

**Comment on
Jorgen Elmeskov, John Martin, and Stefano Scarpetta:
Key lessons for labour market reforms:
evidence from OECD countries' experiences**

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I find this a very interesting and informative paper, which ought to be compulsory reading for all journalists and politicians in Sweden. A very large amount of empirical information is condensed in this work, which tries to distil the main lessons from recent labour market reforms in the OECD countries: Why did some succeed, and some fail?

This is an extremely important question. Political obstacles to reform are often tremendous. This paper helps identify and overcome such obstacles by pointing out what the "success stories" have done and what makes them different from others. The authors try to sort out good measures from bad and see how policy actions counteract or strengthen each other. So in an ideal world, their paper would help politicians to actually pursue and implement a working strategy against unemployment.

My comments are divided into three parts: the analysis, the political conclusions, and a prediction on the Swedish development using the analytical framework in the paper.

1. The analysis

The method of this paper is a fairly straightforward econometric analysis. It takes you as far as such analyses do, including the unavoidable pitfalls. The findings can be summarised as follows:

- *Wage determination* is, by far, the single most important variable affecting unemployment, with the Calmfors hump visible. This is no news, but there are more observations over time than in previous studies, and there is additional information on how institutions change.

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- *Employment protection* laws come in second. *Tax wedges* constitute a weak third, and then there is slight evidence for *unemployment benefits* as fourth.
- As regards *active labour market policies* the evidence is inconclusive, because of Sweden. If Sweden is excluded, they seem efficient, if Sweden is included, they are not. This is a new and important result, because ALMPs in Sweden have previously been judged as rather efficient. The reason this result is contradicted here is probably that we now have more observations than before. We have lived through a period where ALMPs have exploded in Sweden, and because their marginal productivity obviously has been declining, this weighs down on the end result.
- Another conclusion is that *macroeconomic stability* is important but that it interacts with sound supply-side structures. Instability is particularly dangerous in countries with rigid labour markets, because cyclical unemployment then easily becomes structural.

I have no problems agreeing with these results; they fit in nicely with my own prejudices. But I cannot avoid some methodological question marks.

First there is the question of how to quantify institutional arrangements and their effects. In Table 2, there are some pretty fishy technical snags hidden in the footnote, which states that the coefficients represent the unemployment response to "a unitary change in the independent variable". Exactly how employment protection laws and such are transformed into "units" is never fully explained. Surely, it can be done, but it raises the issue of scaling when interpreting the quantitative results.

Secondly, when one searches for so many variables/explanations, there is the problem of multicollinearity. Taxes and employment laws may, for example, affect wage negotiations. The authors have identified several correlations and complementarities. Often strict employment protection laws, unemployment benefits, and the size of the tax wedge are positively correlated.

So what we see in the tables might be the effect of a *specific* set of institutions rather than the effects of different parameters that can be grouped together in several ways.

2. The issue of politics

If so, this is an important result, especially for Sweden. Namely, that the core elements of what has been considered the paramount unemployment-reducing "Swedish model" (strong unions, high taxes, employment protection laws, etc.), taken together, may *create* unemployment or at least diminish the chances of reducing it.

This question is important when it comes to politics. The authors' most important conclusion is that not one, single policy measure is enough. A broad range of measures is necessary. The success stories are those countries that have undertaken a broad range of changes and (in total) have clearly moved in a certain direction. But if reform must be comprehensive to succeed, then one cannot really divide the unemployment problem and its remedies into several separate sub-components! Rather, maybe we should talk about various *clusters* of components—certain combinations of policy institutions, which are more or less favourable to creating employment.

This is important for policy making. A crucial issue concerns what has been most important in the success stories. The mass of measures? Or that the most important are chosen? Or are both necessary? To be more specific: according to the numbers, wage formation is by far the most important factor. Is that consequently the key that dominates other measures?

Are there measures that work in the wrong direction but are too weak to counteract *good* measures? For example, can one afford high tax wedges and high unemployment benefits *if* one gets wage formation going? Or is it impossible to get wages in shape unless you fix taxes and employment protection laws?

The opposite question is also relevant. Are there measures that have such a strong negative impact that they dominate several *good* measures? If one lowers tax wedges but at the same time for some other reason messes up wage formation, will the result then be more unemployment?

The questions may sound silly. But the reason I ask is of course that wages, as a separate issue, keep coming back into the Swedish debate over and over again—and that the remedies in the Swedish discussion all too often are separated from taxes and legislation. The Social Democratic government admits that there has been a wage formation problem. But it sets its hopes on a special rapport with unions, which enables Sweden to achieve a more efficient wage for-

mation without the kind of changes of the tax system, employment protection laws, and unemployment benefits that are seen as reactionary.

The obvious question is whether this is possible—or futile. The paper is not crystal clear here. My own conclusion is that complementarity is indeed important. It is not possible to isolate wage formation. Reforms of wage formation should go together with tax reform and other labour market reforms to be successful.

3. Will Sweden succeed?

This brings me to the likelihood of success in Sweden, given the analytical framework of Elmeskov, Martin, and Scarpetta.

One policy conclusion of this paper is that the strength of insiders must be undermined. The success countries have succeeded in doing just that, and for three reasons:

1. The measures instigated were *broad*, directed at many groups, making the losses of any particular group seem less excessive.
2. Often programmes were decided in times of *crisis*.
3. In all of the success cases, a *new government* was instrumental.

The failures show the opposite. They did some things necessary, but not others; they have not been in deep crisis or have failed to respond to crisis. One reason, according to this paper, is often a very strong commitment to egalitarian distributional principles.

The conclusion is optimistic in the sense that unemployment can be overcome. But it is pessimistic in the sense that the process takes a long time, includes across-the-board measures, and aims at the insiders, that is, it is a politically very difficult task to undertake.

If one applies the analytical framework of this analysis to Sweden, it tends to make me pessimistic rather than optimistic. The paper as well as the 1997 *OECD Economic Survey of Sweden* identify a set of detailed policy recommendations for improving labour market flexibility and for reducing structural unemployment: increased wage and labour market flexibility, reform of unemployment benefits and related benefit systems, increased working-time flexibility and reform of employment security provisions, enhanced effectiveness of labour market policies, improved labour force skills, and enhanced product market competition.

Looking at the Swedish response, the government has proceeded mainly by education and training. The *1998 OECD Economic Survey of Sweden* states that such an approach is welcome. But education efforts must be underpinned by economic structures that are conducive to human-capital formation not only in a general way, but also to ensure that clear signals guide occupational choice. Specifically, the wage-formation process must be restructured. Although extensive education efforts might work to validate the present compression of wages relative to productivities, this will only be fully effective in the longer run and can only belatedly start to offset the forces that work to keep unemployment high. So the structural reform programme must be revitalised.

The OECD is very careful here. But going through the proposed actions and what actually has been done, it is obvious that Sweden is not following OECD advice. In several respects, most noticeably the unemployment compensation level, Sweden has moved in the opposite direction. Indeed, Margareta Winberg, former Labour Market minister, publicly condemned the OECD programme, saying it was neo-liberal (which is an insult in her circles).

Why is Sweden so slow to react to unemployment? Comparing the Swedish institutional and political setting with the analytical framework in this paper shows that Sweden is at odds with the three success criteria identified by Elmeskov, Martin and Scarpetta:

- *The insiders are strong.* The beliefs that have to be broken are strong. And after many years of the Swedish model, institutions create their own support by giving rents to special interest groups.
- Right now, the *crisis consciousness is dissipating*, as cyclical forces also help ease the unemployment problem—temporarily.
- There is no big political crisis looming, which could result in a *new government* in the foreseeable future.

This points to the risk of Sweden not becoming a success story. Actually the risk is the opposite. If we follow the analytical framework in this paper, we must draw the conclusion that Sweden probably will be a failure, and unemployment will persist. Unless, of course, Sweden for some reason would fall outside this framework...

Is Sweden that different? An optimist might say that Sweden managed to get out of the budget crisis of the early 1990s, so why couldn't Sweden fight unemployment as successfully?

Unfortunately, the analogy does not hold. The Swedish politicians were able to react forcefully to the budget crisis because it was so acute, the warning signals were so strong (giant deficits, skyrocketing interest rates), and the solutions were so clear cut: reduce expenditure and hike taxes. Also, strong public finances are not at all at odds with the Social Democratic legacy.

But even though unemployment is high, the warning signals in this case are not as obvious, the costs are harder to pinpoint, and the proposed policy prescriptions are broad. This makes it possible to regard them as a smorgasbord, where you pick only the palatable ones, which is exactly what the Swedish government is doing. The liberalisation of the labour market implied by the OECD prescription is clearly at odds with traditional Social Democratic policies.

The uncomfortable conclusion is inevitable. *If* the analytical framework of this paper is applied to Sweden, labour market reforms will not come until after the next recession. I hope the ensuing discussion will prove me wrong.

