

How do corporatist and liberal labour markets differ, and what does it mean for economic policy?*

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Abstract

How do labour market institutions affect unemployment? Whereas some empirical studies find that mainly such institutions explain unemployment, others argue that this correlation is not robust. By means of a survey of the literature I provide evidence that one explanation for these contradictory results is that labour market institutions affect unemployment differently within distinct labour market regimes. Because of institutional complementarities and a trade-off between external and internal flexibility, certain labour market institutions yield distinct impacts on unemployment within labour markets characterized by a high degree of corporatism, good labour relations, and high internal flexibility. Thus it is crucial for policymakers to take institutional complementarities into account when reforming the labour market.

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1. Introduction

Until now there exists no empirical consensus explanation on the causes of high unemployment. Several econometric studies investigate this topic, but the results are very ambiguous. According to the “standard explanation”, structural unemployment is driven by labour market flexibility. This view is confirmed by many authors who argue that unemployment is primarily the result of rigid labour markets (e.g. OECD, 1994; Nickell, 1997; IMF, 2003; Nickell et al., 2005; Bassanini and Duval, 2006, 2009).

But several researchers object that the empirical support for this view is not conclusive. For example, Blanchard and Katz (1997: 67) argue that “the crosscountry evidence on the relation of unemployment to rigidities is less than fully supportive.” Fitoussi et al. (2000: 257), referring to the OECD Jobs Study series, find that “the institutional reforms in the OECD proposal can only be a small part of the story.” Baker et al. (2004: 15) consider the impact of labour market institutions on unemployment nebulous: “While it is possible to construct multivariate regressions that find significant relationships between various labour market institutions and the unemployment rate, it is also easy to construct equally plausible regressions that do not.” Baccaro and Rei (2007: 563) show that “the impact of labor market institutions is, for the most part, not robust and that unemployment is mostly increased

by high real interest rates and independent central banks.” Freeman (2007: 19) summarises that “despite considerable effort, researchers have not pinned down the effects, if any, of institutions on [...] unemployment and employment.” Bell and Blanchflower (2009: 15f) conclude:

“The orthodox explanation of unemployment that argues that institutions matter has been subject to fairly extensive econometric testing, and in recent years, the validity of the empirical results supporting this view has been called into question. It has proved difficult to [...] show that any of the labour market rigidity variables work.”

They also doubt that labour market institutions interacting with macroeconomic shocks explain unemployment satisfactorily, as is argued by Blanchard and Wolfers (2000).

The impact of labour market institutions on unemployment is an ongoing debate. In this article I discuss the possibility that one reason why it is hard to detect a robust impact of labour market institutions on unemployment is that there exist several labour market regimes in OECD countries. External labour market flexibility might not play the same role in determining unemployment in corporatist labour market regimes as in non-corporatist ones.

2. Is there evidence for different labour market regimes?

As is illustrated in the introduction, it is often stated that the “standard” linear estimates of reduced-form unemployment equations, where institutions explain the development of unemployment, are not robust or may even be misspecified. In response, one focus of recent research has been on institutional complementarities. Institutions are complementary if the presence of one increases or decreases the returns from the other (Hall and Soskice, 2001: 17). This helps to explain why countries with very diverse institutional settings and different degrees of labour market flexibility have equally low unemployment rates.

Several studies tested for institutional complementarities. Some of them focused on the wage-bargaining system, as it seems to have important empirical effects on labour markets. For example, Elmeskov et al. (1998) test for complementarities between some labour market institutions and/or bargaining centralisation/coordination in OECD countries. They find evidence that different collective bargaining arrangements influence the way in which employment protection legislation and the tax wedge affect unemployment. Belot and van Ours (2004) find that unemployment benefit replacement rates and tax rates reinforce each other, and that in countries where bargaining mainly takes place at the firm level, employment protection legislation has a strong negative effect on unemployment, while union density has a positive one.

Bassanini and Duval (2006) explain unemployment in OECD countries econometrically with a new labour market institutions data set, compiled by the OECD. They estimate standard reduced-form unemployment equations, but also identify institutional complementarities. Although they do not pay explicit attention to these results, they find that the impact of the tax wedge on unemployment is lower in countries with decentralised wage bargaining, and that employment protection legislation affects unemployment only in countries with decentralised wage bargaining.

While much of the empirical literature focuses on interactions between labour market institutions, the OECD (2006: 183-205) follows a different approach. In this study 24 OECD countries are grouped into clusters according to their institutional labour market settings in the early 2000’s (see Table 1). Principal components analysis is used to identify them. When analysing the labour market performance of these clusters, the findings are that the “North and Central European countries” are as successful in achieving low unemployment as the “English-speaking countries”, although these two clusters exhibit strong institutional differences in nearly every selected area. For example, the generosity of the unemployment benefit system and union bargaining coverage are highest in the North and Central European countries, and lowest in the English-speaking countries. The North and Central European countries also have a higher tax wedge, higher union density, stricter employment protection legislation, and spend most on active labour market policy. According to the OECD (2006: 192), “[t]his suggests that there is not a single road for achieving good employment performance.”¹

1 As is shown in Table 1, the “North and Central European countries” are also most successful in keeping income inequality low.

The approach of OECD (2006) has enriched the debate, since it acknowledges that labour market institutions are part of a broader institutional model and that different labour market regimes exist. This finding is also confirmed in Sturn (2013). For a set of 20 OECD countries in the period 1985-2008, evidence of differing impacts of labour market institutions on unemployment in corporatist labour markets is presented. Strict employment protection legislation is found to go along with lower unemployment in corporatist labour markets.

3. Why does the impact of institutions on unemployment depend on the labour market regime?

As is argued in the literature on “varieties of capitalism”, institutions are elements of complex socio-economic arrangements and strategic interactions, and fulfil different functions within distinct economic regimes (e.g. Hall and Soskice, 2001; Amable, 2003; Freeman, 1998, 2000). Indeed, there is growing evidence that important variables are omitted in the standard approach of explaining unemployment only with standard labour market institutions, *and* that these institutions do not play the same role in all institutional regimes.

First, Estevez-Abe et al. (2001) argue that if employment and income protection is high, as is particularly the case in corporatist countries, workers are more willing to invest in firm- and industry-specific skills (see also Harcourt and Wood, 2007). In turn this makes it more attractive for firms to invest in skill-intensive production techniques. Because of the resulting international institutional comparative advantage of these firms in a particular skill-intensive production niche, strict employment protection legislation and high unemployment benefits are favourable for employees *and* employers. This is in turn reflected by good labour relations.

Supportive cross-country evidence is presented by Bassanini and Ernst (2002a and 2002b). They find that the stricter is employment protection in countries with a coordinated system of industrial relations, the greater is their technological comparative advantage in “routinised” industry-specific innovation regimes, where firms undertake incremental innovations along an existing technological trajectory (e.g. electronic components, aircrafts and spacecrafts). The reverse effect of employment protection legislation is found for decentralised countries. They argue that industries characterised by a routinised innovation regime have a strong incentive to use the firm’s internal labour market. “[S]tringent employment protection and coordinated systems of industrial relations, by aligning workers’ and firms’ objectives, enhancing the accumulation of firm-specific competencies and encouraging firm-sponsored training, may allow firms to fully exploit the potential of the internal labour market.” (2002a, p. 419)

Related arguments are put forward by Blanchard and Philippon (2004) and Feldmann (2006). They find that good labour relations (which are highly correlated with corporatism; see Table 2) decrease unemployment. Good labour relations increase the probability of concessions of workers to overcome adverse economic shocks. They further decrease labour turnover, making employers more willing to invest in hu-

Tab. 1. Different regimes of the labour market according to OECD (2006)^a

	OECD unweighted average	High employment outcomes		Low employment outcomes	
		English- speaking countries, mainly ^b	North European countries, mainly ^c	Countries of continental and southern Europe, mainly ^d	Countries of eastern Europe ^e
Employment protection legislation	2.01	1.38	2.13	2.71	1.83
Generosity of unemployment benefit system ^f	27.81	18.23	39.86	36.17	9.69
Active labour market programmes ^g	29.25	15.76	64.14	25.84	3.46
Tax wedge ^h	27.10	18.54	27.42	34.33	32.43
Union coverage	59.96	30.75	83.33	82.57	38.33
Union co-ordination	2.88	1.88	3.92	3.79	1.33
Product market regulation	1.42	1.20	1.28	1.55	1.97
Total LMP expenditures ⁱ <i>of which ALMP</i>	1.86	0.98	2.68	2.60	0.82
<i>expenditures^j</i>	0.76	0.39	1.31	0.94	0.25
Employment rate	67.11	70.92	71.91	62.54	58.00
Unemployment rate	7.47	5.30	4.79	8.97	15.12
Income inequalities (Gini index) ^k	29.35	31.50	25.58	29.85	31.35
Relative poverty rate ^l	9.64	11.78	7.77	9.86	7.05

a This country classification is derived from a Principal Component Analysis, a simple statistical technique which helps to identify existing combinations of policy settings and to highlight similarities and differences across countries. However, some countries are barely representative of the group of countries to which they belong, being close to the frontier between two regimes of labour market functioning. This is for instance the case for Austria, Finland, Germany, Ireland, Japan, Korea, Portugal, Sweden and Switzerland.

b This group of countries includes Australia, Canada, Japan, Korea, New Zealand, Switzerland, the United Kingdom and the United States.

c This group of countries includes Austria, Denmark, Ireland, the Netherlands, Norway and Sweden.

d This group of countries includes Belgium, Finland, France, Germany, Italy, Portugal and Spain.

e This group of countries includes the Czech Republic, Poland and the Slovak Republic.

f Average unemployment benefit replacement rate across two income situations (100% and 67% of APW earnings), three family situations (single, with dependent spouse, with spouse in work), over a five-year period of unemployment.

g ALMP expenditures per unemployed workers as a percentage of GDP per capita.

h Tax wedge between the labour cost to the employer and the corresponding net take-home pay of the employee for a couple with a dependent spouse and two children earning 100% of APW earnings.

i Total expenditures on active and passive measures as a percentage of GDP.

j ALMP expenditures as a percentage of GDP.

k Gini index for total population. Not available for Korea and the Slovak Republic.

l Calculated as the proportion of the population with income below 50% of the current median income. Not available for Korea and the Slovak Republic.

Source: OECD 2006: 191, own presentation

man capital of their employees, and employees become more motivated to acquire firm-specific skills and to make proposals for an improvement of production techniques and work organisation. This results in higher productivity and lower unemployment. According to these arguments, employment and income protecting institutions, good labour relations, skill investments of workers and low unemployment are interrelated in a systematic way in corporatist countries.

Second, the standard-approach focuses only on indicators for external labour market flexibility. But, especially in corporatist countries, internal flexibility might be as important to adjust production capacities and costs to actual demand. While with external flexibility this adjustment is achieved via hirings or dismissals, with internal flexibility the same outcome is obtained through variations in regular working hours and overtime work, working time accounts, and (publicly funded) short-time work schemes.² Eichhorst et al. (2010) construct a quantitative indicator for 16 European countries in 2003, which includes measures of internal flexibility. They also consider information on functional flexibility, which requires a skilled and flexible labour force adapting to structural change (external functional flexibility), or a flexible organisation of the production process (internal functional flexibility). When internal flexibility is included in their summary flexibility indicator, especially for countries typically described as corporatist – like Austria, Denmark, Finland, Germany, the Netherlands, and Sweden (see Table 2) – much greater overall flexibility is evident. Denmark, Finland, and Germany emerge as even more flexible than the UK. This suggests that important indicators for flexibility are omitted when focusing only on standard labour market institutions.

What's more, the results of Eichhorst et al. (2010) confirm that there exist different labour market regimes. The so called "liberal market economies" (Hall and Soskice, 2001) or Anglo Saxon countries are on average characterised by high external flexibility, but low internal flexibility. The corporatist or "coordinated market economies" (Hall and Soskice, 2001) in Northern and Central Europe show a high degree of internal flexibility and a low degree of external flexibility. And some southern European countries are below average in external and internal flexibility measures. This helps to explain why some countries with very "rigid" labour markets – when focusing on indicators of external flexibility – are very successful in achieving low unemployment.

And third, the standard-approach assumes that wage-moderation, higher work effort and a smoother adjustment of labour supply and demand is achieved through pressure on unions and unemployed via the deregulation of labour markets. While this may be a reasonable approximation for the functioning of labour markets in liberal market economies, it is a very crude description of the process of wage bargaining and labour market policy in corporatist economies. In these countries, employer associations, unions and (perhaps even) the government negotiate wages, working time and (perhaps even) labour market and social policy (see Aidt and Tzan-

2 The German experience in the "Great Recession", where GDP dropped by more than 6% from peak in 2008 to trough in 2009, and employment remained nearly constant, while working hours were drastically reduced, illustrates the importance of internal flexibility in determining unemployment (Möller, 2010; Herzog-Stein et al., 2013).

atos, 2002, for a survey of the literature on corporatism). Social partners consider the situation of the whole economy in decision-making, and may respond to rising unemployment from macroeconomic shocks with social pacts and other arrangements to fight unemployment (e.g. Visser, 1998; Baccaro, 2003). Therefore, external labour market flexibility plays a less relevant role in achieving low unemployment in a corporatist environment.

In the literature on (neo-)corporatism and social partnership, it is further argued that trade unions are compensated by the government for wage moderation and social peace (Headey, 1970; Schmitter, 1977; Lange and Garrett, 1985; Alvarez et al., 1991). Although this tendency has probably decreased since the 1970s (Hassel, 2003), it still plays a certain role (Hicks and Kenworthy, 1998; Hemerijck et al., 2000; Baccaro, 2003; Brandl and Traxler, 2005). This means that there is some trade-off between internal and external flexibility in corporatist countries. Also the OECD (2010: 63) points out that there is evidence for a cross-country trade-off between low employment protection regulation and high internal flexibility.

To sum up, internal flexibility plays an important role in adapting labour demand to labour supply especially in corporatist countries. In wage bargaining processes in corporatist countries (with good relations between the social partners and the state) workers' representatives accept increasing internal wage and working time flexibility, but receive some compensation in the form of job and income security. There exists a (certain) trade-off between internal and external flexibility as a result of the political economy of wage bargaining in corporatist countries. These mechanisms are amplified by the impact of good labour relations and employment and income protection on the skill-investments and productivity of workers. Therefore, external labour market flexibility, especially in the form of employment protection legislation and unemployment benefits, shows a different impact on unemployment in corporatist labour market regimes.

4. Concluding remarks and policy implications

In this article it is argued that labour markets function differently in corporatist labour market regimes than in non-corporatist regimes for mainly two reasons. Firstly, internal flexibility is much higher in corporatist labour markets than in non-corporatist. Therefore, overall flexibility is especially underestimated in corporatist labour markets when focusing only on standard labour market institutions for external flexibility. Secondly, there is evidence for a trade-off between high internal and external flexibility, due to the political economy of wage bargaining processes. Therefore, labour market institutions play a different role in corporatist regimes than in non-corporatist ones.

This casts doubts on the view proposed by OECD (1994), IMF (2003), and others, that labour market deregulation is a universal panacea against high unemployment. There is clear evidence in the literature for different labour market regimes, which are able to achieve low unemployment through different channels. Following the deregulation paradigm in corporatist economies may reduce the quality of labour relations

Tab. 2. Corporatism, internal flexibility, and the quality of labour relations in OECD countries

Country	High corporatism from 1985 to 2008 (according to the definition in Sturn, 2013)	High internal flexibility in 2003 (according to Eichhorst et al., 2009)	Good quality of labour relations from 1985 to 2002 (according to the World Economic Forum's EOS-Survey, cited in Feldmann, 2006)
Australia	0	n.a.	-
Austria	+	+	+
Belgium	+	-	-
Canada	-	n.a.	-
Denmark	+	+	+
Finland	+	+	+
France	-	+	-
Germany	+	+	+
Ireland	+	-	n.a.
Italy	0	-	-
Japan	0	n.a.	+
Netherlands	+	+	+
New Zealand	-	n.a.	-
Norway	+	n.a.	+
Portugal	-	-	-
Spain	0	-	-
Sweden	+	+	+
Switzerland	+	n.a.	+
UK	-	-	-
USA	-	n.a.	-

Note: + = yes, - = no, 0 = varying, n.a. = no data

Source: Own presentation

and the willingness of employees to cooperate in aspects of internal flexibility, as well as the necessity for social partners to deal with these issues. Therefore external flexibility increases, but this may be outweighed by a reduction in internal flexibility, with unclear or negative net-effects on unemployment. Partial deregulation in a corporatist country can push its labour market into the intermediate position of having relatively low external and internal flexibility. Therefore, taking account of a country's specific labour market regime and institutional complementarities is crucial for successful employment policy.

This review is also helpful for answering why in the Great Recession "[u]nemployment generally rose by less in those countries which had strict employment protection legislation, as it did in those countries with relatively high collective-bargaining coverage" (Amable and Mayhew, 2011: 207),

even after correcting for the severity of the drop in output and the strength of macro policy responses. High internal flexibility in these countries allowed firms to hoard labour during the recession, which helped to distribute low labour demand more equally.

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