Employment Performance in OECD Countries

A Test of Neoliberal and Institutionalist Hypotheses

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This article provides the first comprehensive test of the frequent, sharply differing market liberal and insitutionalist political economy recommendations for employment creation. The statistical analysis is a pooled time series for 17 advanced capitalist democracies from 1974 through 1999. Consistent with both neoliberal and institutionalist hypotheses, long-term unemployment replacement rates, social security taxes, and employment protection laws have negative effects on employment levels. Contrary to neoliberal hypotheses but consistent with institutionalist hypotheses, the authors find that short-term unemployment replacement rates, active labor market policy, and neocorporatist bargaining have positive effects on employment levels and that total taxes have no effect on employment levels.

Keywords: *employment; welfare state; OECD Jobs Study; European Employment Strategy*

Throughout the 1980s, the superior performance of the US in job creation compared to OECD-Europe suggested that labour-market flexibility, US-style, was the panacea for European unemployment problems. Remove labour-market regulations, eliminate job-protection laws, reduce unemployment benefits, weaken unions, decentralize wage-setting, and presto! European unemployment would vanish. That, at least is the crude version of the conventional wisdom of the decade. In more sophisticated form, this is the message of the *OECD Jobs Study*. (Freeman, 1995, pp. 63)

In the quote above, Richard Freeman (1995) nicely summarizes both the conventional wisdom and *The OECD Jobs Study* (Organization for

Economic Cooperation and Development [OECD], 1994) on the role of "labor market rigidities" in accounting for the high and persistent unemployment in Europe.[1] As former Organization for Economic Cooperation and Development [OECD] economist Bernard Casey has recently noted, the economic theory underlying the OECD Job Strategy is neoclassical economics in which market liberal solutions predominate. He contrasts this to the economic thinking underlying the European Employment Strategy, which is based on "'social market' theories, whereby the state intervenes to moderate the negative effects of market relationships and to enhance the efficiency of market performance" (Casey, 2004, p. 346). Accordingly, with the exception of the endorsement of Nordic style labor active market policy, the original OECD Jobs Strategy recommendations—reduce the generosity of unemployment compensation, cut employment protection, reduce union strength, reduce minimum wages, decentralize wage bargaining, lower taxation, increase wage dispersion—would, if consistently applied, move a country toward the U.S. model of unregulated labor markets, weak unions, and high income inequality. By contrast, although European Employment Strategy also recommends increased labor market flexibility, it envisions retention of the European Social Model—generous welfare states, strong unions, coordinated bargaining, and relatively equal income distribution.

We present the first comprehensive test of the neoliberal hypotheses on social policy and labor market institutions and employment performance using pooled time series data. We test these hypotheses against a set of largely contrary hypotheses drawn from institutionalist work in comparative political economy, above all the corporatism and varieties of capitalism literatures and institutionalist work in the sociology of labor markets. Earlier analyses, many by the OECD itself, were cross-sectional and, because of degrees of freedom constraints, could not introduce a full range of control variables. In part, this was due to the dearth of pooled time series data on important indicators of employment and labor market regulation—most notably, unemployment compensation replacement rates and employment protection legislation. The OECD can be credited with solving this problem with the release of its database on unemployment benefits and replacement rates in the late 1990s and its employment protection database in late 2004.

In addition to taking advantage of these new data, our study makes several improvements over the only other pooled time series analyses with total employment as the dependent variable (Kenworthy, 2003; OECD, 2002, pp. 249-255). Both of these studies enter public employment as a control variable. This makes the Nordic model, which produces the highest employment rates of any welfare state or production regime, incomprehensible. The Nordic employment model produces high levels of employment by providing a wide range of social services that simultaneously increase the demand for labor through public-sector employment and the supply of labor by providing services and transfers, such as day care and maternity leave, which make it possible for people to combine work and family. The model requires high taxes, but the potential employment dampening effects of this can be tested directly (as we do) with measures of tax burden. In addition, the OECD study suffers from omitted variable bias, as the authors do not include unemployment replacement rates, active labor market policy effort, or wage dispersion as independent variables.

Deregulation and Employment Performance

The conventional wisdom, in the form of the neoliberal hypothesis regarding OECD employment problems, suggests that labor market rigidities are at the root of employment problems in OECD countries and that deregulation is the solution.[2] Briefly stated, the neoliberal thesis suggests that labor market "rigidities"—welfare state generosity, employment protection, high levels of union density, minimum wages, high levels of taxation, or any other nonmarket institutions—prevent the labor market from producing optimal outcomes – low unemployment rates and high employment rates—by raising the cost of labor above its market-clearing level.[3] This flexibility or deregulation thesis is simple and powerful, and provided that governments care about improving employment performance, provides a model to follow. The policy prescriptions flowing from these analyses are deregulation of labor markets to the level of the United States or, more recently, the United Kingdom.

Despite decidedly mixed empirical support, the deregulation argument still dominates the OECD policy prescriptions for poor European employment performance since the 1980s. For example, of the 37 recommendations in the 1999 volume of the *Jobs Study* for reforming member country labor market policies, 22 contain some call for decentralization (for wage bargaining systems), deregulation (for employment regulations), lower taxes (overall and payroll), and a reduction in benefit generosity (lowering replacement rates).[4]

The OECD and analysts of this orientation tend to focus primarily on unemployment as an indicator of labor market performance. Treating the unemployment rate as the single best indicator of economic performance biases this type of analysis toward success in one type of outcome. Unemployment rates are sensitive to labor force participation; in fact, they can be lowered or raised based on participation regardless of whether more jobs have been created or destroyed. Because of both to social policy provisions (early exit schemes common in continental welfare states; see Esping-Andersen, 1999) and personal choice within existing provisions (use of disability schemes), people can be excluded from the labor force, thus lowering the overall unemployment rate without representing improved employment performance (Scharpf, 1997). The point is that the rigidity literature tends to equate success with a lower (or declining) unemployment rate. Part of the corrective of this study is to widen the measure of success to include employment-to-population ratios. In a recent path-breaking study on globalization, welfare states, and employment, Scharpf and Schmidt (2000) argue that employment rates are better indicators of comparative performance than unemployment rates. Thus, the employment-to-population ratio is used as the dependent variable throughout the Scharpf and Schmidt study as an indicator of comparative performance.[5]

Institutions and Employment Performance

The general message of neoliberal economics—that a complete deregulation reform package is necessary and it works across the universe of OECD member states—runs counter to much of the institutionalist comparative political economy literature. The "varieties of capitalism" literature and the corporatism literature that preceded it suggest at least two broad classifications of contemporary capitalist political economies: coordinated market economies (CME) and liberal market economies (LME). The "varieties of capitalism" approach provides the rationale for both the positive and negative contributions of labor market institutions (Hall, 1998, 1999; Kitschelt, Lange, Marks, & Stephens, 1999; Soskice, 1990, 1999). What the deregulationist approach considers "rigid" labor market institutions, the institutionalist approach treats as a potentially positive part of the overall production and employment regime. For example, high benefit replacement rates, extensive social services, and active labor market policies have traditionally played a key role in efficient job search and labor mobilization in CMEs, particularly in the social democratic variant of

CMEs (Estevez-Abe, Iversen, & Soskice, 2001; Huber & Stephens, 2001; Iversen, 2005). Furthermore, the institutions of wage bargaining in CMEs have been key components in delivering wage restraint, economic growth, and investment (Hicks & Kenworthy, 1998; Iversen, 1999). Particularly with the reduction in the ability of countries to use exchange rates and interest rates as adjustment tools in the era of EMU and financial deregulation, coordinated bargaining systems may well be the most efficient way to deliver real wage restraint and thus job creation in highly unionized countries (Huber & Stephens, 2001, 2005).

In sum, the institutional comparative political economy questions the fundamental tenet of the deregulation thesis—that institutional intervention in the labor market leads to suboptimal outcomes in the labor market. Instead, the institutional literature suggests that labor market institutions are situated within larger institutional configurations and form part of the overall political economy. Thus, there is no prior assumption that all non-market institutions negatively affect employment. Finally, as Hall (1998) points out, the institutional literature also points to a potential time inconsistency problem with the deregulation thesis. That is, for institutions to be at the root of OECD employment problems, institutional rigidity had to increase around the mid-1970s (or the early 1990s for Sweden and Finland), ceteris paribus. As a review of some of the literature on institutions shows, however, labor market institutions appear relatively "sticky" with time, meaning that they show no great movement up or down the rigidity scale. Because countries achieved low unemployment and job growth in the presence of rigid labor market institutions in the first three decades after 1945, the deregulation thesis is incomplete. By contrast, the nuanced argument of Iversen (2005) gives one clear theoretically grounded reasons to expect that at least some of these institutions might turn from an asset to a liability with the transition from industrial to postindustrial economies.

Hypotheses

The key explanatory variables are taken from those highlighted in the "labor market rigidity" literature and the European unemployment literature in general (Baker & Schmitt, 1999; Bean, 1994; Nickell, 1997; OECD, 1999b, 2002). Our hypotheses are informed by both the neoliberal and institutionalist literature in comparative political economy and sociology as well as previous empirical work on employment performance.

The Welfare State and the Benefit System

Welfare-state spending, as it directly relates to the labor market, can be divided into active and passive labor-market spending. The neoliberal interpretation of OECD employment problems posits that a higher level of passive benefits—income support for workers temporarily out of the active labor force—and a longer duration of receipt may increase one's reservation wage and reduce job search while raising the "choosiness" of the unemployed (OECD, 1994, 1999a, 2002; Siebert, 1997). The replacement rate (or the percentage of working income received while unemployed), benefit duration, and conditionality (training requirements for continuation of benefits) are the key measures of benefit generosity. Thus, for the neoliberal interpretation of OECD labor markets to be correct, higher replacement rates should be negatively correlated with employment (see Table 1).

The institutional literature is more nuanced and suggests that some types of welfare-state spending will increase employment and improve the functioning of the labor market. In fact, a high replacement rate in itself does not have to exert the above disincentive effect; rather, the combination of a high rate and long duration may prove to be a bigger job search disincentive. We hypothesize that the combination of a high level of benefits through a long duration may have a negative effect on employment. However, contrary to the neoliberal hypothesis, we hypothesize that a generous replacement rate of shorter duration may have positive effects on employment. High replacement rates may serve more to reward a worker for his or her skill investment while out of work than to create a reservation wage that prevents the worker from seeking re-employment, and they may allow workers with industry-specific skills to conduct longer and more costly job searches to find employment in which their skill is fully used. The importance of social insurance for investment in especially asset-specific high skills is the central theme in Iversen (2005) and Estevz-Abe et al. (2001). High replacement rates also serve as a disincentive for workers to leave the work force altogether.

Institutionalist work in the comparative sociology of labor markets and mobility regimes (DiPrete, 2002; DiPrete & McManus, 2000; Gangl, 2004) on the "scar effects" of unemployment spells on individual life courses indicates that high replacement rates do not simply result in upskilling of workers but also in lower unemployment and higher employment in the long run. High replacement rates reduce the scar effects of unemployment bouts and thus result in better, longer term employment prospects. This

Table 1
Variable Descriptions, Data Sources, and Hypothesized Effects on Employment level

Variable	Description	Neoliberal	Institutionalist Comparative Political Economy
Dependent variable			
Employment level	Percentage of the population aged		
Independent variables			
Gross replacement rate, 1-year	Replacement rate for an unemployment spell of 1 year	–	+
Gross replacement rate, 5-year	Replacement rate for an unemployment spell of 5 years	–	–
Social security taxes	Social security payroll taxes as a percentage of GDP	–	0 or –
Total taxes	Total taxes as a percentage of GDP	–	0
Wage coordination	Degree of coordination of wage bargaining	–	+
Neocorporatism	Hicks and Kenworthy's (1998) seven-item index (see text)	–	+
Union density	Union members as percent of wage and salary workers	–	–
Capital market openness	Index of controls and international agreements on capital and currency accounts (high values indicate fewer controls)	+	–
Trade openness	Exports plus imports as a percentage of GDP	+	–
Wage dispersion	Ratio of median wage and salary worker to wage and salary worker at the 10th percentile (full-time work)	+	0 or +
Employment protection	Index of employment protection legislation	–	0 or –
Active labor market policies	Spending on active labor market policy measures divided by the unemployed population	0	+

process of accumulating disadvantages of job loss is self-reinforcing, because according to DiPrete (2002), the seriousness of such scar effects is heavily influenced by how often such a trigger event takes place as well as the individual's capacity for recovery. The institutional mobility regime of welfare state transfers can reduce such scar effects, not only through short-term income compensation. More important, it also contributes to long-term unemployment recovery by serving as an incentive for private risk taking so that during unemployment spells, individuals are more likely to conduct adequate job searches and locate the jobs that match their skills. Through their first-order effect of income replacement and second-order effect of unemployment recovery, Gangl (2004) demonstrates a clearly positive effect of unemployment benefits, not only on the quality but also on the stability of future careers after employment interruption. The macro outcome of the upskilling of workers is to reduce structural unemployment, the mismatch between job seekers' skill and the skill demanded by available opening. As we move into the information-age economy, this constant upskilling of worker would appear to be ever more important.

Active labor market policies (ALMP) may mitigate the potentially negative impact of generous benefits by retraining and reintegrating unemployed workers into the labor force. In general, a more active approach should have a positive impact on employment by increasing the employability of the working-age population. We hypothesize that greater spending on ALMP will have a positive impact on employment by increasing the employability of the working-age population. As we noted above, the original OECD Jobs Study departs from its otherwise neoliberal formula in recommending increased spending on ALMP. By contrast, neoliberal economists have tended to be skeptical of ALMP, arguing that it is not an efficient use of taxpayers' money because it does not, they contend, improve worker employability that much. They do not argue that ALMP ceteris paribus decrease employment but rather that the taxes levied to fund them could cause work disincentives. Thus, we indicate no relationship for the neoliberal hypothesis in Table 1.

The Structure and Level of Taxation

Because payroll taxes raise nonwage labor costs, neoliberals argue that they are a disincentive to employers to hire workers. That is, the tax wedge is the difference between the cost of labor to a firm and the wage paid to the worker. When this difference is large or increases, equilibrium hiring

will be lower than in the absence of the tax, as it increases the cost of employment to the firm. The exception, of course, occurs if wages adjust downward enough to compensate for the increase in the nonwage part of the total labor cost. Recent institutionalist comparative political economy agrees with the neoliberals on this point, at least with regard to private-sector employment. For example, Scharpf (1997, 2000) suggests eliminating or at least reducing payroll taxes on lower wage jobs as a way of stimulating private-sector employment growth. He argues that a reduction could be compensated by shifting more welfare-state financing to general revenue.

The neoliberal hypothesis not only suggests that the structure of taxes affects employment but also that the overall level of taxation will affect employment. The OECD argues that "cutting one part of the wedge while increasing another does not shift the overall tax burden away from labor"; thus, according to the deregulationist argument, the overall tax burden must not just be shifted around but must actually be cut to avoid negative labor market consequences (OECD, 1997, p. 68). By contrast, based on analyses of Nordic model that combine high taxes and high employment, the institutionalist comparative political economy argues that the negative effect of total taxes on private-sector employment is offset by positive effect on total employment (Huber & Stephens, 1998, 2000; Kitschelt et al., 1999). Thus, we indicate no relationship between total taxes and employment in Table 1 in the institutionalist column.

Wages and the Wage Bargaining System

In a standard demand-supply labor market model, as implied in the neoliberal hypothesis, the price of labor determines the level of employment. Although other variables—taxes, employment protection, and welfare benefits—are all costs, it is wages that make up the majority of labor costs. The OECD policy guidelines urge member countries to decentralize wage determination, widen wage dispersion, abandon or relax administrative extension (of wage settlements), and modify (i.e., cut) minimum wages (OECD, 1999b, p. 178). The neoliberal hypothesis thus holds that greater bargaining decentralization, lower union density, and greater wage dispersion will lead to higher levels of employment.

Contrary to the neoliberal literature, the large corporatism literature suggests that in general, the more "encompassing" the labor market institutions are (i.e., wage-setting mechanisms), the better labor-market actors are able to overcome collective-action problems in setting wages; otherwise, the

labor market must be sufficiently free and uncoordinated so that particular groups cannot on their own create wage-price spirals. In addition to achieving wage moderation, encompassing and coordinating labor market institutions are also associated with greater investment and a positive trade balance (Hicks & Kenworthy, 1998). Coordinated wage bargaining systems should deliver real wage restraint and thus be positively correlated with employment. However, this literature expects strong unions and decentralized wage bargaining, as in pre-Thatcher Britain, to result in wage inflation and loss of economic competitiveness. Thus, we expect to find a negative association between union density and employment, once we control for wage coordination and/or bargaining centralization as indicated in Table 1.

There is a potentially strong link between wage dispersion and employment. In a standard model of the labor market, the demand for labor is expected to increase as the cost of it falls. If the wage dispersion (controlling for productivity) in a country is excessively tight (i.e., the distance between the top and bottom deciles is small), then this may cause supply problems at the top end of the wage scale (if more highly skilled workers do not receive a sufficient premium, they may opt out of the labor market) and demand problems (if low-skilled workers are costly to employ, the demand for them will decline). Most of the economics literature (see Siebert, 1997, for a review) suggests that increasing wage dispersion (particularly in more egalitarian European countries) may lead to greater employment, especially at the bottom end of the labor market. Implicit in this view is that it is the lower end of the wage scale that must move down to create the greater dispersion. If the level of wage inequality does affect the employment level in society, the 50 to 10 ratio in particular should be important. It is lower wage labor markets that are at the heart of arguments about labor market rigidities (OECD, 1999a; Siebert, 1997).

The comparative political economy literature argues that the effect of wage dispersion will depend on which sector is producing employment in a country in a given stage of economic development (Huber & Stephens, 2001; Iversen, 2005; Iversen & Wren, 1998). During the period of postwar industrial expansion up to the early 1970s, compression could be an advantage, because it delivered cheap skilled labor and the costs at the bottom end could be offset with increased productivity. This was the logic of the Swedish Rehn-Meidner Model combining wage compression, industrial rationalization, and the ALMP. With the end of industrial employment expansion, employment growth had to come from expansion of service employment. In many low-end jobs in private services, such as hotel and restaurant and personal service, it is very difficult to raise productivity to

compensate for wage compression. Wage compression makes such services expensive and, as Esping-Andersen (1999) points out, because people have the option to "self-service" (cook their own food, wash their own clothes, etc.), wage compression is associated with lower levels of private-service employment (Iversen & Wren, 1998; Scharpf, 2000). The Nordic countries expanded employment by increasing public-service employment in the 1970s and 1980s, where wage compression was not a large constraint, but this strategy hit the wall of tax saturation by the late 1980s. Because our analysis is for the 1974 to 1999 period, clearly in the postindustrial era, we hypothesize that wage dispersion will either be positively related to employment levels or not related to employment.

Employment Protection

Although some form of employment protection exists in nearly every OECD country, significant cross-national differences exist in the strictness of these measures (see OECD, 1999a). Neoliberal claims that employment protection legislation (EPL) is one cause of post 1970s European unemployment are based on the assumption that job protection rules make hiring an "irreversible decision," thus eventually weakening labor demand (Bertola & Ichino, 1995; Siebert, 1997). In its *Jobs Study*, the OECD argues that EPL, as part of overall rigidity, may have two negative effects on labor market outcomes. First, as firms are not certain of future demand levels for their products and future employee productivity, future dismissal costs are calculated as part of total labor costs and thus may discourage new hires. Second, in countries with strict job protection laws but relatively low levels of restrictions on fixed-term and temporary-agency work, a dual labor market may emerge in which outsiders may face difficulty breaking in to find stable employment. On the other hand, in the face of particularly stringent employment protection, the unemployment rate itself should be less volatile over business cycles, because firms may hoard labor in downturns and adjust hours rather than the number of employees, in upturns. Thus, the neoliberals expect a negative relationship between EPL and employment as indicated in Table 1.

There are two views of EPL in the comparative political economy literature. Esping-Andersen and Regini (1999) argue that EPL affects who is employed (insider vs. outsiders) but not the volume of employment. Iversen (2005) and Scharpf (2000) argue that the inflexibility that EPL brings is particularly difficult for small, labor intensive, private-service sector enterprises, and thus in the postindustrial period, EPL will have negative effects

on employment levels. Thus, our institutionalist comparative political economy hypothesis for EPL is no or negative effects on employment.

Measurement

We confine our analysis to the period 1974 to 1999 for 17 advanced industrial democracies, because the neoliberal hypotheses focus on employment performance in this period and not in the Golden Age period when Europe generally outperformed the United States in growth and unemployment.[6] Our main data sources are the OECD and the Huber, Ragin, Stephens, Brady, and Beckfield (2004) Comparative Welfare States Data Set, which in turn relies heavily on OECD data (see Table 1).[7] The dependent variable in the analysis is total civilian employment as a percentage of the working age population (15 to 64 years of age). As we have argued above, the level of employment is a more appropriate dependent variable than unemployment because unemployment does not pick up inactivity rates, principally disability, early retirement, and nonworking spouses, which vary greatly across these countries.

The best indicators of welfare-state generosity as it relates directly to the labor market are replacement rates and duration of unemployment insurance. The OECD summary indicator of benefit generosity has the following structure: the average of unemployment benefit replacement rates for two earnings levels (average earnings and two third of average earnings), three family situations (single, married with dependent spouse, and married with spouse in work), and three durations of unemployment (1st year, 2nd or 3rd years, and 4th or 5th years of unemployment). Our independent variables are the 1-year replacement rate and the 5-year replacement rate averaged across the income levels and family situations. The OECD data are gross replacement rates: Both the income and the transfer are pretax. Net replacement rate is clearly the preferable measure. Scruggs (2004) has recently released data on net replacement rates and duration of benefits, but it is not possible to calculate the replacement rate for bouts of long duration from the data, which is essential for our purposes. To check the validity of the gross replacement rates data, we calculated a net replacement rate for a bout of unemployment 1 year long from the Scruggs' data. The 1-year gross and net replacement rate series are highly correlated (.85), which increases our confidence in the analysis using the OECD measure.

Our measure of social security taxes and total taxes are those taxes as a percentage of the GDP. Our measure of wage coordination is Kenworthy's

indicator. This measure is preferable to measures of bargaining centralization, because it taps institutionalized practices such as pattern setting, tacit coordination, and government intervention, which are missed by measures of bargaining centralization. In addition to this measure of wage coordination, we include a broader measure of neocorporatism developed by Hicks and Kenworthy (1998), which includes wage coordination and six other items tapping tripartite government–capital-labor cooperation, union federation centralization, employers' federation centralization, firm–investor relations, and firm provided job security. Although the wage coordination measure is expected to operate primarily via wage restraint, this measure is expected to have additional effects via cooperative promotion of investment, increased productivity, trade performance, and macroeconomic stability. This measure is available only up to 1995. Our measure of union strength is net union membership as a percentage of wage and salary workers.

As control variables, we include two measures of economic openness or globalization. Following Bradley, Huber, Moller, Nielsen, and Stephens (2003), we use the Quinn and Inclan (1997) measure of capital and current account controls as our measure of capital market openness. As a general measure of capital market openness, we favored the control measures over the flow measures (inward and outward FDI as a percentage of GDP), because as Simmons (1999) and others have argued, it is the possibility of easy exit that changes the behavior of actors, not variations in actual flows. In the Quinn and Inclan measure, the maximum score indicates no capital controls. For these same reasons, our preferred measure of trade openness would be a measure of tariff and nontariff barriers to trade. Unfortunately, no such time series exists, so we use the conventional measure of trade flows, imports plus exports as a percentage of GDP.

For the remaining variables, data coverage is more limited and the time series are unbalanced with varying time points per country but without gaps in the time series. The wage dispersion measure is the 50 to 10 ratio, the ratio of the wage or salary of the median full-time employee to the wage or salary of the full-time employee at the 10th percentile. We reasoned that wages at the bottom of the distribution would be most relevant for the development of a large private service sector.[8] For this variable, we have 291 observations from 1974 to 1999.

Our data on employment protection laws (EPL) are the OECD's (2004) recently released annual time series. The summary index summarizes a number of subindices measuring the difficulty of layoff (notice, severance pay, etc.) and regulations restricting the use of temporary work. The data are available for 16 of the 17 countries from 1985 to 1991 and all 17 from

Table 2
Mean Values of Key Variables by Country

	Percentage of Working-Age Population	1-Year Gross Replacement Rate	5-Year Gross Replacement Rate	Neocorporatism	Employment Protection Legislation	Social Security Taxes	Active Labor Market Policy	Wage Dispersion, 50 to 10 Ratio
Nordic coordinated market economies								
Sweden	76	64	19	.95	3.0	11	.54	1.3
Norway	71	38	23	.96	2.8	11	.21	1.4
Denmark	74	67	45	.75	2.0	1	.19	1.4
Finland	70	41	25	.86	2.2	6	.17	1.5
Mean	73	53	28	.88	2.5	7	.28	1.4
Continental coordinated market economies								
Austria	66	28	25	.96	2.2	12	.09	1.9
Belgium	57	47	41	.72	3.0	13	.15	1.4
Netherlands	58	64	46	.63	2.7	16	.18	1.6
Germany	66	39	29	.81	3.0	14	.18	1.6
France	62	56	30	.42	2.9	17	.07	1.7
Italy	55	9	5	.41	3.5	12	.04	1.6
Switzerland	78	40	13	.55	1.1	9	.24	1.6
Mean	63	40	27	.64	2.6	13	.14	1.6
Liberal market economies								
Australia	66	21	22	.21	1.0	0	.04	1.6
Canada	65	51	26	.09	.8	4	.05	2.3
Ireland	57	34	24	.12	.9	4	.11	2.0
United Kingdom	69	29	22	.13	.6	6	.07	1.8
United States	66	26	12	.07	.2	7	.03	2.0
Mean	65	32	21	.12	.7	4	.06	1.9
Japan	72	32	11	.76	2.1	7	.09	1.7

1992 to 1999. Following Nickell (1997), we operationalize ALMP effort as active labor-market spending as a percentage of GDP divided by the unemployed portion of the population. This OECD series is available for 10 countries from 1980 to 1984 and all of them from 1985 to 1999. Mean values for the dependent variable and selected independent variables are displayed in Table 2.

Analytic Techniques

Hicks (1994) notes that "errors for regression equations estimated from pooled data using OLS [ordinary least squares regression] procedures tend to be (1) temporally autoregressive, (2) cross-sectionally heteroskedastic, and (3) cross-sectionally correlated as well as (4) conceal unit and period effects and (5) reflect some causal heterogeneity across space, time, or both" (p. 172). We follow Beck and Katz's (1995) recommended procedure, using panel-corrected standard errors, corrections for first-order autoregressiveness, and imposition of a common rho for all cross-sections. This procedure is implemented in version 8.0 of the STATA econometrics program. Because there is some trend in our data, we do not include a lagged dependent variable as recommended by Beck and Katz (1996), because in this situation, the lagged dependent variable inappropriately suppresses the power of other independent variables, as Achen (2000) has shown.[9] Beck and Katz (2004) have shown that correcting for first-order autoregressiveness actually does include a lagged dependent variable on the right-hand side of the equation. Thus, it does deal with the problem of serial correlation but without, as our results show, suppressing the power of other independent variables.

To check our results for robustness, we re-estimated all of the models with OLS estimation of the regression coefficients, which provides consistent estimates of the regression coefficients and robust cluster estimators of the standard errors. It provides correct standard errors in the presence of any pattern of heteroskedasticity (i.e., unequal variances of the error terms) but not in the presence of correlated errors (i.e., nonzero off-diagonal elements in the covariance matrix of the errors). The robust-cluster variance estimator remains valid (i.e., provides correct coverage) in the presence of any pattern of correlations among errors within units, including serial correlation and correlation because of unit-specific components (Rogers, 1993; see also Sribney, 1998). Thus, the robust-cluster standard errors are unaffected by the presence of unmeasured stable country-specific factors

causing correlation among errors of observations for the same country or, for that matter, any other form of within-unit error correlation. We included period dummies to control for unmeasured factors affecting the dependent variable in all units at the same point in time.

As previously noted, the data on wage dispersion, ALMP, EPL, and neo-corporatism are only available for a subset of our cases. Data for all of the independent variables are only available for 148 of the 442 observations. For wage dispersion and ALMP, we enter the variables one at a time to the baseline equation, which includes 1-year gross replacement rate (or 1-year net), 5-year gross replacement rate (or duration of benefits), social security taxes, total taxes, wage coordination or neocorporatism, union density, capital market openness, and trade openness. In the case of EPL, the data are available for a subset of data points for which we have ALMP data, so EPL is added to the model containing ALMP. The full model that adds wage dispersion to the equation with EPL and ALMP suffers from multicollinearity, so we do not include it in the table. Suffice it to say that none of the relationships change in the full model.

Results

Table 3 shows the results of our analysis. Both the neoliberals and institutionalist political economists predict that social security payroll taxes and high, long-term replacement rates should depress employment levels, so it is not surprising that our findings support this very strongly in the case of payroll taxes. In the case of EPL, the two theoretical approaches differ only in emphasis. Here, the results support the neoliberal view and institutionalists, such as Scharpf (2000) who hypothesize that EPL reduces the volume of employment, not just its distribution across groups as Esping-Andersen and Regini (1999) maintain. The neoliberals and the institutionalist political economists also differ on their hypotheses on wage dispersion only in emphasis, as the institutionalists argue that wage dispersion becomes a barrier to increasing employment only with the advent of postindustrialism. In Models 3 and 4 in the table, wage dispersion is wrongly signed though not significant, contrary to the expectations of both theoretical schools. The results for union density do not support the view, common to the neoliberal and institutionalist literature, that union density will be negatively related to employment levels once wage coordination and neocorporatism is controlled for.

On the variables on which the institutionalist political economists and the neoliberals disagree about the relationship between the variable and

Table 3
Prais-Winsten Models of Employment Levels with Panel Corrected Standard Errors (Wage Coordination)

Independent Variables	Model 1	Model 2	Model 3	Model 4	Model 5	Model 6	Model 7	Model 8
1-year replacement rate	.117***	.176***	.257***	.283***	.100**	.223**	.098**	.192***
5 year replacement rate	-.125***	-.216***	-.286***	-.316***	-.082	-.178***	-.042	-.098*
Social security taxes	-.377***	-.539***	-.393***	-.603***	-.310***	-.580***	-.256**	-.488***
Total taxes	.021	.005	.020	-.022	-.078	-.150	-.072	-.070
Wage coordination	.112		.123		.118		.322	
Neocorporatism		9.053***		7.336***		9.798***		15.577***
Union density	.004	-.048	.009	-.034	-.001	-.050	.000	-.078*
Capital market openness	.121	.155	.022	.107	.152	.310*	.162	.441*
Trade openness	-.028	-.049***	-.056*	-.048***	-.045*	-.084***	-.064**	-.101***
Wage dispersion			-1.290	-.500				
Active labor market policies					12.174***	10.798***	16.405***	15.443***
Employment protection legislation							-1.180*	-3.144***
Constant	67.204***	67.301***	70.310***	69.007***	69.812***	70.108***	69.889***	68.109***
Common rho	.88	.87	.87	.84	.91	.84	.89	.75
R^2	.90	.93	.95	.96	.92	.96	.93	.96
N	442	357	291	248	305	220	255	170

***p =.001. **p = .01. *p =.05.

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employment, the models support the political economists in every case. The coefficients for the short-term unemployment replacement rate, neocoporatism, and ALMP are positive and highly significant in every model they are entered in. Total taxes is not significant in any model. Wage coordination is correctly signed from the institutionalist point of view but is not significant. However, it was significant in all three of the four robust cluster models (not shown). This was the only consistent difference between the robust cluster and Prais-Winsten estimates.

To get an idea of the magnitude of the effect of the significant variables, we can calculate how large a change in the dependent variable is associated with a move in the independent variable from the 10th to 90th percentile. In the case of the short-term replacement rate, a move from 22.8% (Untied Kingdom in 1993) to 72.3% (Denmark in 1993) is associated with a 9.5% increase in the percentage of the working-age population employed. A move from the long-term replacement rate of 10.3% (Japan in 1985) to 47.3% (Belgium in 1975) results in a 3.7% decrease in employment. For social security payroll taxes, a move from 1.6% (Denmark from 1995 to 1998) to 16.7% (Netherlands in 1975) results in a 7.4% decrease in employment. A move in ALMP from the U.S. 1997 level (.035) to the Danish 1996 level (.281) results in a 3.8% increase in employment. A move on the EPL index from .6 (United Kingdom from 1985 to 1999) to 3.2 (Germany and Belgium from 1985 to 1992) results in an 8.2% decrease in employment. A move on the neocorporatism index from a Canadian level (.026 for 1976 to 1994) to an Austrian level (.957 for 1974 to 1994) is associated with a 14.5% increase in employment. A comparison of the coefficients for Model 8 with the coefficients for the same variable for other models indicates the changes in employment estimated on the basis of Model 8 may be too high in the cases of EPL and neocorporatism, but in both cases, even the lowest estimates show substantively meaningful effects.

Citing Kenworthy (2004, chapter 5), one reviewer argued that our dependent variable, the level of employment in a given year, might be misleading if countries entered the post–Bretton Woods–OPEC period with different levels of employment, contending that we should examine changes in employment in addition. We did this in two ways: We replicated the models in Table 3, controlling for level of employment in 1973, and we replicated them with change in employment from 1973 to the year of the observation as the dependent variable. The results were very similar to those in Table 3 with two exceptions. Union density was negative and highly significant when controlling for 1973 employment levels but positive and highly significant with long-term change as a dependent variable. EPL was not significant in both specifications.

The values for Italy on the dependent variable and two of the independent variables—EPL and short-term replacement rates—suggested that Italy might be a significant outlier (see Table 2). In the case of unemployment benefits, Esping-Andersen (1999, p. 23), among others, points out that the OECD figures do not included the Cassa Integrazione, in which experienced workers receive and which have 80% replacement rates. To test the hypothesis that Italy inappropriately drove our analysis, we dropped Italy and reran the same models as in Table 3 (not shown). The results were substantially the same as in Table 3.[10]

Conclusion

To summarize, our analysis confirmed the neoliberal view for social security taxes, high unemployment insurance replacement rates of long duration, and EPL. However, on all of these point, the neoliberals and institutionalists shared the same view. All of the other neoliberal hypotheses—on wage bargaining arrangements, short-term (one-year) unemployment replacement rates, total taxes, wage dispersion, ALMP—found no support in the data analysis. By contrast, we found support for nearly all of the hypotheses derived from institutionalist political economy and sociology of labor markets. The two hypotheses derived from institutionalist work that we did not find support for were ones in which they shared a common prediction with neoliberal economics. We found that union density had no effect when bargaining arrangements were controlled for and that wage dispersion had no effect. Consistent with the institutionalist view and contrary to the neoliberal view, we found that neocorporatism, short-term unemployment replacement rates, and ALMP were strongly related to employment levels, and total taxes were not related to employment levels.

Other than the neocorporatism finding, our results would appear to be highly policy relevant and, in many cases, would be also politically feasible. In the case of replacement rates, our results suggest that one might finance an increase in the 1-year replacement rate with a reduction in duration and long-term replacement rates. The fact that a number of the countries included in the analysis made very large changes in unemployment replacement rates indicates that it is politically possible to do this. For instance, Switzerland increased the short-term replacement rate from 14% in 1974 to 39% in 1977 and 66% in 1985. Increases in active labor market spending have clear employment payoffs.[11] The average percentage of GDP spent on ALMP in our sample was only 0.8%. This means that very large increases

in ALMP could be financed by small increases in taxes in the short run and, if the employment benefits did materialize in the long run, the policy might well pay for itself. Our results for social security taxes indicate that there appears to be solid cross-national quantitative ground for the claims of scholars working on the German case who identify the high levels of social security taxes as a major source of German employment woes (Manow & Seils, 2000; Scharpf, 2000; Streeck & Trampusch, 2005). A comparison between Denmark (payroll taxes of 1.6% of GDP in the late 1990s) and Germany (15.2%) here is relevant, as total taxes as a percentage of GDP were actually much higher in Denmark (55%) than in Germany (44%) in the late 1990s, indicating that German social security taxes could be lowered by a reallocation of the tax burden rather than reduction of welfare state generosity. Denmark also shows that very low levels of poverty and inequality are compatible with just average levels of employment protection.

Taken as a whole, our results are more consistent with the European Employment Strategy (EES) than with the initial OECD Study recommendations. As Bernard Casey (2004), the former OECD economist, cited in the opening paragraph notes, given the theoretical point of departure, there is actually more overlap than one might expect. As we pointed out, even the original Jobs Study recommended introducing or intensifying ALMP, a traditional Nordic social democratic policy measure, and through the years, the OECD has modified its policy recommendations, particularly in the area of wage bargaining where it has recognized the virtues of coordinated wage bargaining. However, these adjustments come as afterthoughts to the still neoclassical view. By contrast, the EES owes much to traditional Nordic social democratic employment and labor-market policies and converges even more on Third Way social democratic policies (Huo, 2006). The core of the EES and Third Way policies is labor market activation and training. The goal is to move people from welfare (dependence on transfers) and nonwork to work so that they can upgrade skill levels and match skills to existing job vacancies. Whereas the neoliberal policy prescriptions are best represented by the United States, Denmark best represents the policy package suggested by our analysis: very low social security taxes, modest EPL, strong ALMP effort, high levels of wage coordination and neocorporatism, and high short-term unemployment replacement rates. The one policy on which Denmark is less than optimal is the duration of unemployment benefits, which is 4 years, but even there, it is moving in the right direction, having reduced it from 9 years and also having increased the compulsion to work or enter training by adding more qualifying conditions. Denmark and the United States might be thought of as alternative paths to high employment

as they rank second (77%) and third (74%), respectively, on our dependent variable in the final year included in this analysis. The difference is that the U.S. model carries costs in terms of the levels of poverty and inequality, which the Danish model does not.

Notes

1. See DiTella and MacCulloch (1998), OECD (1994, 1999b), Siebert (1997), or much of the popular media reporting on the topic.

2. The Organization for Economic Cooperation and Development (OECD) offers the most complete formulation of neoliberal arguments through its *Jobs Study* series, starting in 1994 and continuing through the present. Despite its consistent support for neoliberal solutions to labor market problems, the OECD is currently in the process of reassessing its *Jobs Strategy*, possibly including greater consideration for the positive role of labor-market institutions in creating jobs. See, for example, the editorial in the *OECD Employment Outlook 2004*. Because of these adjustments through time based on empirical research, the *Jobs Strategy*—which was never completely neoliberal because of its support for active labor market policy—cannot be equated with neoliberal economic thinking. Thus, the hypotheses in Table 1 under the neoliberal column do not necessarily represent current OECD recommendations.

3. The terms *deregulation thesis* and *neoliberal hypothesis* are used interchangeably as catch-all phrases for various arguments that place institutional rigidity at the core of poor employment performance in the OECD. See Crouch (1998) for a similar use of this phrase.

4. See OECD (1999b, p. 178).

5. The employment-to-population ratio is not without problems either; for example, this measure does not account for differences in the number of hours worked and part-time employment. However, as Scharpf notes, "employment/population ratios still seem to be the most valid indicators of relative employment performance" (Scharpf, 1997, p. 2).

6. Unless otherwise specified, the data for variables in the analysis are annual time series from 1974 to 1999 for all 17 countries.

7. The Huber, Ragin, Stephens, Brady, and Beckfield (2004) data set can be downloaded at the Luxembourg Income Survey Web site at http://www.lisproject.org/publications/welfare-data/welfareaccess.htm. The countries included in this model are the following: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Italy, Ireland, Japan, Netherlands, Norway, Sweden, Switzerland, the United Kingdom, and the United States. The classification scheme in Table 2 follows Kitschelt, Lange, Marks, and (1999).

8. We got similar results for the 90 to 10 ratio.

9. In these data, the lagged dependent variable explains 98% of the variation in the dependent variable.

10. This analysis is included in Bradley and Stephens (2006), which is available at http://www.europanet.org//conf/conf_papers.html. The conference paper also included an analysis of Scruggs' net replacement rate data with and without the inclusion of the Cassa Integrazione and other Italian special benefits. The results support the conclusion of the analysis here on the effect of short-term replacement rates.

11. This is an aggregate generalization. ALMP is generally thought to be most effective when unemployment is moderate or low. When unemployment is very high, the mismatch between job vacancies and the skills of the unemployed is not a central problem.

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