lower in EU than in the U.S.

Total Factor Productivity Growth



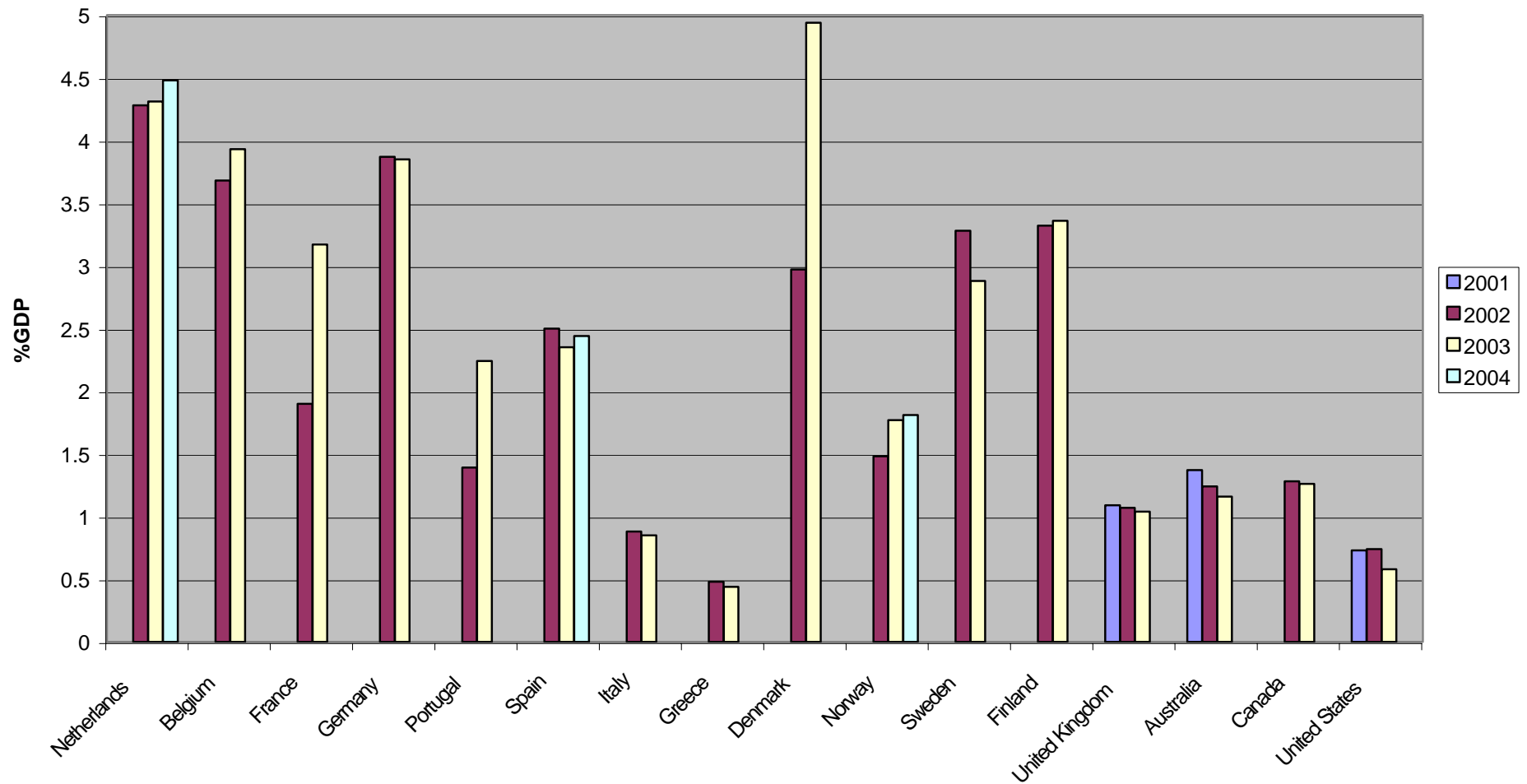
- GDP growth lower in past 5 years in EU than U.S.

Real GDP Growth

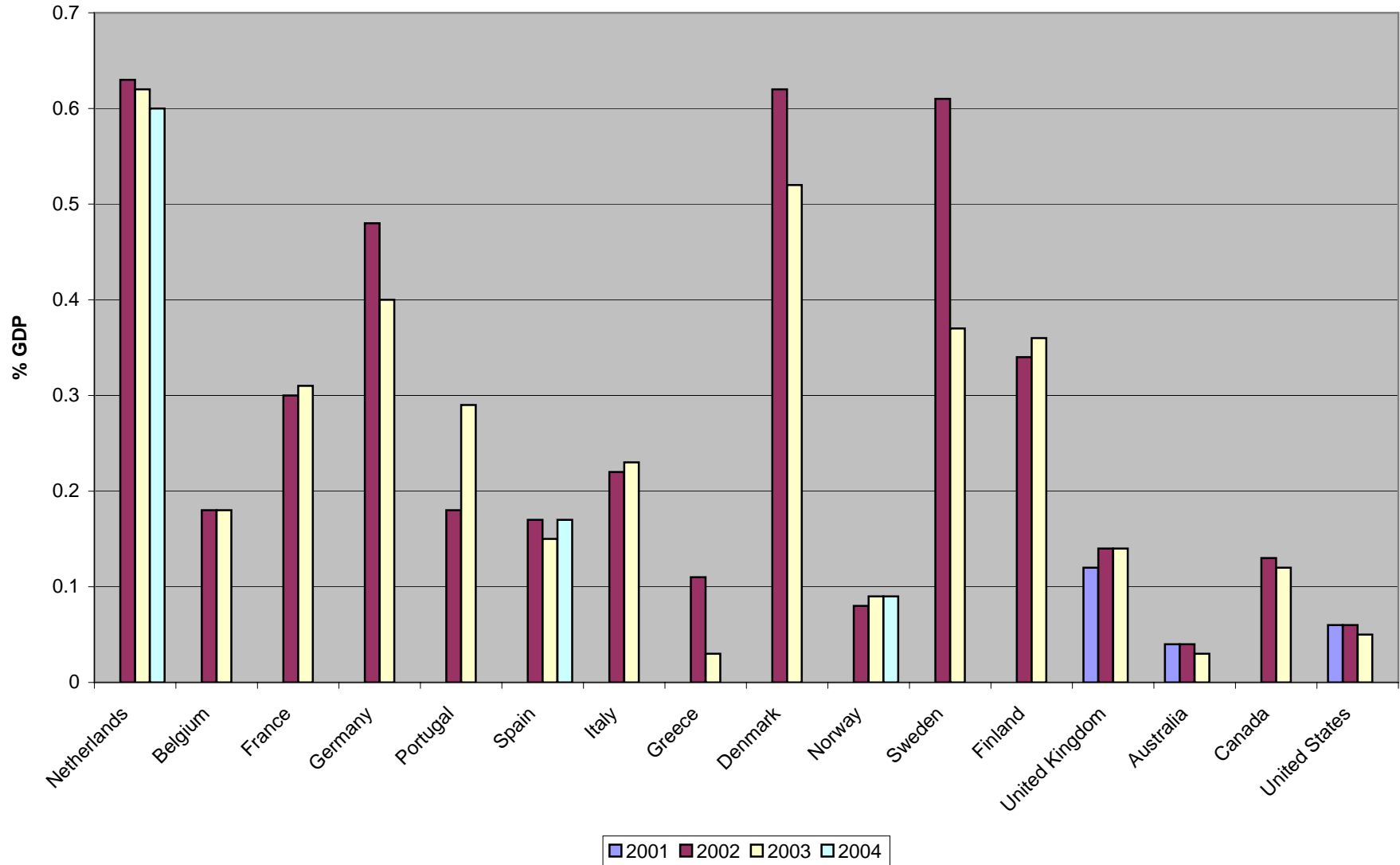


- There has been a substantial commitment to expenditure on active labor market programs in many European countries and especially in corporatist Europe.

Total expenditure on training and passive/active labor market programmes (%GDP)
Source: OECD Labor Force Statistics, 2005



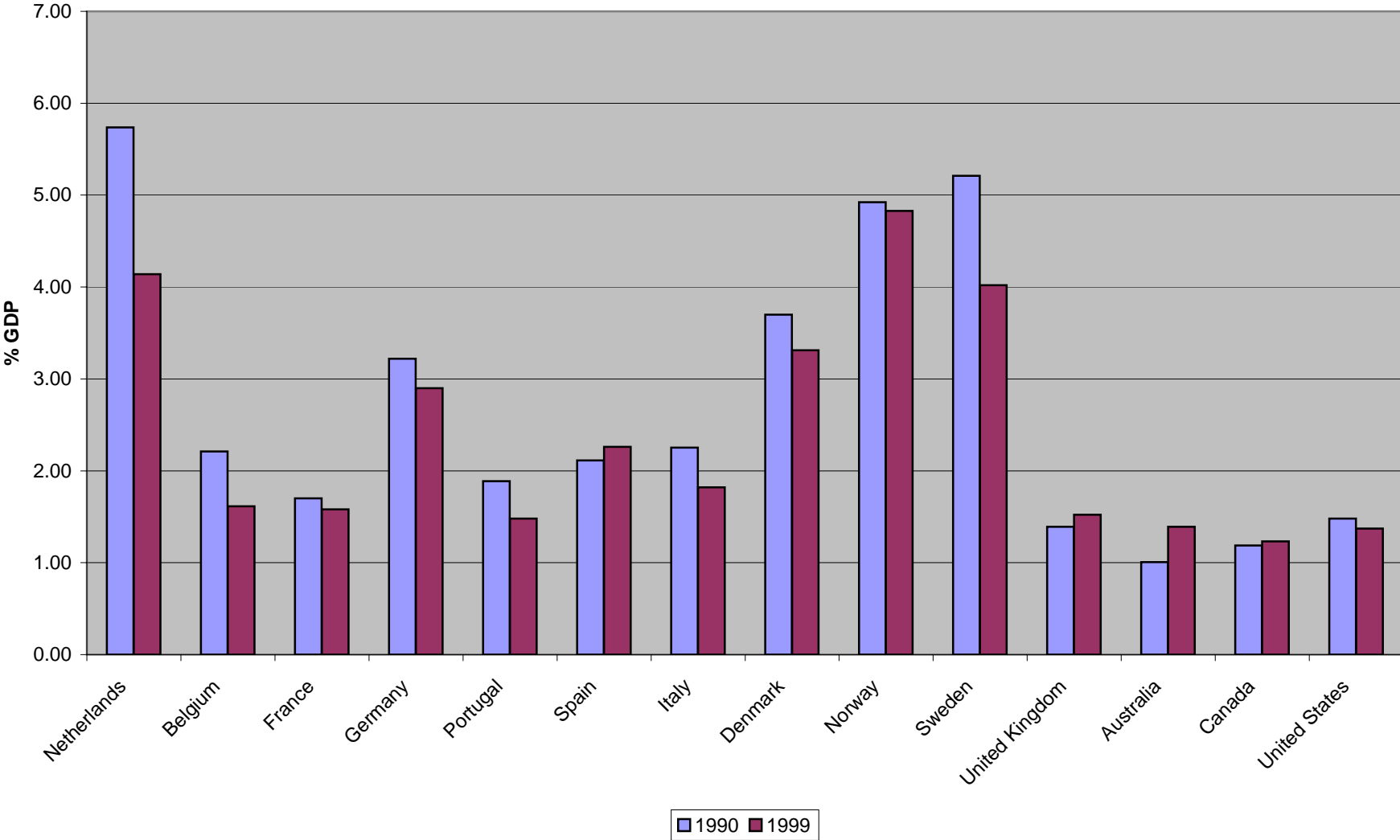
Expenditures on training (%GDP)



- A large array of studies surveyed in Heckman, LaLonde, and Smith (1999) and Martin and Grubb (2001), as well as more recent studies, show that these programs at current levels of funding have at best minor long term effects on wages and employment and most do not survive a cost benefit test.
- Few programs lift most participants out of poverty.

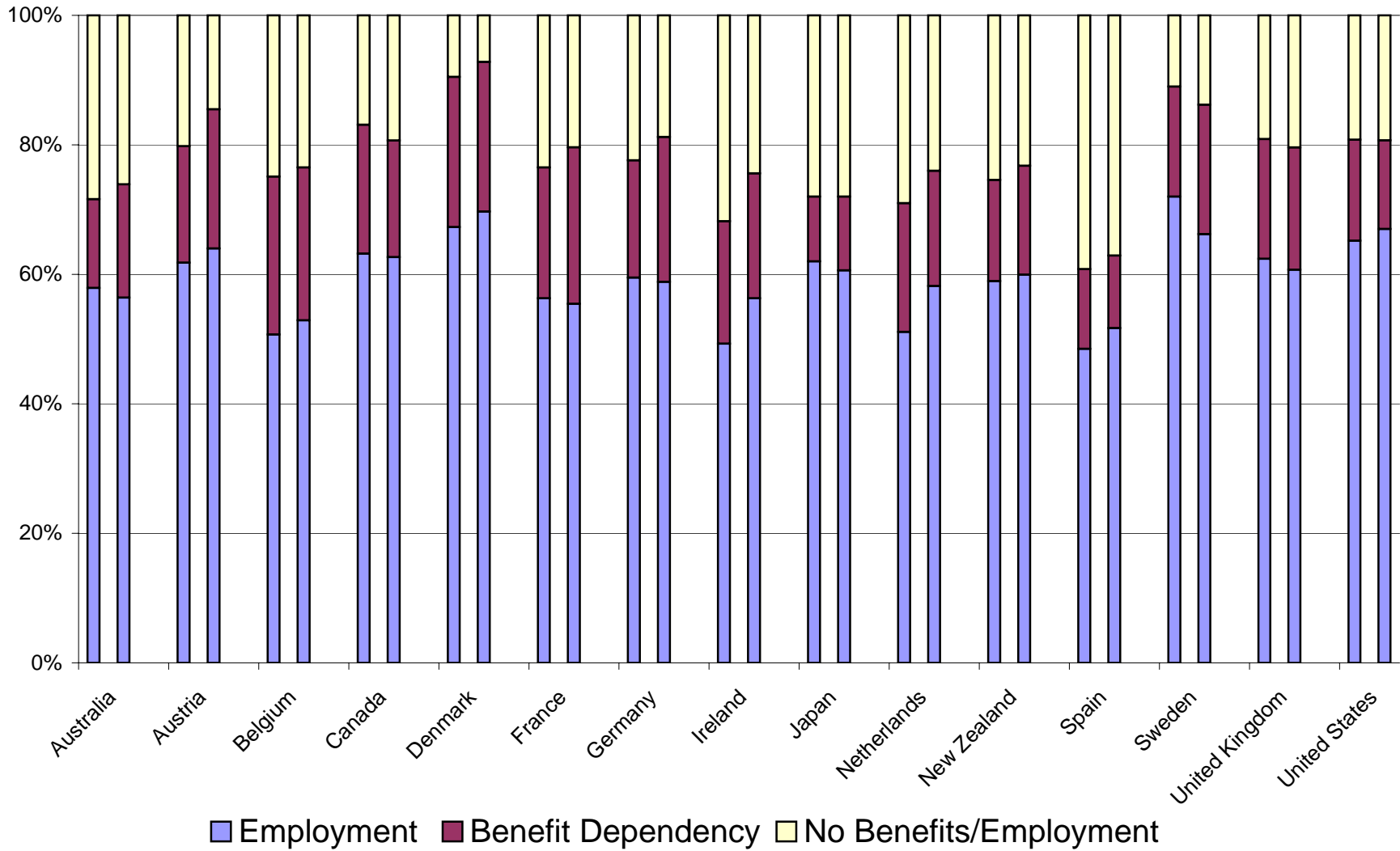
- ALMP programs are only part of the story.
- Europe has many more persons dependent on government programs than the U.S.
- For example consider just one program: expenditure on disability is much higher in EU than U.S.

Disability related expenditures (%GDP) (1990,1999)
Source: OECD Social Indicators 2005



- More generally, dependency rates are much higher in the EU and the structure of dependency is different.
- Participation in the EU tends to be much more long-term.
- In many countries the rate of dependency is high, and has gone up and not down.
- Participation in these programs has produced lower rates of employment in many OECD countries.

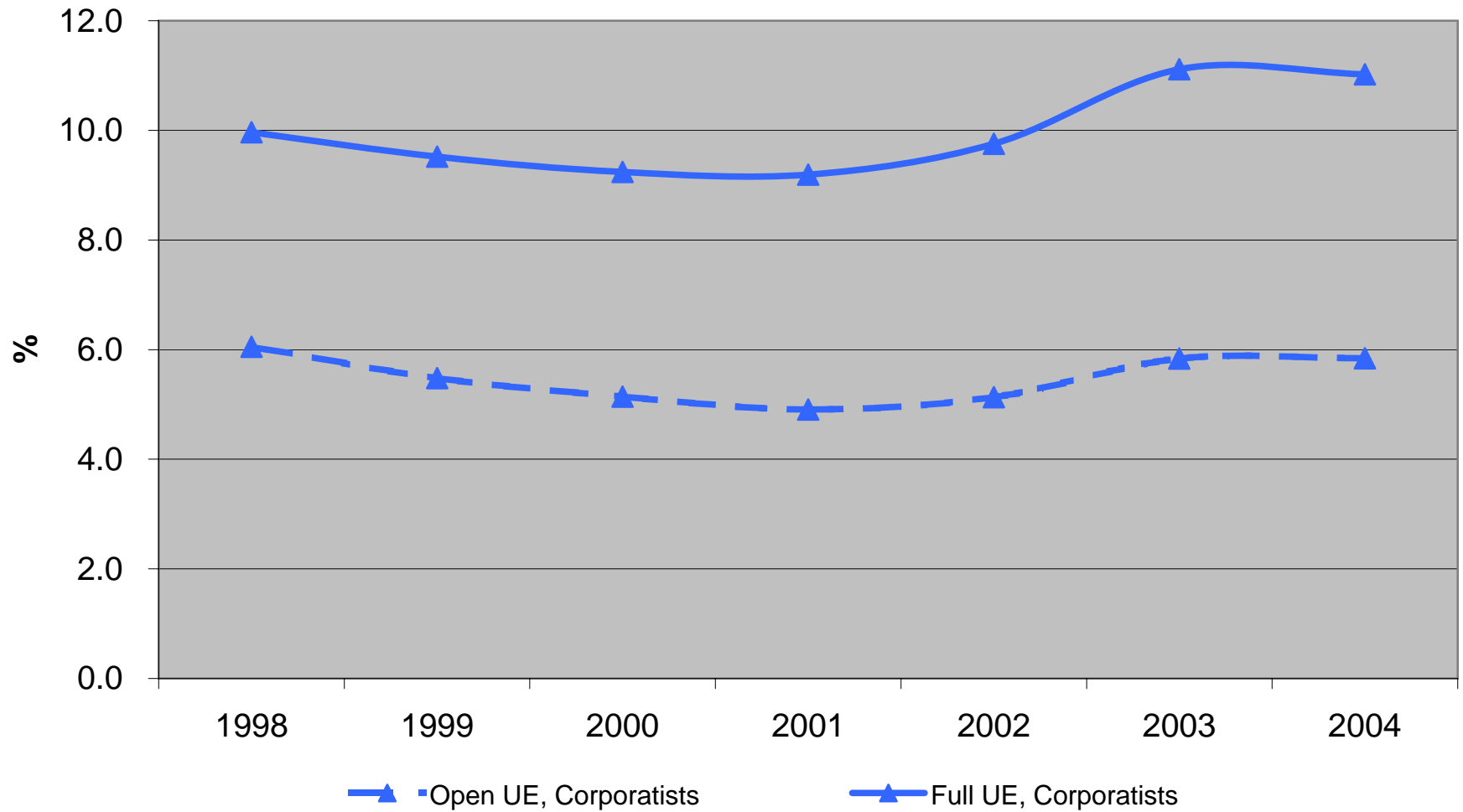
Percent of Population in Full Time Equivalents Engaged in Various Activities 1990 and 1999



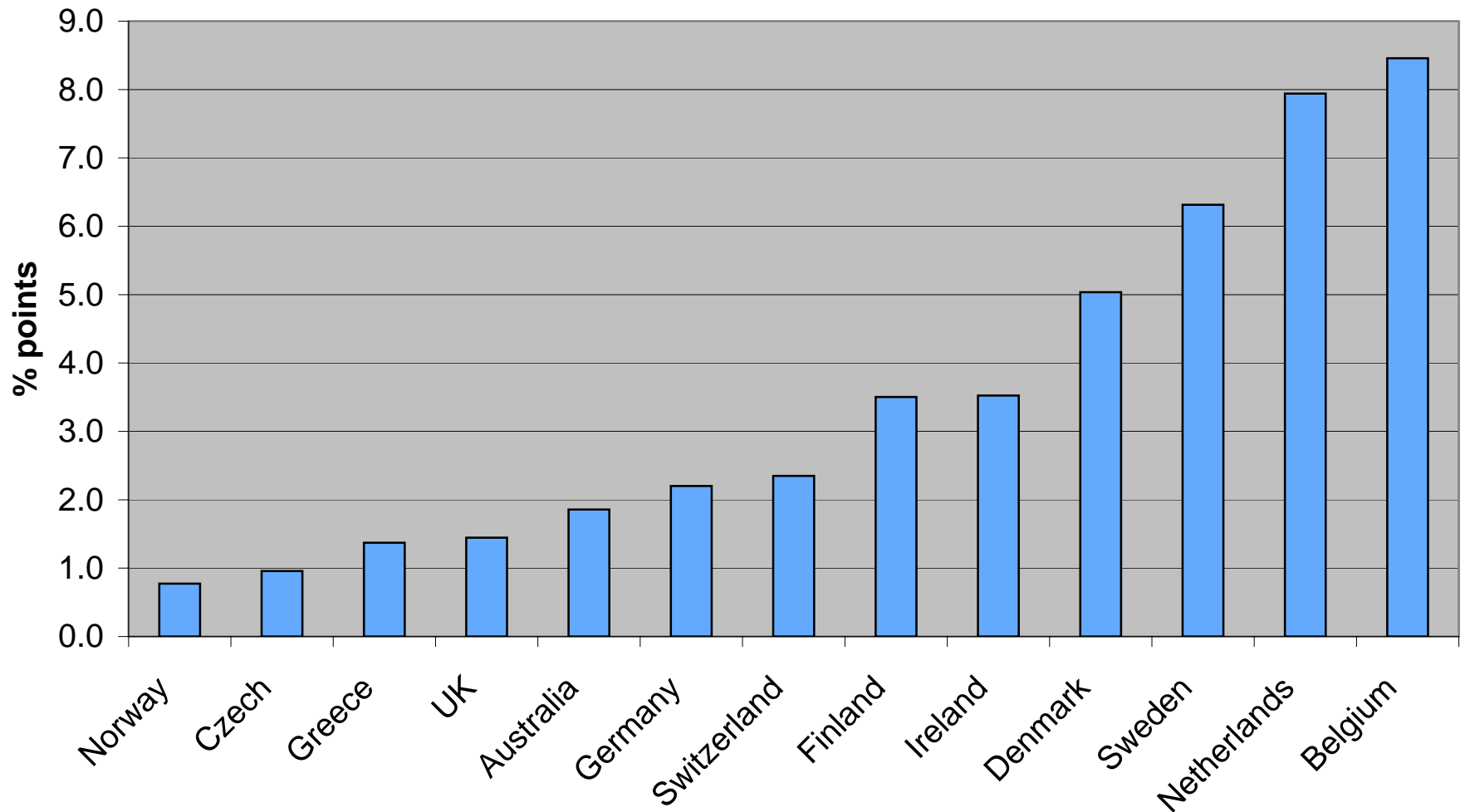
- Adjusting “open” unemployment by disguised unemployment produces a very different image of the performance of corporatist Europe compared to the performance of the U.S. than is given in the current Jobs Report.

Open and Full Unemployment

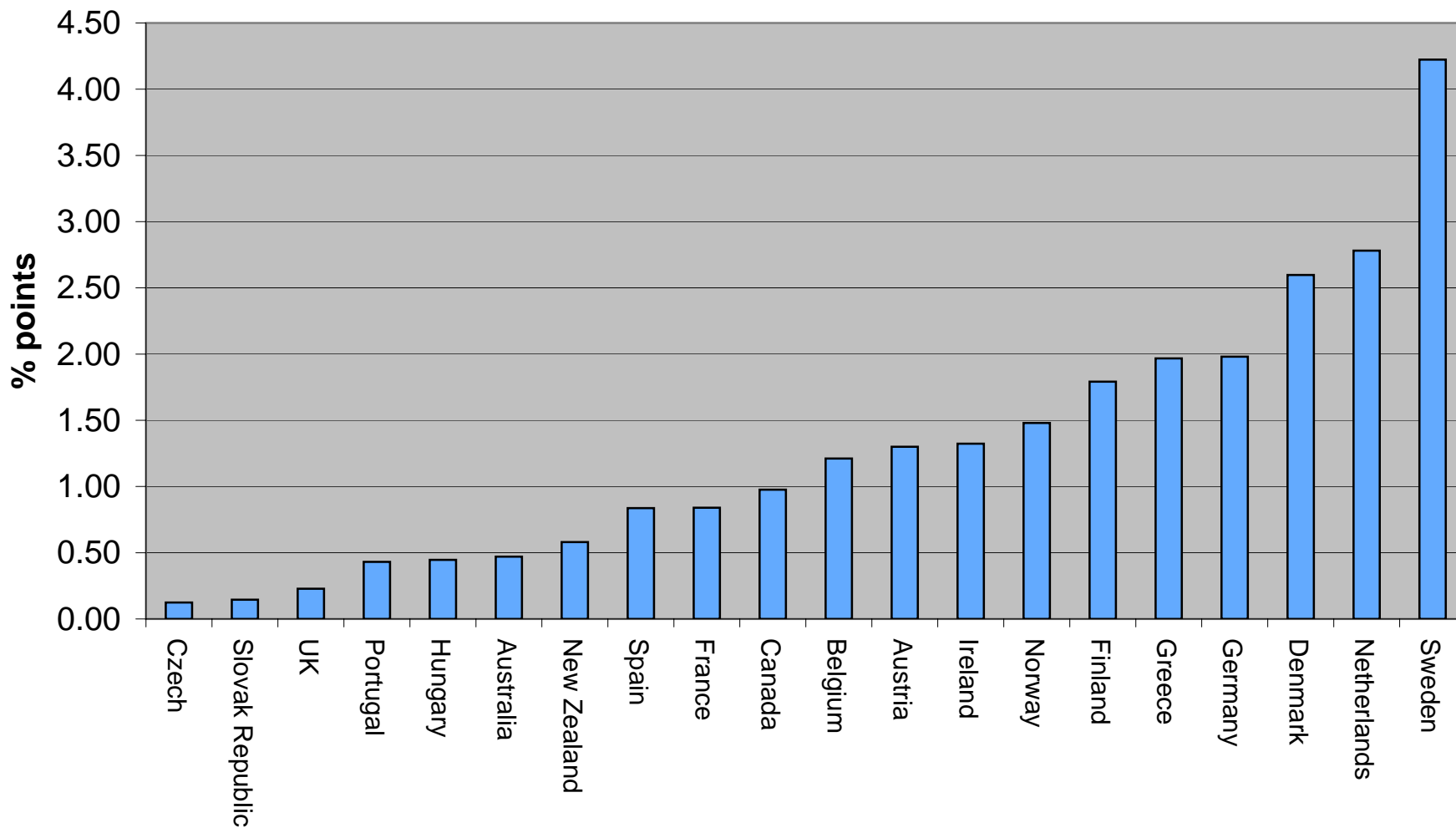
The corporatist countries are DNK, FIN, NLD, NOR. Full unemployment accounts for participants in training and subsidized employment programs.



Differences between Open and Full Unemployment, 1998-2004 averages

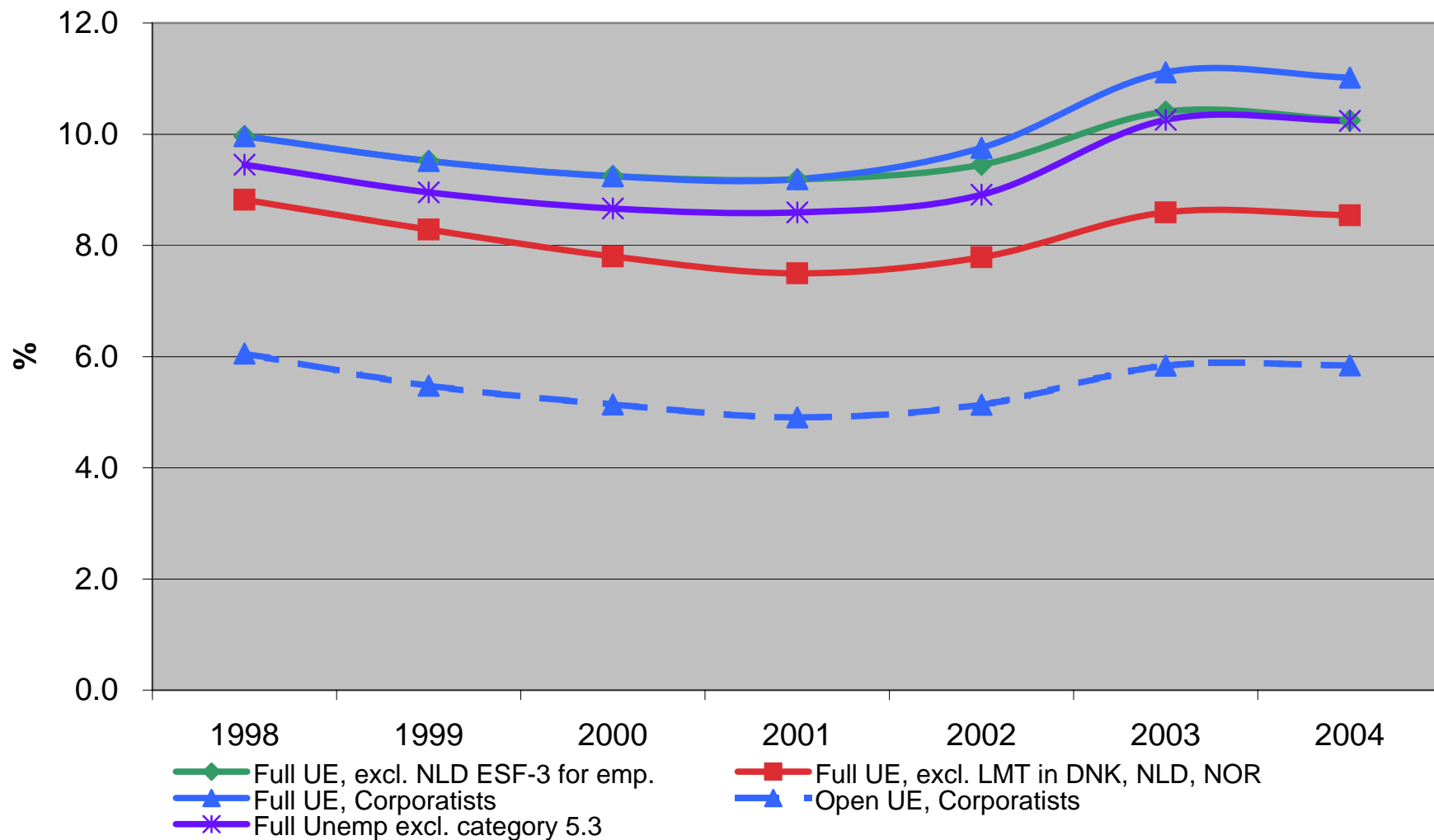


Differences between Open and Labor Market Training Adjusted Unemployment Rates, 1998-2004 averages



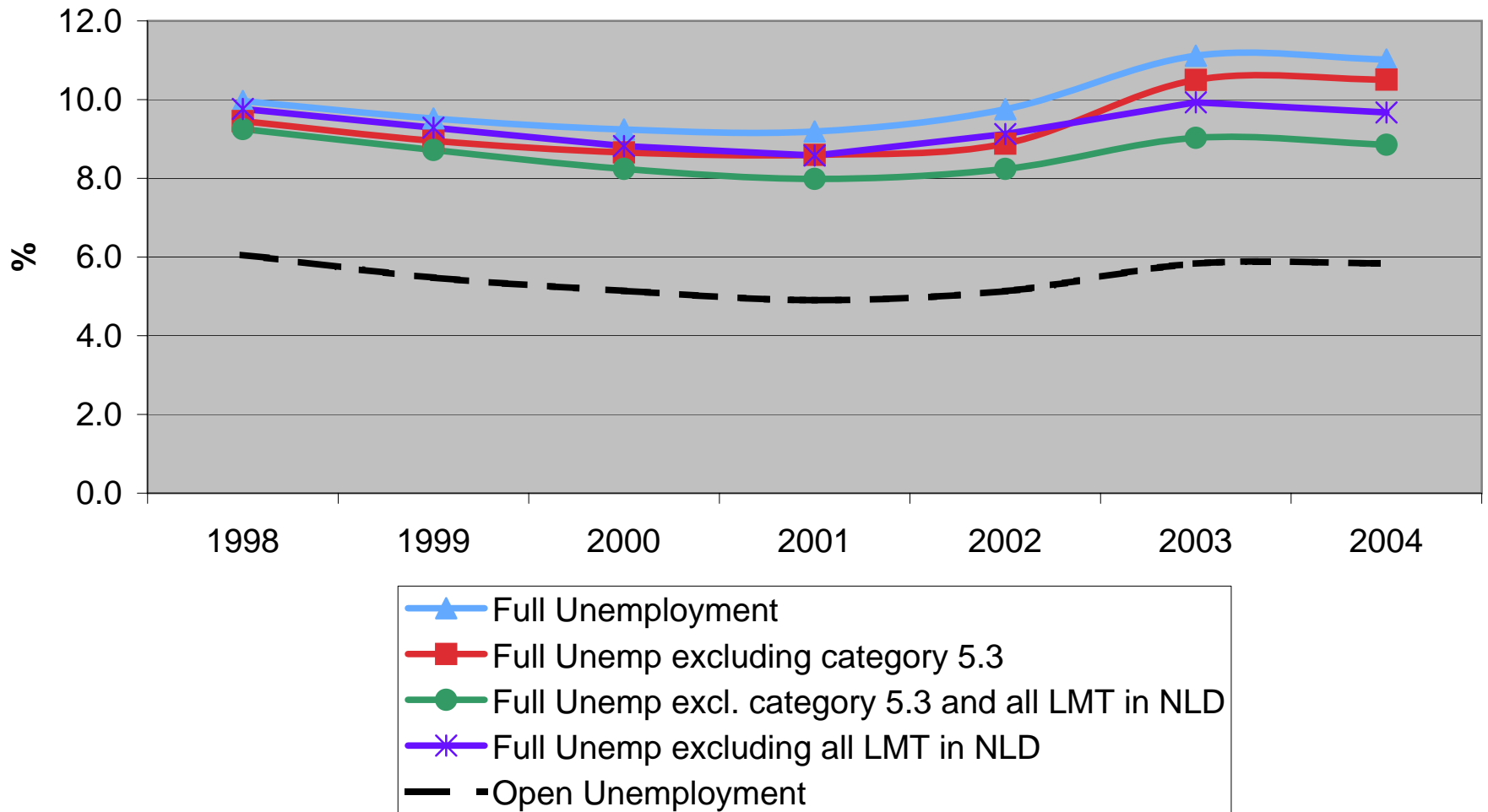
Sensitivity Analysis of Full Unemployment Rate Definitions

The corporatist countries are DNK, FIN, NLD, NOR.



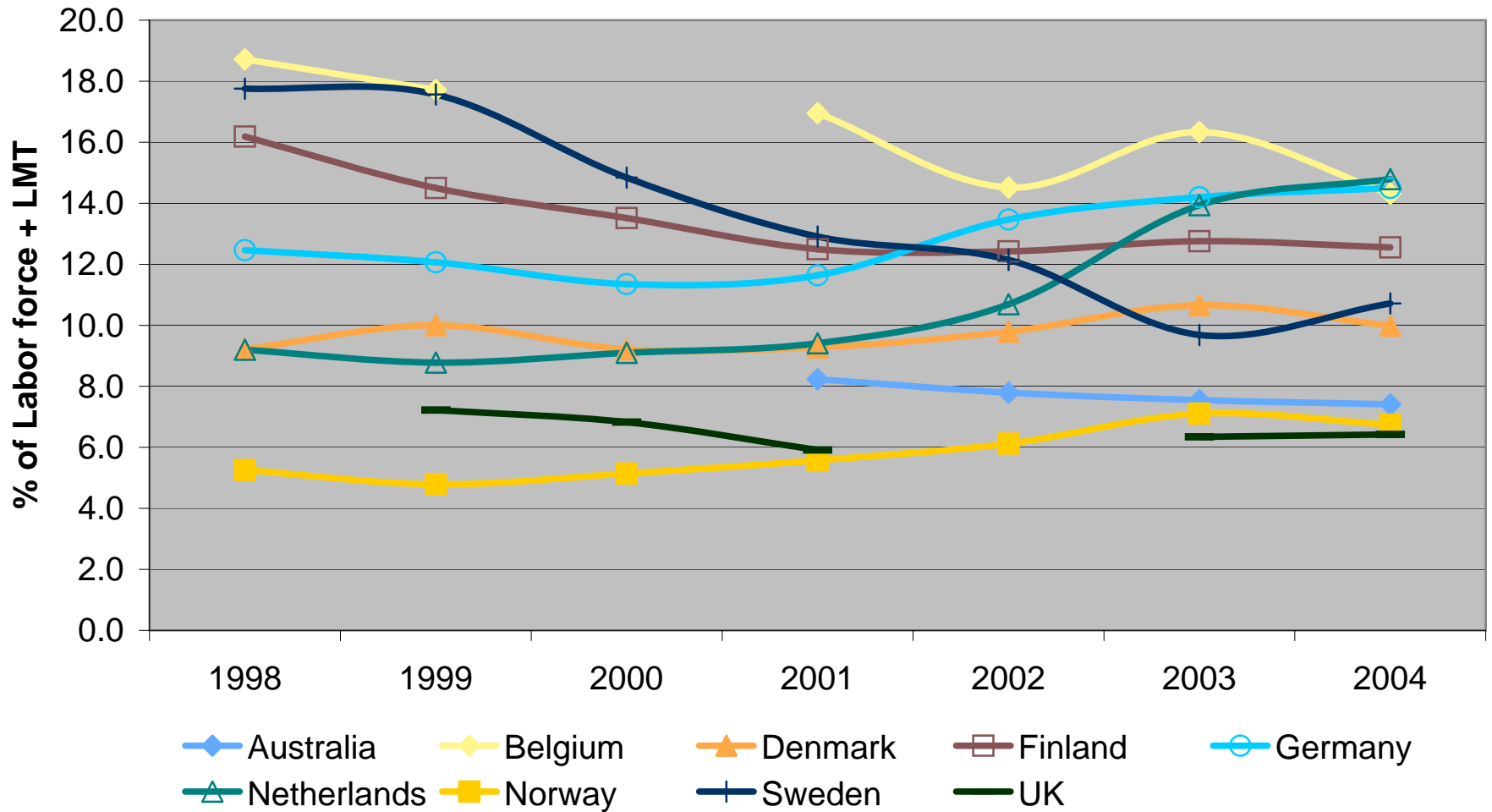
Sensitivity of Full Unemployment Definitions

Corporatist Countries: DNK, FIN, NLD, and NOR. Program category 5.3 is Disabled - Rehabilitation and Training.



Full Unemployment Rates

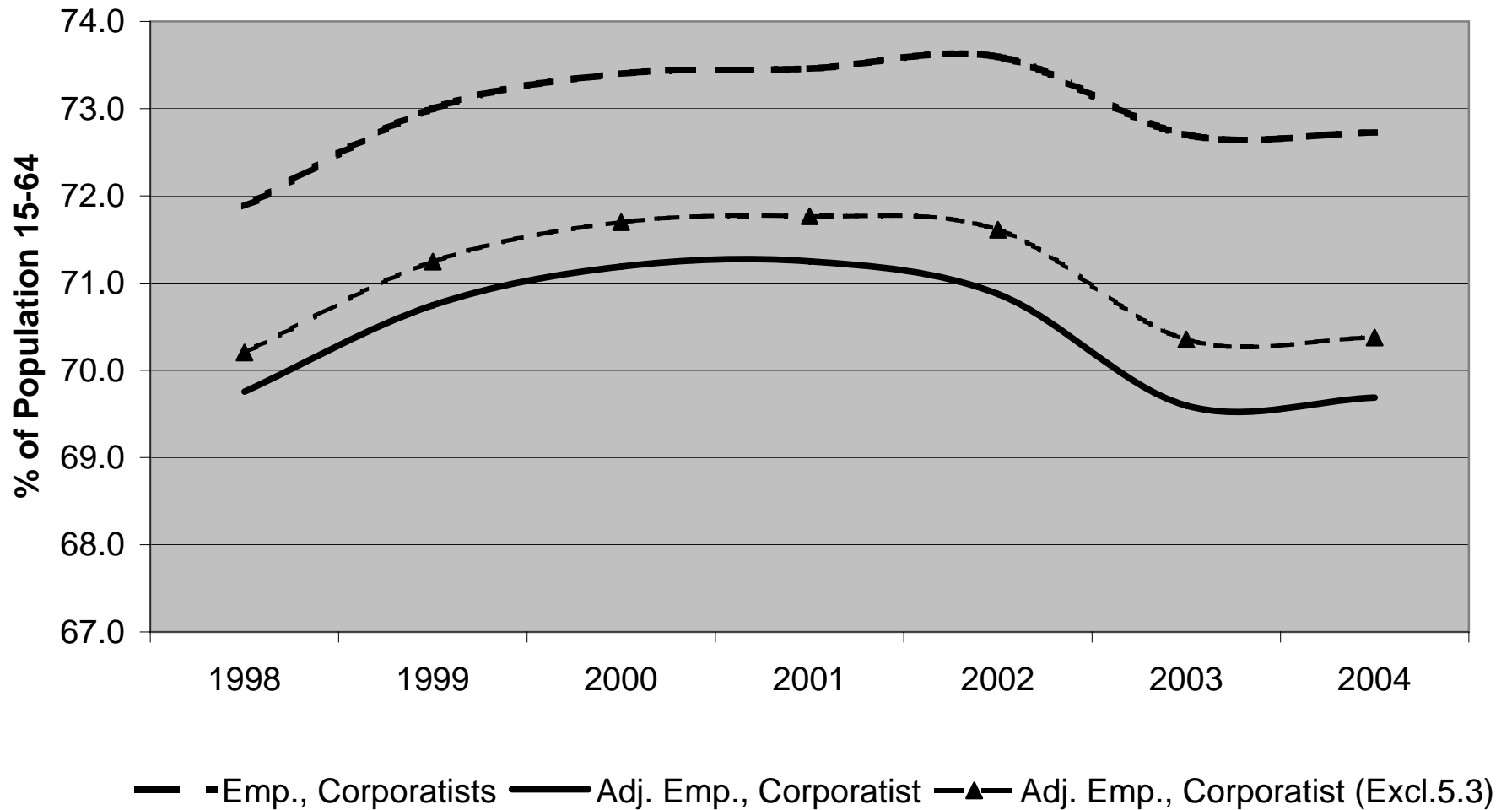
Includes open unemployment, employment programs (EP) and training programs (LMT)



- We get similar results when we adjust for employment subsidies.
- Adjustment slows down the rate of employment growth.

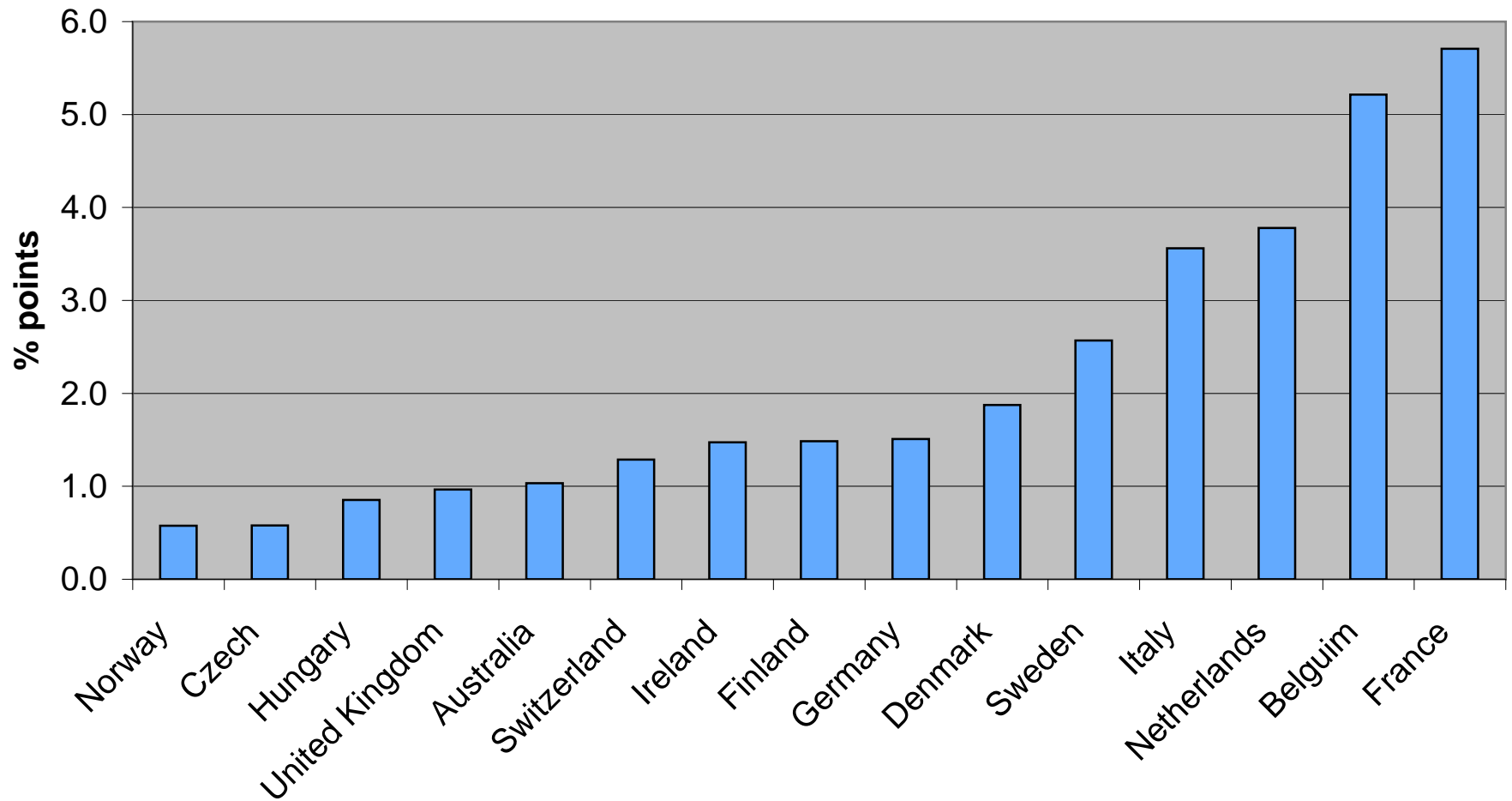
Open and Adjusted Employment Rates in a Subset of European Countries

Countries: DNK, FIN, NLD, and NOR are the corporatists. Adjusted employment subtracts participants in subsidized employment programs.



Differences between Open and Full Employment rates, 1998-2004 averages

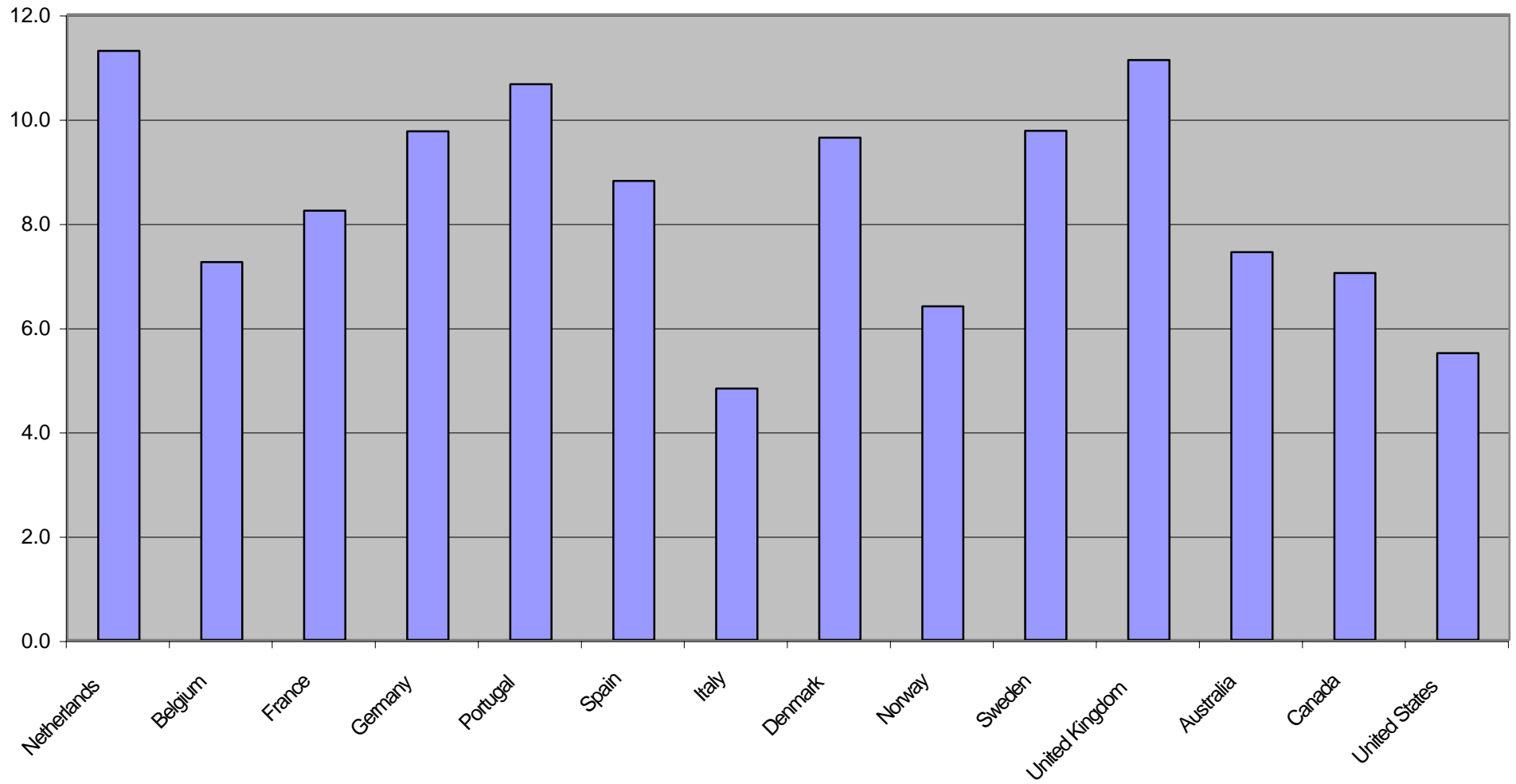
Full employment rates are net of subsidized employment program participants (excl. category 5.3)



- Each person in an ALMP reduces open unemployment by .3 persons but raises true unemployment by .7 (Lindbeck, 2006).
- The gap between open and nonsubsidized employment rates is substantial.
- Full unemployment rates are much higher than open unemployment rates.

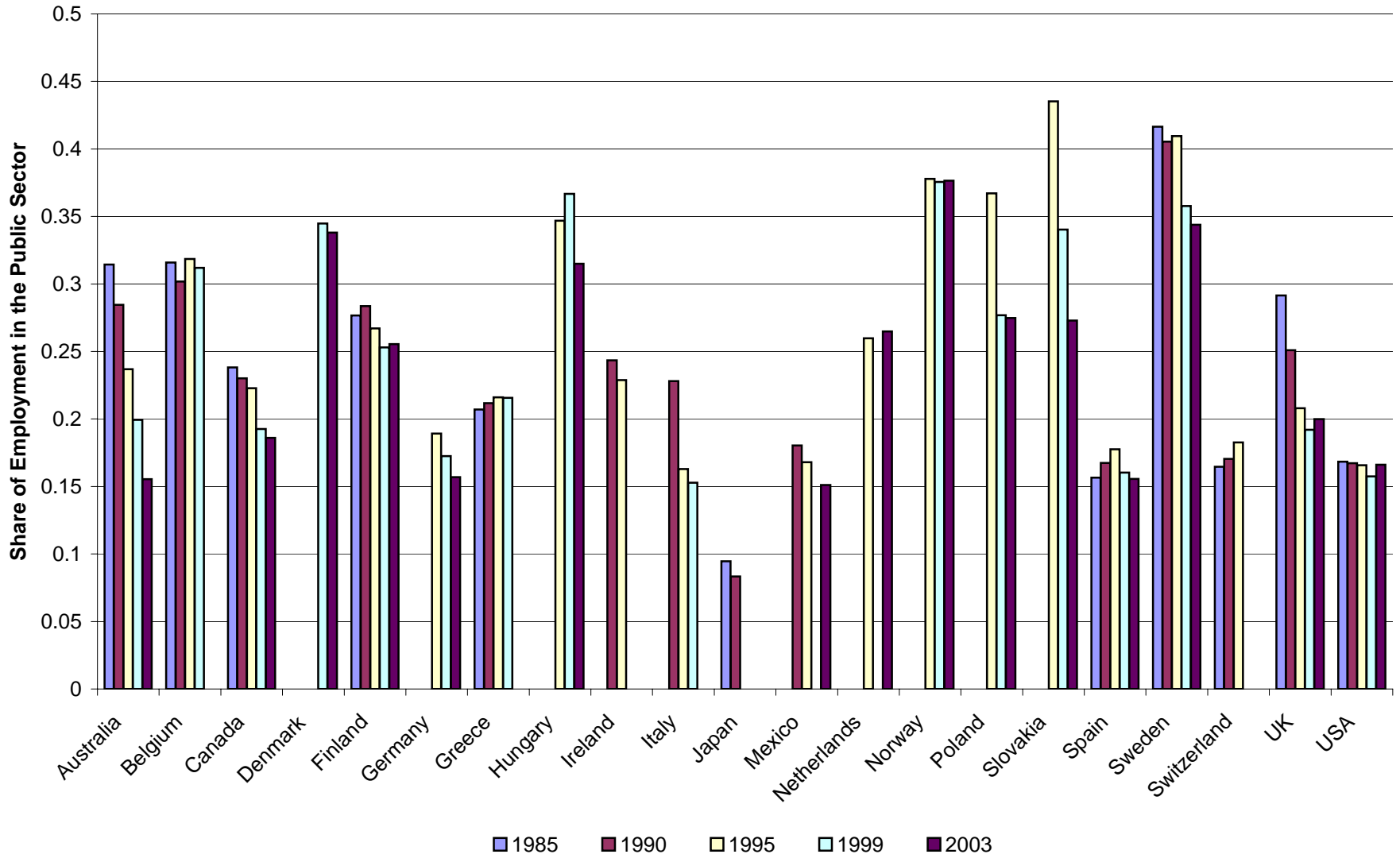
- Disability programs are major contributors to lower levels of European employment.

Non-employed disabled workers (% of labor force)
Source: OECD Social Indicators, 2005



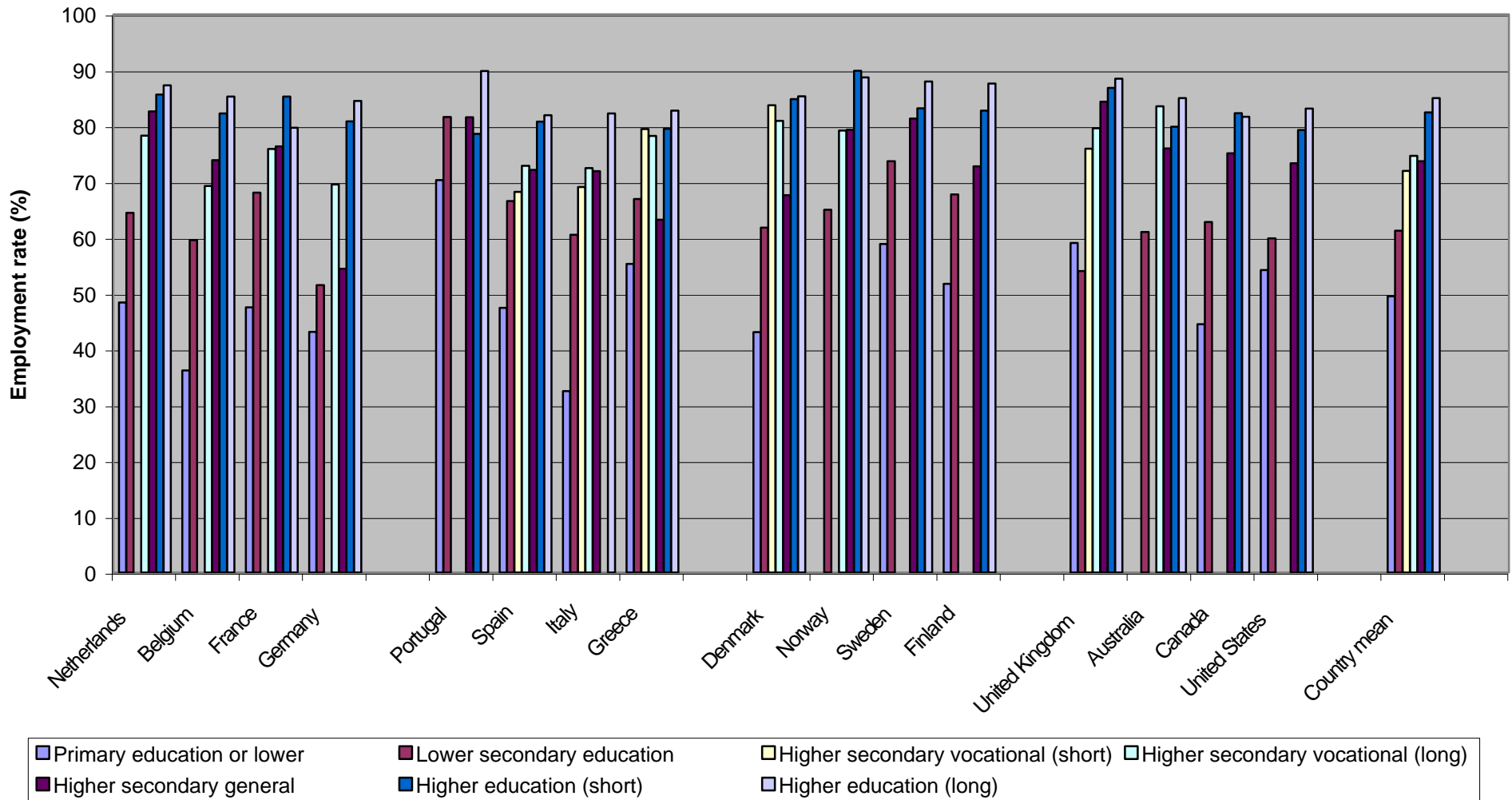
- A larger fraction of the EU and especially corporatist EU employment is in the government sector.
- It is an index of regulatory activity and also unproductive activity.
- It creates a serious political economy problem because if one adds current dependents to government workers there is much inertia to protect the status quo.

Public Sector Employment Share

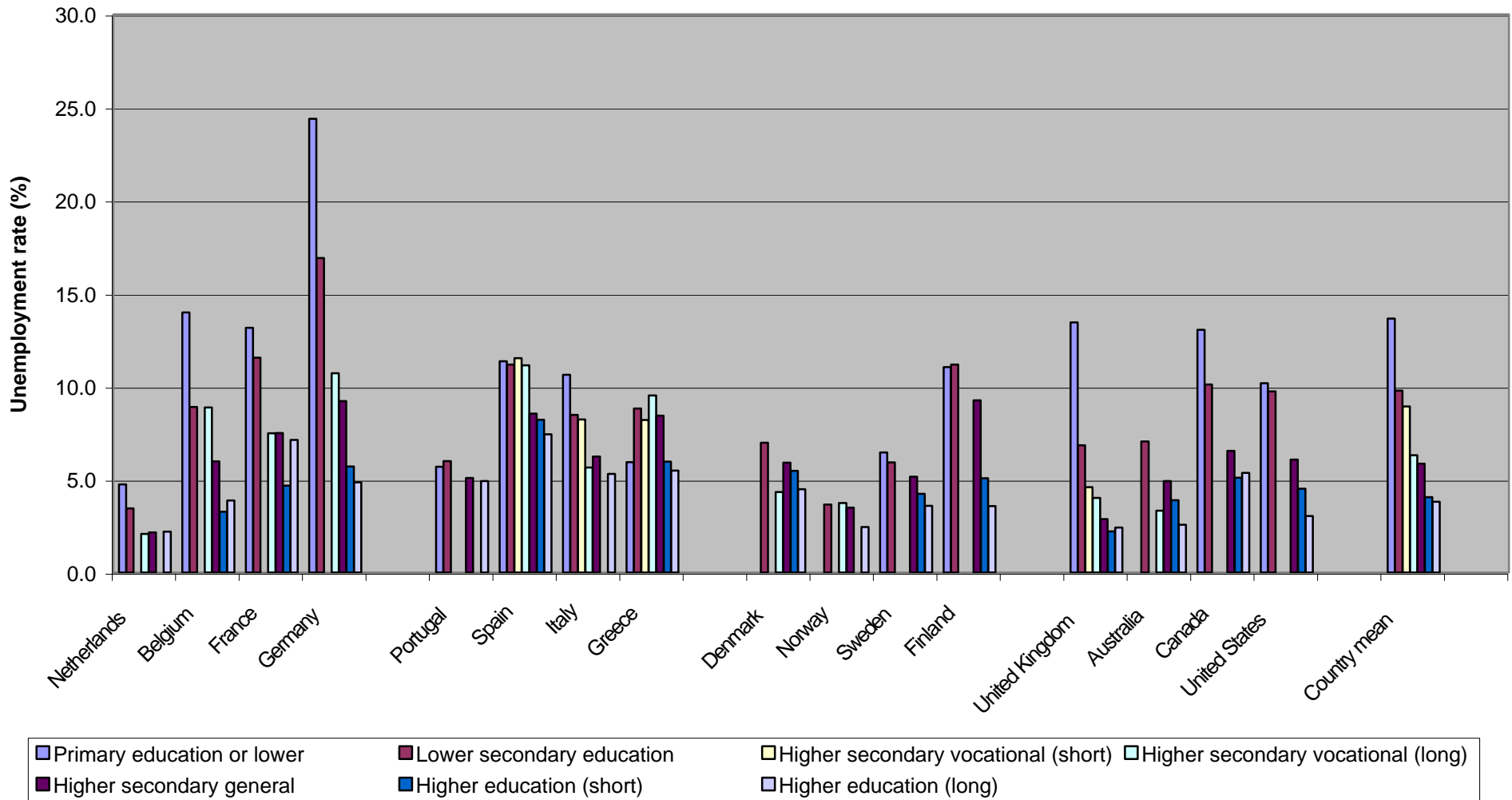


- Education is a major determinant of long run employment and unemployment.

Employment rates by level of education (2003)
Source: OECD, Education at a Glance 2005

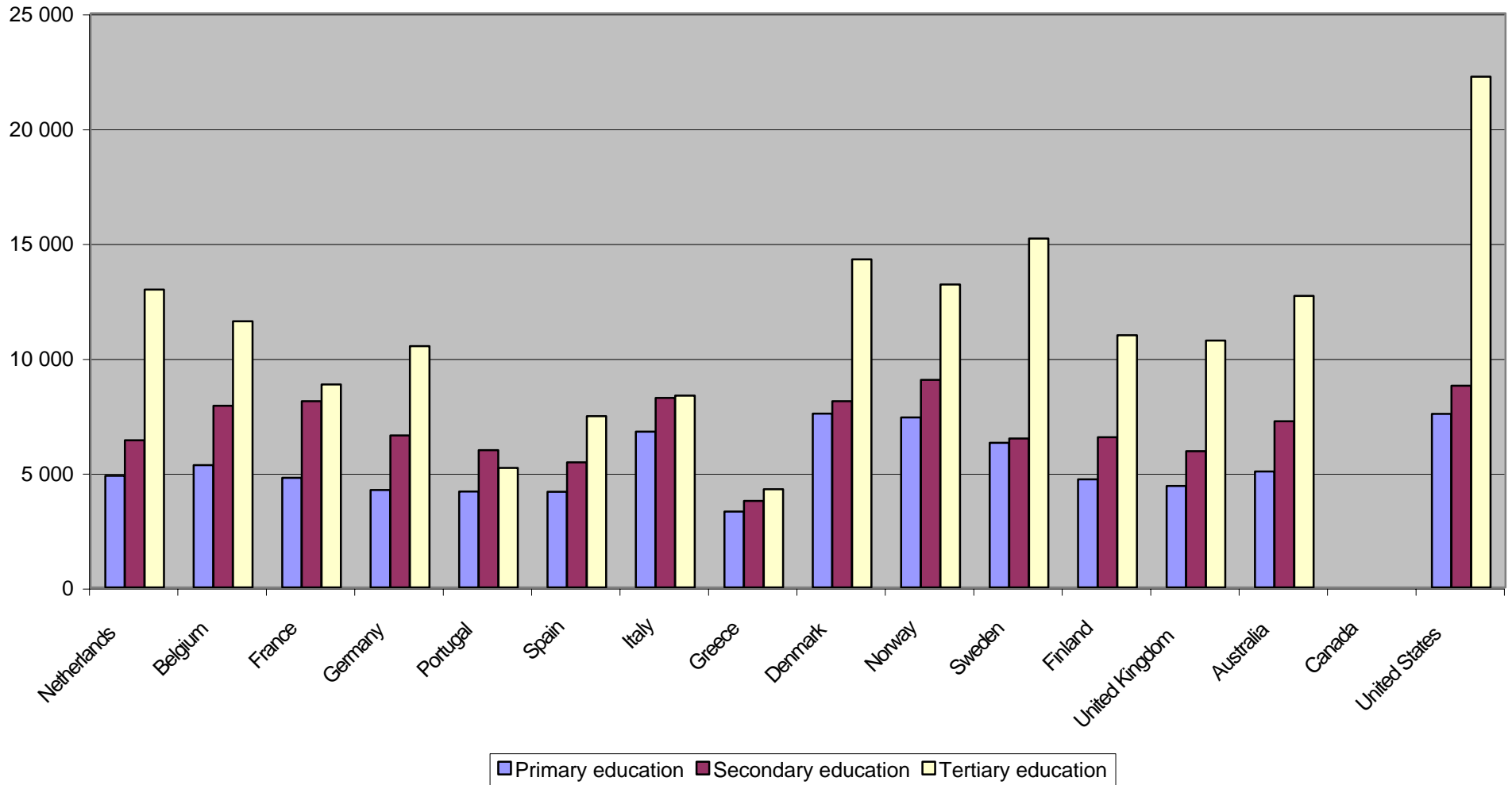


Unemployment rates by level of education (2003)
Source: OECD, Education at a Glance 2005



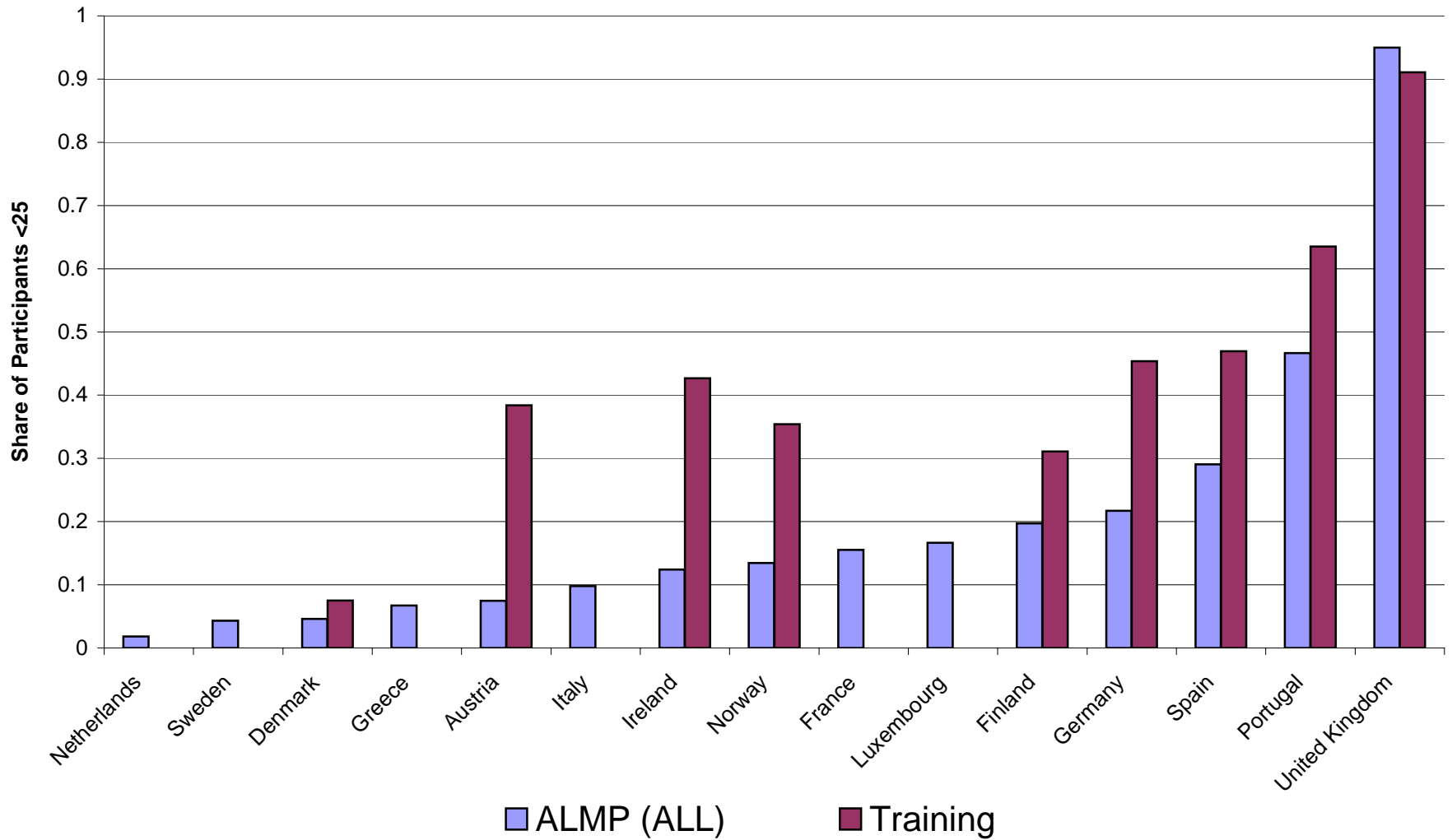
- But educational expenditure per student is much lower in the EU than in the U.S.

Real expenditure per student in US \$
Source: OECD in Figures, 2005

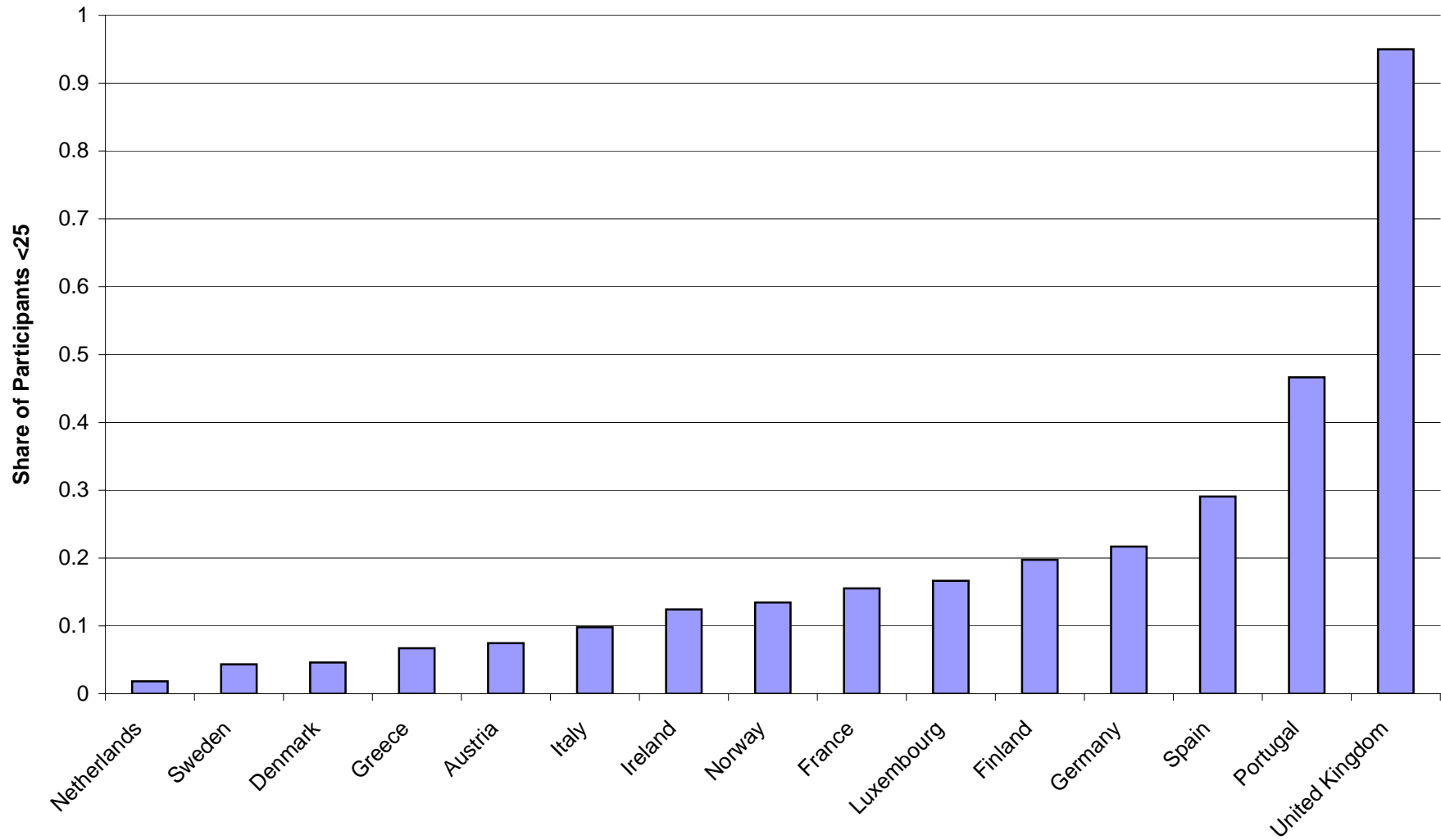


- The evidence on training programs suggests that they are effective when they offer genuine education (classroom instruction) and are targeted to the young.
- However much ALMP and training program activity is targeted to older workers.

**Share of Young ALMP Program Participants
(1998-2003 Average Conditional on Young Participant Data Reported)**

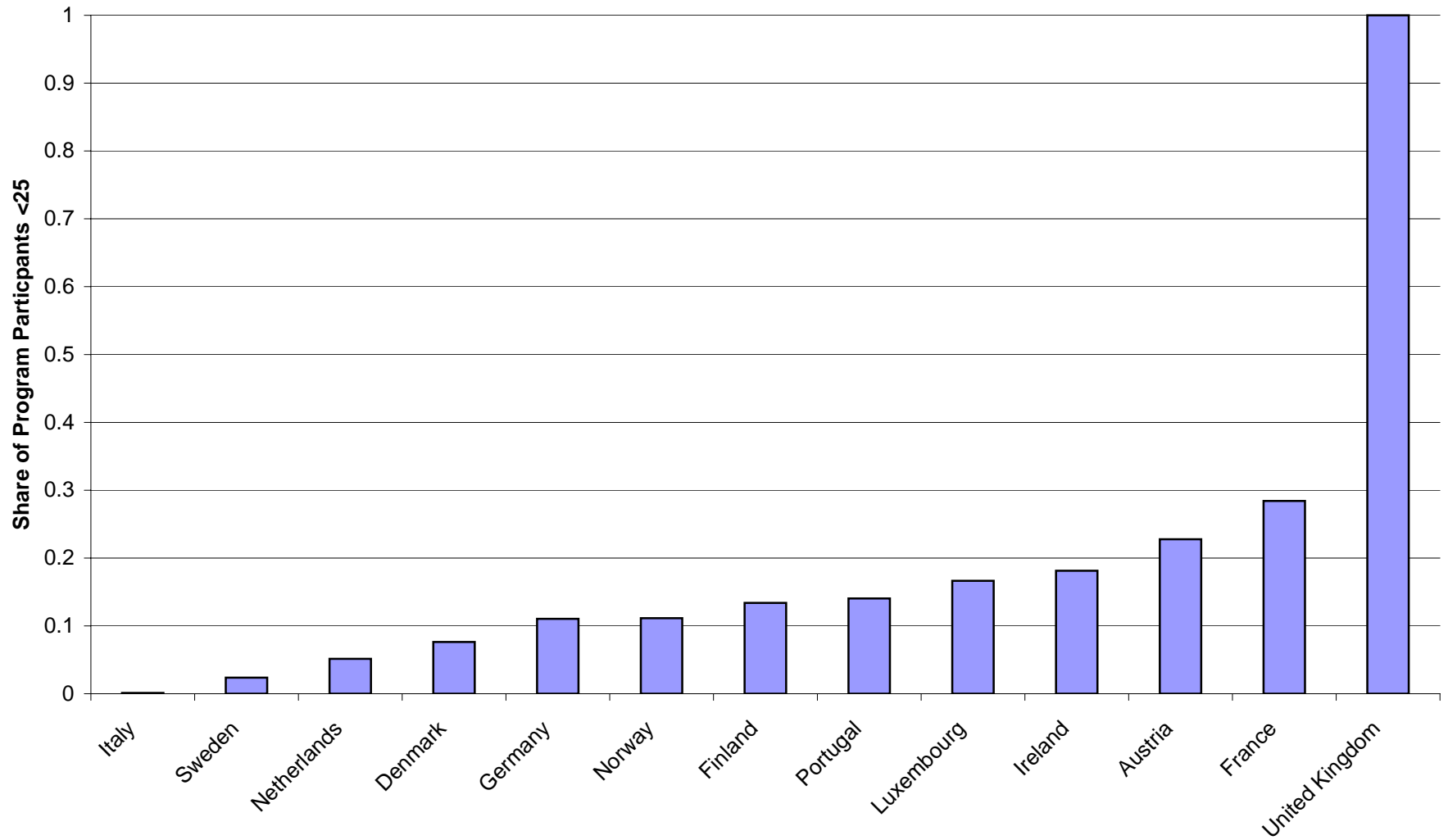


**Share of Young ALMP Program Participants
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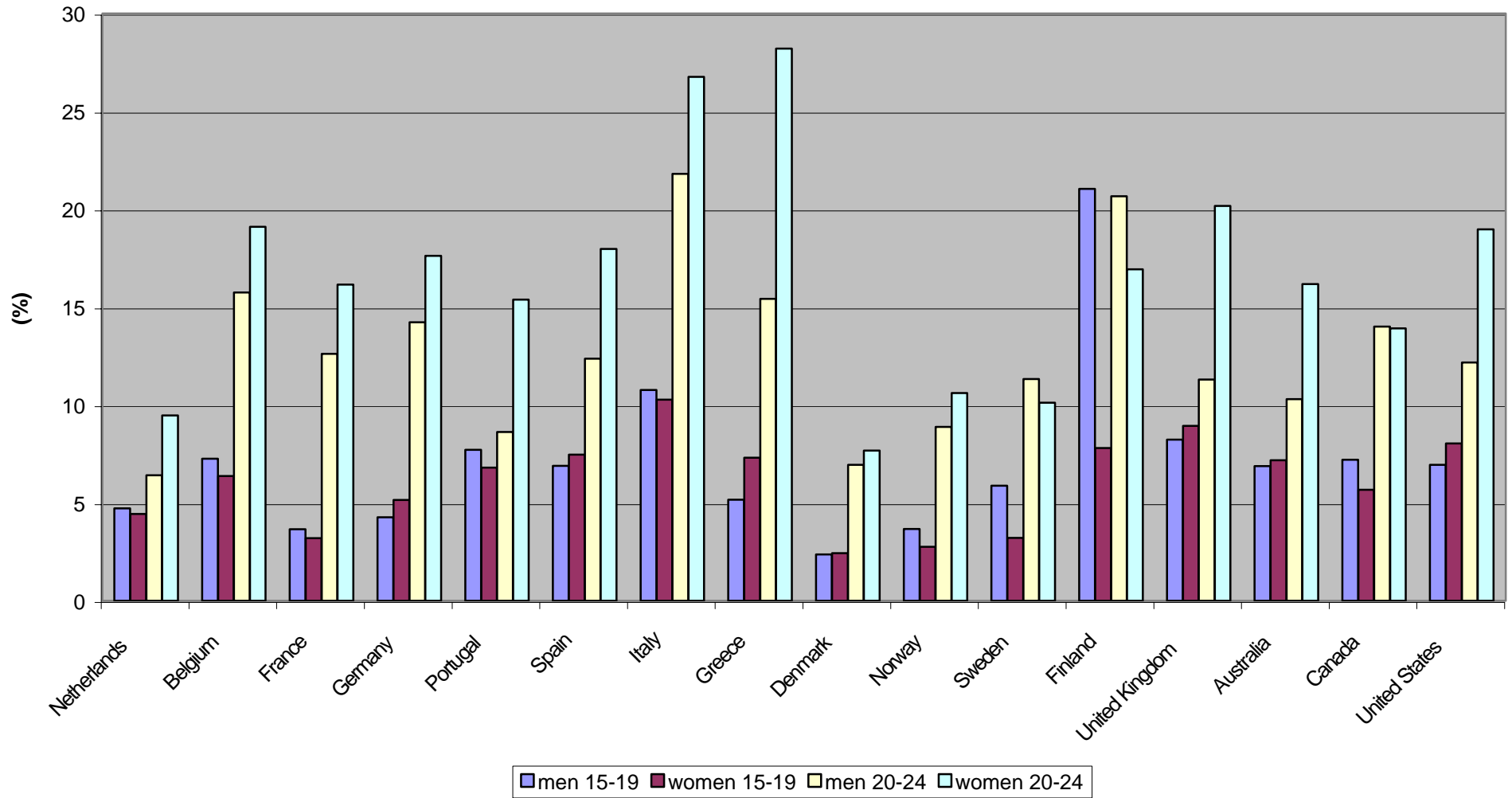
- Job creation schemes largely focus on older workers as well.

**Share of Job Creation Program Participants Age 24 and Less
(1998-2003 Average)**



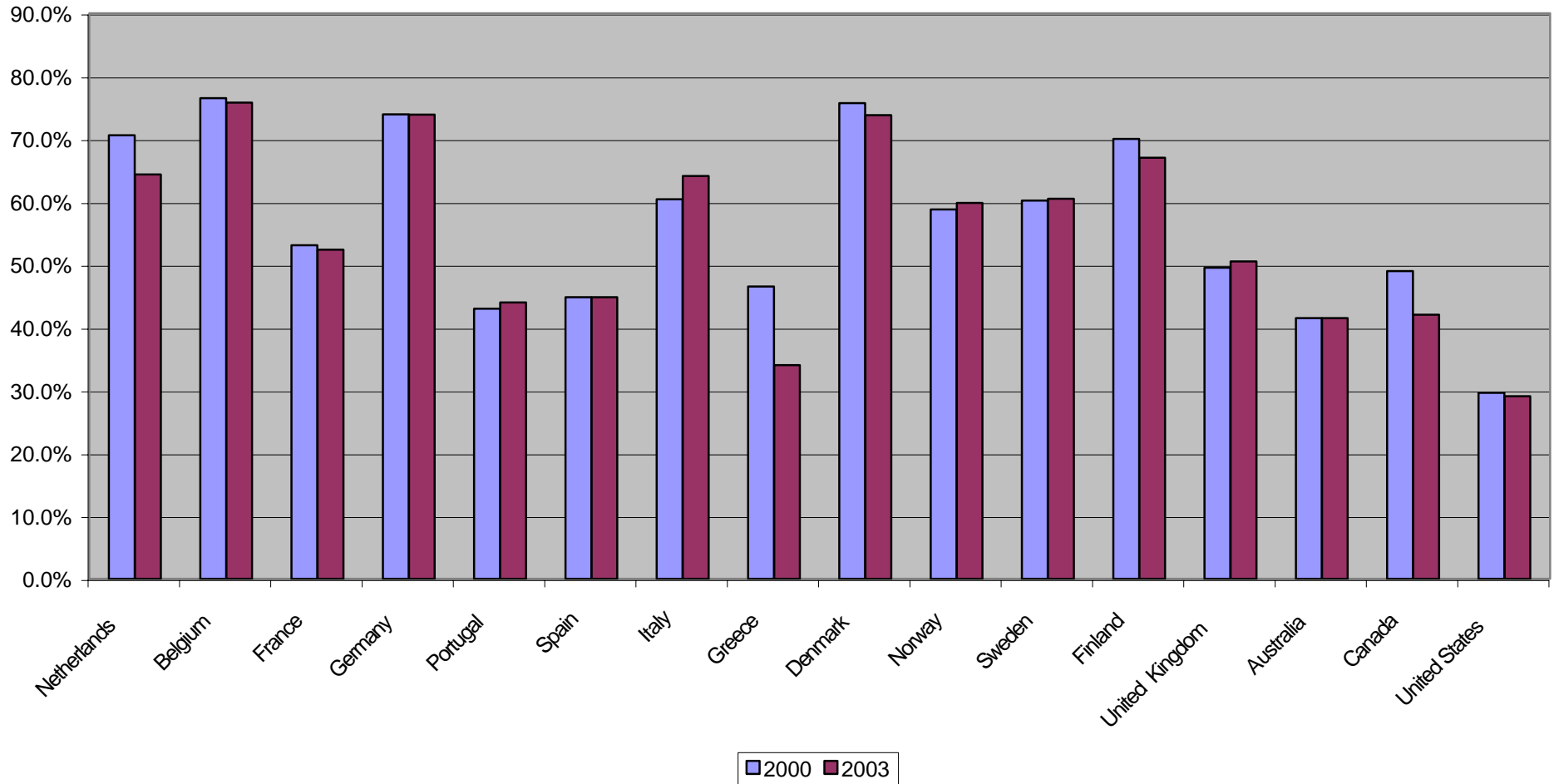
- Current policies neglect large groups of youth neither in school nor employed.

Fraction of young cohorts neither in school nor employment (2002)
 Source: OECD Social Indicators, 2005



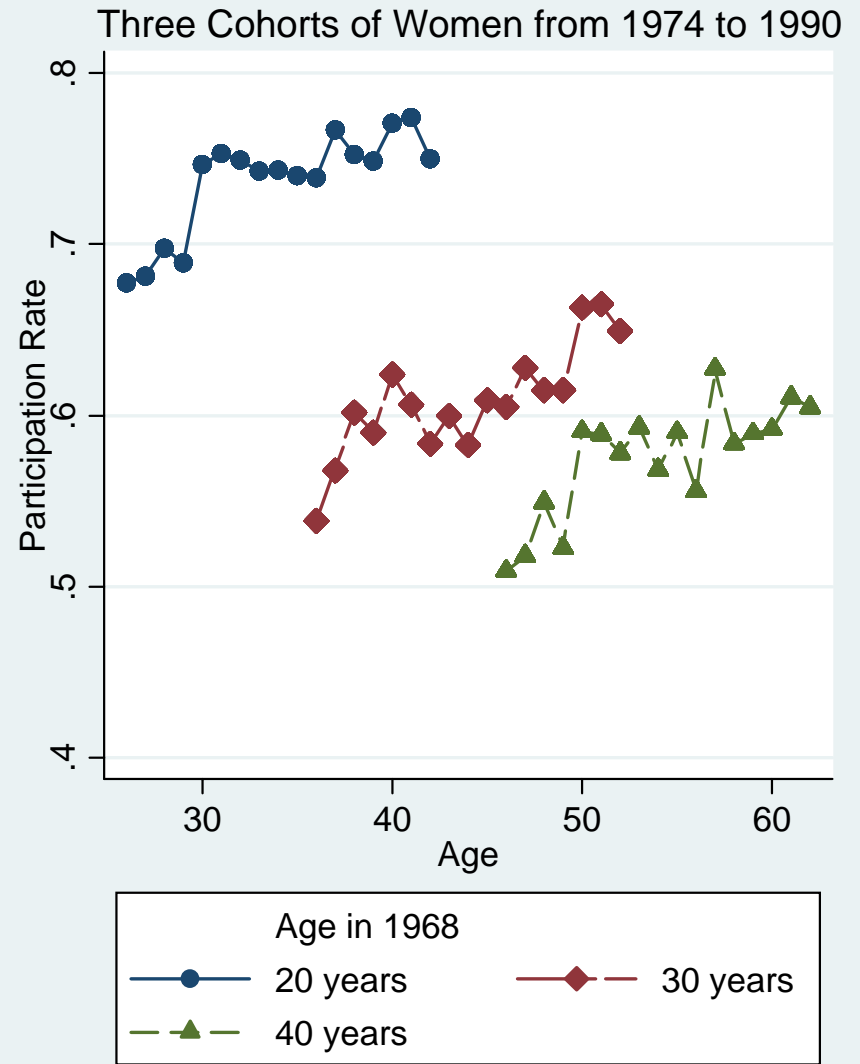
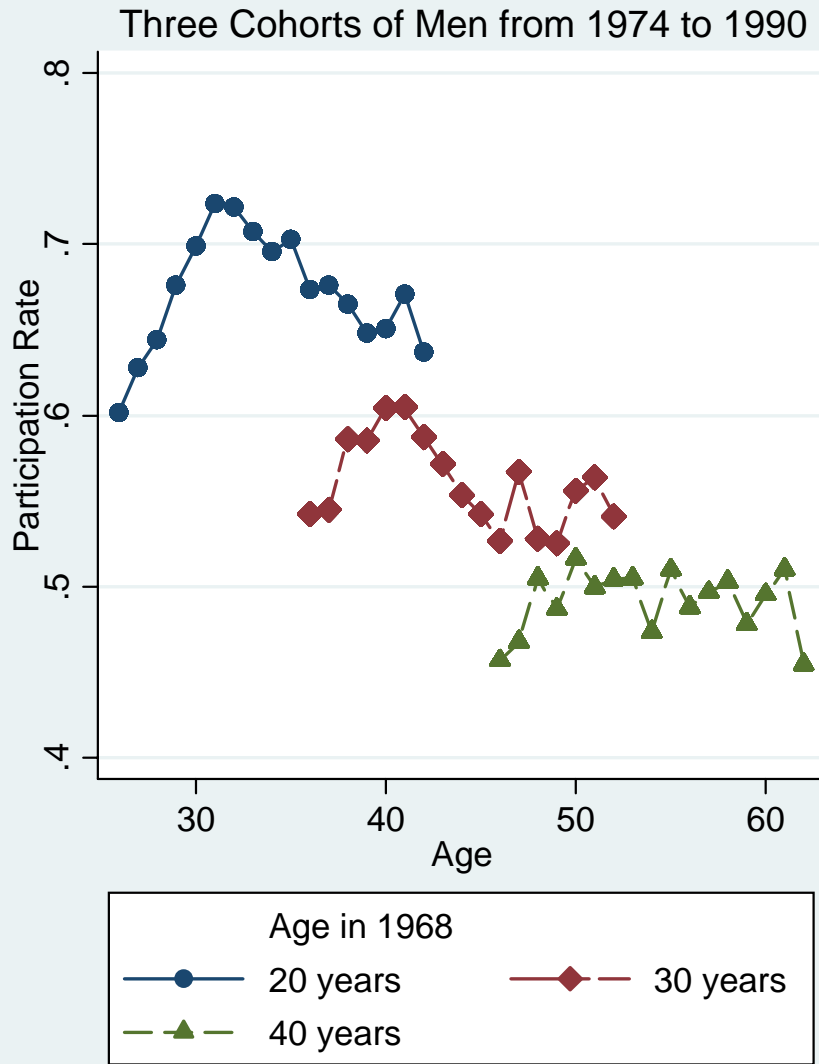
- Tax and benefit rates discourage work.
- They also discourage investment in skills.

Total marginal tax wedge on personal income, including consumption taxes (% of income) for a single worker earning the average production wage without children (US: no cons. taxes available)
Source: OECD Tax Data Base, 2005



- There is concern that participation in generous welfare states leads to erosion of the work ethic and of participation in the social compact.
- Cohort drift in welfare participation.
- This is a serious long-term problem for the European welfare state.

Sick Leave Participation for Men and Women.



Sample: Labor force participants, ages 26-62.

Source: Ljunge (2006)

- European welfare states are not creating incentives for investment in skills needed for performance in the global economy.
- The policies reduce incentives to work and create dependency.
- The current arrangement is rigged against reform because so many persons are beneficiaries of the current system.
- Reforms have occurred, but they are small.
- More drastic reforms are needed.

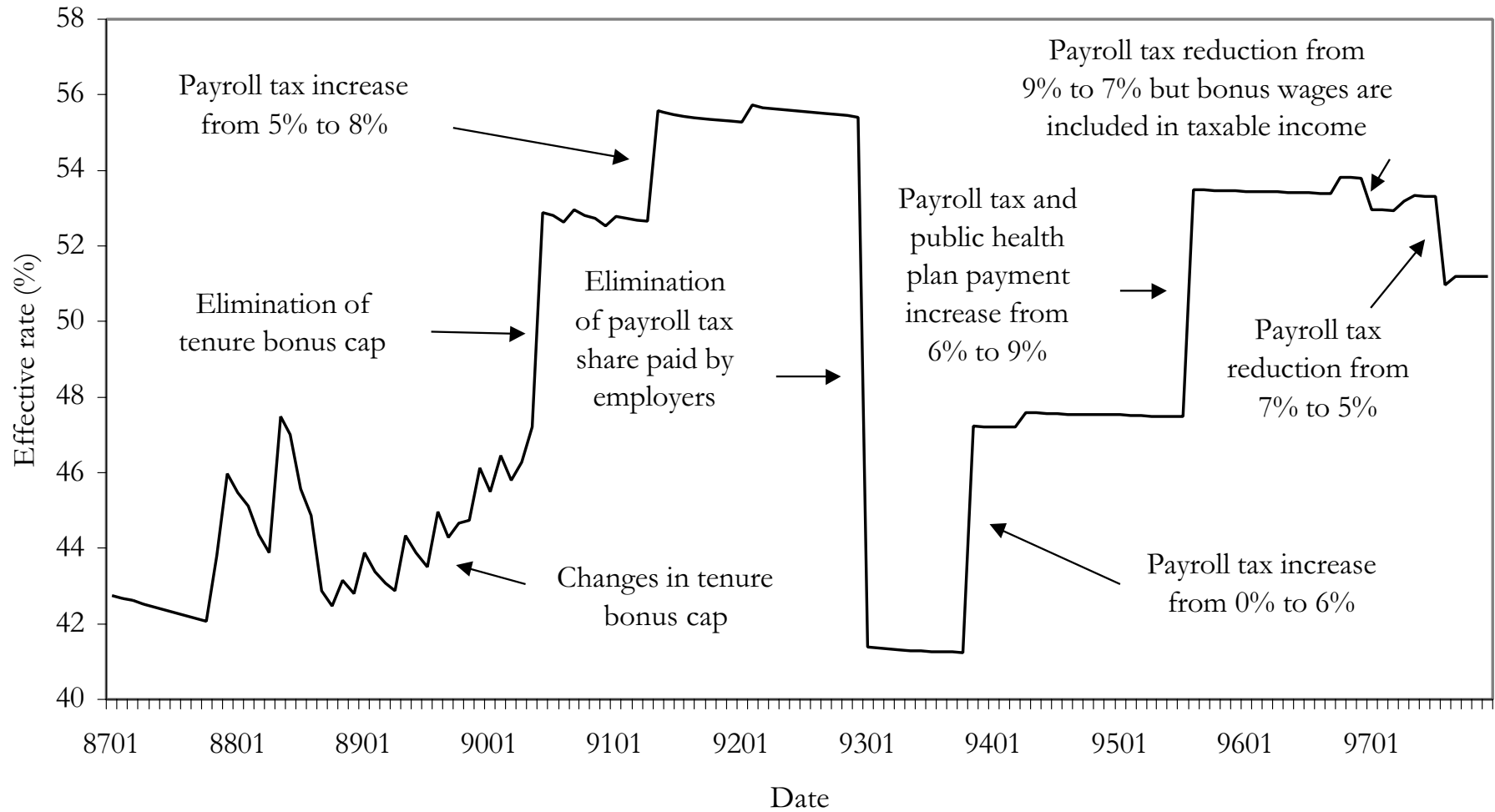
II. The OECD Methodology of Evaluating Institutional Effectiveness: An Alternative

- The OECD, following the lead of many scholars of European unemployment, analyzes the effectiveness of institutions by comparing the economic performance over time of countries with and without various institutions.
- The countries studied are very heterogeneous and the time series analyzed are short.
- Many measurements of institutions are indexes which are not quantified in terms of their incentive effects on firms and workers.

- It is widely remarked that such evidence is fragile and unreliable.
- A template for future OECD studies would be to follow the lead of students of the Latin American labor market and quantify the costs and incentives of institutions governing the labor market.
- This would reveal how quantitatively small the reforms in the past decade have been.
- Scholars of Latin America also collect micro data on costs, employment, wages and turnover in their countries.

- Latin America has conducted many policy experiments good and bad which can teach lessons transportable elsewhere.
- This policy instability produces sometimes crazy economic experiments from which we can learn about the basic economics of incentives.

Evolution of non-wage costs paid by employers - Peru



Note: Non-wage costs paid by the employer include payroll tax, tenure bonus, public retirement plan payments and public health plan payments. Vacations and holiday bonus are included in the effective rate, although they were not modified during the period, and stand for 25% of non-wage costs paid by the employer (2 bonus wages and one month of paid vacations per year).

- Using these and other data the costs of institutions (unions, labor market regulations, severance payment schemes, minimum wages) are quantified.
- Cost data allow analysts to summarize a variety of features of labor market institutions into an interpretable schedule.
- The cost data can be joined to labor demand estimates which exhibit a stability across countries and time periods.

- Labor demand curves are downward sloping.
- This is found around the world.
- Elasticity of demand for labor with respect to wage ($\sim .7$); Hamermesh (2004).
- Regulations, unions and many institutions raise labor costs and reduce employment.
- Binding minimum wages reduce employment.

- Payroll taxes reduce employment unless offset by public benefits.
- Employment protection creates slow adjustment, discourages investment, and reduces long run demand for labor.

- Using measured cost quantifies the scale of true reforms and gives a more accurate measure of their magnitudes.
- It reduces the burden on short time series cross section data by summarizing the effects of institutions on a single schedule comparable across time and space.
- It allows analysts to use well established economic principles to interpret the data.
- Current practice of using *ad hoc* measures of the costs of institutions on highly aggregated statistics from very heterogenous countries is guaranteed to produce the finding that “institutions don’t matter” when in truth they do.

- Just as we should ground the analysis of institutions on the demand for labor using economic analysis, so we should motivate the analysis of incentives on labor supply.

III. Long Term Skill Strategies Based on the Technology of Skill Formation

- The current training and education policies in place in many OECD countries are shotgun in nature.
- Something for everyone policies are politically popular but economically ineffective.

Skill Formation

- Recent work in the economics of skill formation emphasizes the importance of recognizing the interrelated life cycle dynamics of skill formation.
- Investments in human capital starting at early ages have profound effects on skills and abilities throughout the life cycle.
- The OECD should recognize that the most effective way to raise long term economic performance is to boost the skills of workers.
- Recent research demonstrates that effective skill enhancing policies start at early ages.

- Early interventions for disadvantaged children promote schooling, raise the quality of the workforce, enhance the productivity of schools and reduce crime, teenage pregnancy and welfare dependency.

- They raise earnings and promote social attachment. Focusing solely on earnings gains, returns to dollars invested are as high as 15–17%.
- These policies promote social equality, economic opportunity and at the same time improve economic productivity.

- A large body of research in social science, psychology and neuroscience shows that skill begets skill.
- Learning begets learning. The earlier the child is stimulated and encouraged, the more successful the adult.
- There is substantial evidence of critical or sensitive periods in the lives of young children.
- Environments that do not stimulate the young and fail to cultivate both cognitive and socioemotional skills, place children at an early disadvantage.

- Once a child falls behind, he or she is likely to remain behind.
- Remediation for impoverished early environments becomes progressively more costly the later it is attempted.
- The track record for criminal rehabilitation, adult literacy and late-teenage public job training programs is remarkably poor.

- This has profound implications for ALMP and training programs which typically start in the adolescent and early adult years and target disadvantaged persons.
- They come too late and at current levels of funding are ineffective.
- Making such programs effective would require substantially greater expenditure on them. We would have to venture into unknown territory to make them effective and this would entail substantially greater cost.

- The most effective policies start much younger and create the skills needed for success.
- ALMP policies will be much more effective if the people coming into them are much better trained.
- Given the importance of family environments, such policies also facilitate immigrant assimilation.

- Impoverished early environments are powerful predictors of adult failure on a number of social and economic dimensions.
- Impoverishment is not so much about money as it is about resources of cognitive and socioemotional stimulation given to young children.
- Experimental interventions that enrich early childhood environments produce more successful adults.
- These interventions raise both cognitive and noncognitive skills.

The Argument in a Nutshell

- I.** Life cycle skill formation is dynamic in nature. Skill begets skill; motivation begets motivation. If the child is not motivated and stimulated to learn and engage, the more likely the adult will fail in social and economic life.
- II.** Many major economic and social problems can be traced to low levels of skill and ability in the population.
- III.** Abilities are multiple in nature.
- IV.** Much public policy discussion focuses on promoting and measuring cognitive ability and especially IQ.

- V. Cognitive abilities are important for socioeconomic success.
- VI. But, a large body of recent work reveals that socioemotional skills are also important for success in life.
- VII. Motivation, perseverance and tenacity feed into performance in society at large and even affect scores on achievement tests.
- VIII. Early family environments are major predictors of both cognitive and socioemotional abilities.
- IX. Skill gaps across children from different socioeconomic groups open up early and persist.
- X. Schooling does little to eliminate or exacerbate the gaps.

- XI.** Family environments in many OECD countries have deteriorated over the past 40 years. Many immigrant enclaves do not invest in the skills of their children.
- XII.** Experimental evidence supports the large body of evidence that adverse family environments promote adult failure.
- XIII.** If society intervenes early enough, it can affect both cognitive and socioemotional abilities.
- XIV.** Early interventions promote schooling, reduce crime, promote workforce productivity and reduce teenage pregnancy.

- XV.** These interventions have high benefit-cost ratios and rates of return.
- XVI.** Early interventions have much higher returns (15–17%) than other later interventions such as reduced pupil-teacher ratios, public job training, active labor market programs, convict rehabilitation programs, tuition subsidies or expenditure on police.

Remediation and Active Labor Market Programs

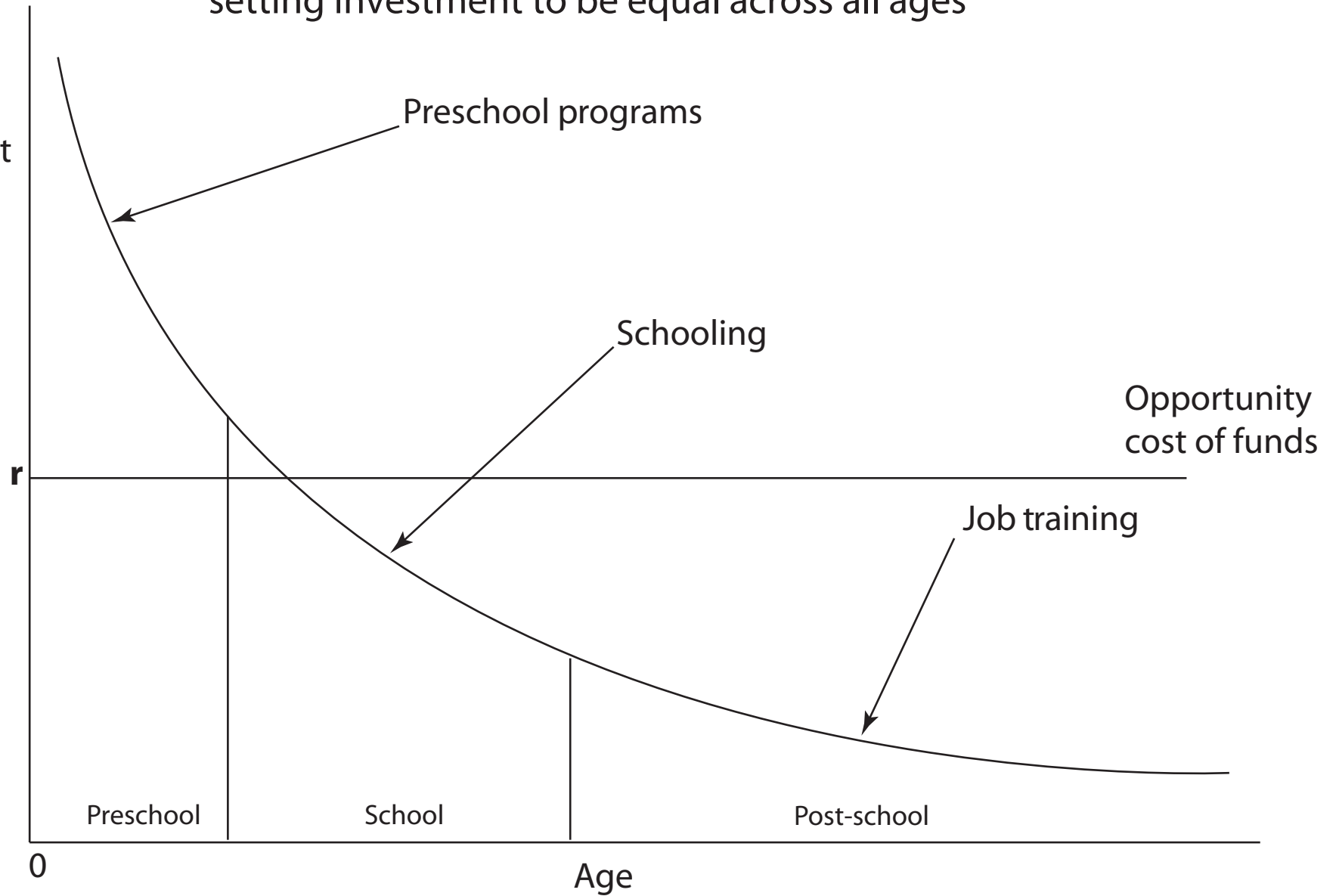
- The track record of criminal rehabilitation programs, adult literacy programs and public job training programs in boosting skills is poor.
- Recent studies of adult literacy programs show that the main reason they fail is that people do not stick with the programs.
- A failure of noncognitive skills.
- A few selectively targeted versions of these programs may yield modest benefits.

- None of these late-stage remediation programs raise more than a small proportion of participants out of poverty.
- The dynamics of human skill formation as analyzed in Cunha and Heckman (2003) and Cunha, Heckman, Lochner, and Masterov (2006) reveal that later compensation for deficient early family environments is very costly.
- Lack of early skill and motivation begets lack of future skill and motivation.
- If we wait too long to compensate for the accident of birth, it becomes economically inefficient to invest in the skills of the disadvantaged.

- An important trade-off exists between equity and efficiency for adolescent and young adult skill policies.
- There is no such trade-off for policies targeted toward disadvantaged young children.
- This has profound implications for the appropriate design of active labor market policies.
- The following figure captures the findings of a large literature.

Rates of return to human capital investment initially setting investment to be equal across all ages

Rate of return to investment in human capital



Rates of return to human capital investment initially setting investment to be equal across all ages

- The economic returns to early interventions are high.
- The returns to later interventions are lower.
- The reason is the technology of skill formation.
- Skill begets skill and early skill makes later skill acquisition easier.

The Problem of the Transition

- For low skill adults caught up in the transition, human capital investment is inefficient.
- Wage subsidies are effective in promoting employment if not in boosting skills.
- Need to make sure that they are cohort specific.
- We should not encourage the young to count on subsidies rather than investing in themselves.

IV. Summary

- The OECD focus on unemployment and short term employment problems emphasizes short run fix-ups rather than long term solutions.
- The new Report focuses more on levels of employment and dependency than did the 1994 Report, but the main focus of OECD and much of the literature is still on the problem of unemployment.
- Substantial unemployment and employment problems are disguised by ALMP and other social programs.

- Incentives for employment and skill investment in OECD Europe are weak.
- A problem of long term erosion of the work ethic and social participation.
- Corporatist state labor markets are not as efficient as the U.S. labor market. They are just effective in disguising long term problems.

- The methodology of comparing the effectiveness of OECD institutions is flawed because it does not quantify costs and benefits of the institutions, or use economics to measure their effect.
- Using highly aggregated data on heterogeneous countries with few degrees of freedom and *ad hoc* measures of costs and incentive features of institutions is rigged to find the conclusion that “alternative institutions are equally good”.
- Poorly measured institutional details lead to an inability to distinguish any effects of the institutions.

- Quantifying the effects of institutions on costs and incentives allows analysts to quantify reform and to use economics to measure the impact of policies.
- This coupled with micro data within countries produces much more convincing evidence of the costs of regulation and inflexibility.
- OECD should adopt a long run view on how to raise the skills of workforces.
- OECD skill formation policies should recognize the technology of skill formation and the importance of a unified life cycle strategy that recognizes that skill begets skill, and the importance of the early years in producing successful adults.

- Later remediation is ineffective even when “later” is the late adolescent years.
- Wage subsidies for older, disadvantaged and less able workers have a role to play but they have to be designed to phase out across cohorts and not encourage workers not to invest in their skills.