Are Economic Flexibility and Social Welfare Programs Incompatible?

by Adam M. Zaretsky

The 1980s were a decade of economic expansion for both the United States and Western Europe. This expansion, however, did not proceed down the same path or at the same pace on each side of the Atlantic.

Growth rates for real gross domestic product (GDP), for example, were more volatile in the United States than they were in Europe. Europe’s unemployment rate, despite healthy output growth, was far higher during the decade than it was in the United States. Conventional wisdom has typically blamed Europe’s generous social welfare programs for its unemployment woes. According to recent research, however, this might not be the case.

A Look at the Facts

After declining during the recessions of the early 1980s, U.S. real GDP increased dramatically, reaching a peak of 6.2 percent annual growth in 1984. Growth rates in Europe were more moderate, peaking at about 4.1 percent in 1988.

Unemployment rates in both the United States and Europe were very similar early in the decade. After 1982, however, U.S. unemployment began to drop, while European unemployment remained at about 10 percent until 1988. The cause of this wedge between the two unemployment rates is usually attributed to a significant increase in Europe’s natural rate of unemployment during the period. This increase, though, has been quite controversial.

Typically, Europe’s social safety nets—unemployment insurance, child care provisions, health care programs or maternity leave, for example—have been charged with reducing European labor markets inflexible, hampering growth. The United States, of course, has similar policies, but they are fewer in number and more limited in scope.

The Flexibility Issue

What do we mean by flexibility in an economy anyway? Defining flexibility in a labor market is difficult because of the many paths along which economic agents can be flexible. A common usage of the term is “the speed of labor market adjustment in a changing economic environment.” The flexible market is one in which firms adjust wages rapidly...alter employment or work hours quickly...and workers move smoothly...across sectors or geographic areas.”

Thus, programs that limit short-run wage and employment adjustments in the face of macroeconomic shocks are said to cause inflexibilities in the market and hinder a speedy accommodation of the change. When such programs exist for some period of time, as they have in Europe, they are said to induce people to behave in an economically inefficient manner, leading to long-run patterns of high unemployment and slower growth.

To illustrate, let’s look at some programs that might create inflexibility in the labor market and unintentionally promote high unemployment: 1. Legislation that limits an employer’s ability to hire or fire workers in the face of short-run shocks. Under this type of legislation, firms may limit employment growth during an expansion because it may be too difficult to reduce employment during a recession. 2. Income protection, such as unemployment insurance payments or welfare programs, that provides workers with monetary support. Paying support to people when they do not work may reduce the urgency with which people search for a job and may lead to longer durations of unemployment. 3. A minimum wage or centralized wage-setting system that artificially raises the wages of the less-skilled. Employers may be less willing to employ less-skilled workers or invest in sectors or technologies that employ them because of their relatively higher wage. 4. Mandated social security taxes or household leave policies that raise the cost of labor. Mandating higher compensation costs for employers usually means less demand for labor. 5. Housing support or employer-based health insurance that ties people to a location or job. The fear of losing such benefits or subsidies may make workers less responsive to changing market opportunities.

That these programs have adverse effects on labor markets is not a matter of debate. That such programs yield benefits that may outweigh these costs, however, must also be considered. Specifically, social programs are designed to improve social well-being by increasing workers’ security in the face of economic change—particularly unemployment, sickness and aging.

Social Protection vs. Economic Flexibility

To evaluate this cost/benefit comparison, the National Bureau of Economic Research (NBER) published a series of articles last year that look at individual social programs and their effects on labor markets across countries. Summarizing the conclusions, the volume’s editor, Rebecca Blank, finds that “while these studies and related work [show that] the design of social programs affects employer and worker behavior, these programs do not create major inflexibilities in the labor market.” Let’s take a look at some specific evidence.
Labor Regulations
Countries like France, Germany and Belgium, that have strong job security laws, should exhibit less ups and downs in employment than the United States, which had no advance notice or severance pay requirement laws during this period. Researchers Katharine Abraham and Susan Houseman found that employment levels and hours worked are both highly cyclical in the United States; in Belgium and Germany, on the other hand, hours are more cyclical than employment. In addition, employment levels adjust faster in the United States than in any of the three European countries. Thus, adjusting worker hours rather employment levels is more important in the European countries than in the United States. This does not imply that European firms are inflexible, only that they are flexible along a different path than U.S. firms.

Social Protection Programs
Laws that increase the well-being of tenants and homeowners—for example, rent-increase caps or tax incentives that encourage homeownership—should reduce worker mobility. As Axel Börsch-Supan notes, historically the United States has offered a strong homeownership incentive, while Germany has only recently expanded its tax advantage for homeownership. He finds that the United States, as expected, has much higher levels of homeownership than Germany, but surprisingly higher levels of mobility.

Similarly, countries that have employer-based health insurance should exhibit lower employee turnover than those that do not because of the fear of termination or interruption of health coverage (commonly known as job-lock). Douglas Holtz-Eakin compares patterns of employee turnover in the United States with those in Germany, where workers get insurance through funds, some of which are local. About half of German workers must change funds when they change jobs, which can result in different premiums. Holtz-Eakin finds no evidence in the United States of significant job-lock among workers with comparable characteristics. In Germany, he finds slightly fewer job changes for those who have to change insurance funds, but concludes that different types of insurance systems do not appear to have major effects on mobility.

Income Support Programs
Publicly supported pension systems like Social Security were designed primarily to increase the well-being of the elderly, secondarily, to provide job opportunities for the young. By inducing retirement or extended unemployment during downturns, these programs create market inflexibilities. Although the systems differ in the United States, Japan and Sweden—Marcus Rebick's countries of study—all three witness the percentage of employed older men decreasing as unemployment rises. Because Japanese and Swedish men are more likely to leave the labor force as unemployment rises, these countries usually display a larger response. Rebick also finds that, as Japan and the United States expanded the generosity of their public pension systems in the 1970s, both countries experienced a change in the timing of retirement. He concludes that the primary effect of these expansions occurred in labor force participation and the economic well-being of the elderly, but not in their responsiveness to the business cycle.

Is There A Tradeoff?
In conclusion, Blank acknowledges that "there is clear evidence that these diverse programs influence behavior. Remarkably, however, there is little evidence that labor market flexibility is substantially affected by the presence of these social protection programs, nor is there strong evidence that the speed of labor market adjustment can be increased by limiting these programs." In addition, the comparative studies reveal that different countries have structured their labor markets and income maintenance systems quite differently. Programs that by themselves might appear problematic, may fit coherently into a web of country-specific institutions. Thus, the implication is that single measures of economic flexibility probably say little about the overall adaptability of an economy.

Adam M. Zaretzky is an economist at the Federal Reserve Bank of St. Louis. Thomas A. Pollinmann provided research assistance.

ENDNOTES
1 For more on this view, see Kevin Kliesen's article in this issue.
2 In this article, data for Europe are compiled from the 19 countries that make up OECD (Organization for Economic Cooperation and Development) Europe.
6 See Zaretzky (1994) for a discussion of a minimum wage's effect on employment.
7 To conserve space, this and the following articles, which will be cited by author, can all be found in Blank (1994b).

REFERENCES