ON THE BENEFITS FROM RIGID LABOUR MARKETS:
NORMS, MARKET FAILURES, AND SOCIAL INSURANCE*

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The common view that far-reaching labour market deregulation is the only remedy for high European unemployment is too simplistic. First, the evidence suggests that deeply rooted social customs are an important cause of wage rigidity, going beyond the legal constraints emphasised in the political debate. Second, in a second-best setting, a compressed wage structure may generate an efficiency gain. Finally, based on simple plots of the relation between labour market institutions and openness in OECD countries, I conclude that the globalisation of economic activity may lead to increased demand for various labour market rigidities.

According to a popular view rigid labour markets are an important factor behind Europe’s stubbornly high unemployment. Only if governments get rid of distortions like minimum wages, job protection laws, and generous social benefits, will employment resume growth. This has been a recurring message of publications from the OECD and the IMF, it carries the day in weekly magazines like The Economist, it provides the intellectual backbone for policy proposals from various think tanks and it has generated a number of publications in the academic journals.

Yet, a more agnostic picture seems to emerge when one turns to the evidence. Comparative studies, recently surveyed by Nickell and Layard (1997) for the new edition of the Handbook of Labour Economics, do suggest that generous unemployment benefits of long duration generate unemployment. There is also evidence that the existence of strong but uncoordinated unions spells trouble. But the evidence is less clear-cut for other institutions. There is no strong proof that job security matters for total unemployment. There is no consensus on whether minimum wage laws create unemployment. There is no clear link between employment and the tax wedge on labour income. This mixture of results is in line with the observation that the piecemeal reforms implemented in many European countries appear to have had little success in reducing unemployment; see Coe and Snower (1997).

There are two main ways of reconciling the popular view with the inconclusive nature of the evidence. The work on ‘policy complementarities’, following Lindbeck (1996), and Coe and Snower (1997), argues that a number of reforms have a greater effect on unemployment when implemented in conjunction with other policies than in isolation. As rigidities reinforce each other, piecemeal labour market reform will fail. What is needed is rather a big-

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bang approach, that in one stroke removes a number of regulations. The work on the ‘political economy of labour market reform’, following Saint-Paul (1993, 1996), argues that reforms that could reduce unemployment substantially are blocked by the political majority of workers that have a job. As this majority only accepts reforms that do not reduce insiders’ take-home pay, the reforms that are tried in practice will be less effective in combating unemployment.

In this paper I provide a more benevolent perspective on European labour markets. Today, when so many studies explore the rent-seeking and disincentive aspects of current arrangements, and when so many take for granted that major deregulation is the only way forward, it might be good to remember that a few arguments can be made in favour of some of the existing ‘distortions’. Although it seems likely that certain institutions create persistent unemployment, others may serve quite useful purposes. Reforms that fail to distinguish between good and bad rigidities will do more harm than good. Although this basic message is not novel – previous papers that question the call for flexibility include Blank and Freeman (1993), Gregg and Manning (1997), and Nickell (1997) – my line of argument might be less standard.

First, I put nonstandard factors like fairness and reciprocity at the centre of the discussion. Recent field surveys on wage rigidity, and laboratory studies of reciprocal behaviour, strongly suggest that persistent social norms are an independent and important cause of wage rigidity, going beyond the legal constraints emphasised in the political debate. When these norms are a binding constraint on behaviour, legal reform may accomplish very little.

Second, I turn to the market failures of conventional welfare economics. Due to externalities, the absence of complete insurance markets, etc., a laissez-faire economy may malfunction. These market failures also explain why an unregulated labour market may lead to an inefficient outcome. I overview recent theoretical work showing that there are a number of instances when unrestricted market forces create excessive wage differentials, and that there are potential gains from institutions that promote a rigid and compressed wage structure.

Finally, I turn to a positive analysis of the future of labour market institutions. It is common to argue that the process of globalisation will pressure politicians to make labour markets more flexible. Based on some simple plots of the link between labour market institutions and countries’ openness in the OECD I argue that the opposite may happen. Labour market institutions can be thought of as instruments of social insurance, that protect workers against risks for which private insurance is hard to come by. Due to the increased external risks that accompany globalisation, the demand for social insurance through a rigid labour market may increase in the future.

1. The Social Nature of Wage Rigidity

Towards the end of the 1920s, Britain’s unemployment rate was high and rising. But in spite of this wages appeared to be quite rigid. The reason for this
anomaly was of course discussed among the leading economists of the day, including the members of the special Committee of Economists, appointed by the government in the summer of 1930.\(^1\) Lionel Robbins, recently appointed at the age of 31 as Professor of Economics at the London School of Economics, emphasised that factors like the introduction of widespread unemployment insurance, monopolies, and other restrictive practices had an important role in generating wage rigidity. What was required were policies that eased these constraints on wage flexibility. Arthur Pigou, the founding father of welfare economics, suggested that the main problem lay in the immobility of labour in the face of marked changes in the pattern of demand. This geographical mismatch problem was aggravated by unemployment insurance and a greater resistance to wage cuts.

The chairman of the Committee, none other than Keynes himself, seemed to adopt the position that downward wage rigidity was a fact of life, which policy could do little about. His thought on this crucial macroeconomic issue comes through in the following, often quoted, passage from the *General Theory*:

\[\ldots\] any individual or group of individuals, who consent to a reduction of money-wages relatively to others, will suffer a relative reduction in real wages, which is sufficient justification for them to resist it. On the other hand it would be impractical to resist every reduction of real wages, due to a change in the purchasing power of money which affects all workers alike. (p. 14).

Keynes makes no mention of unions or government regulation. Unlike Robbins and Pigou, he seems to attribute wage rigidity to more basic aspects of the human psyche. Workers care about relative rather than absolute treatment, and for some reason this prevents firms from cutting wages, in spite of high unemployment.

More than six decades have passed, and macroeconomists still argue about the reasons for wage rigidity. One of the more unconventional recent approaches to explain wage rigidity is provided by the noneconomic efficiency wage models developed by George Akerlof, Robert Solow, and others, and discussed at length by Akerlof and Yellen (1990). Akerlof and Yellen argued that wage rigidity hinges on the fact that firms and workers operate under a fairness constraint.\(^2\) A firm that sets a wage below workers’ perception of a fair wage will find that workers respond by reducing effort. As a consequence, firms have little incentive to cut wages, even in the midst of a severe and prolonged recession. To motivate this idea, Akerlof and Yellen pleaded to the reader’s common sense. They pointed at anecdotal evidence, they referred to discussions about pay policy found in textbooks on personnel management, and they reviewed an extensive literature from sociology and psychology.

\(^1\) The following account of the views among members of the Committee of Economists is taken from Moggridge (1992, chapter 19).

\(^2\) For a related, quite forceful, exposition of the view that fairness is an important motivating factor in the labor market, see Solow (1990).

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The unorthodox nature of this evidence, and the fact that many of the cited studies were based on small, and statistically unrepresentative samples probably explain why many economists appear to have remained sceptical, or dismissive, of the fair wage approach. But this may now be changing. According to the recent publication pattern of the leading journals, the fairness-camp is rapidly gaining ground. Game theory, for long a bastion of selfish super-rationality, has got an off-spring, behavioural game theory, which among other things deals with how to formalise situations when people care about fairness and revenge; see Rabin (1993). On the empirical side, researchers exploit field surveys and experiments to uncover otherwise hard-to-catch motives and aspirations.

1.1. Evidence on Wage Rigidity from Field Studies and Experiments

The field-study approach is simple enough. If you want to understand the phenomenon of wage rigidity, why not spend an hour or two interviewing the people that actually set wages? Several such studies have recently been conducted, and they all suggest that firms believe that the price tag on wage flexibility is quite high. Employers are unwilling to cut wages because they fear that wage cuts will affect work morale in an adverse manner. Blinder and Choi (1990) find that managers are concerned that employees might interpret a wage cut as an unfriendly act, which would affect work effort, resignations and the quality of future job applicants. Campbell and Kamlan (1997) report that compensation executives believe that wage cuts would generate negative feelings among workers, and thereby lead to less effort. Bewley (1995), after interviewing managers and labour leaders, reports that firms resist cutting pay ‘... out of fear that ... the insult by lower pay would cause workers to lose their allegiance to the organization’ (Bewley, p. 252). He also found indications that firms are reluctant to hire workers who offer to work for less than the going wage, i.e. underbidders.

Similar conclusions have been reached in surveys conducted in other countries than the United States. In his study of British firms, Kaufman (1984) found that businessmen cited morale issues as a prime reason for not cutting wages. Agell and Lundborg (1995) found that the managers in a sample of large Swedish firms paid great attention to employees’ perception of a fair wage structure, and that these concerns were so strongly felt that many managers would contemplate a wage cut only in case of an emergency that constituted a threat to the existence of the firm. Like Bewley, they also found that managers cited a desire to have an equitable internal wage structure as a reason for not hiring underbidders.

These subjective responses are clearly an imperfect way of testing theories based on hard-to-quantify concepts like fairness. For obvious reasons, there is a need for complementary evidence. One such source is provided by experimental studies of reciprocal behaviour. That fairness has an important effect on behaviour has been a consistent finding in a number of studies of bargaining in ultimatum games. In this game, player A proposes a division of a given sum
of money to player $B$. If $B$ accepts, both players receive the proposed allocation; if $B$ rejects, neither player gets any money. If people behave as selfish maximisers player $A$ would offer one cent to player $B$, who would happily accept. However, this is not what happens in the lab. In spite of inflicting a loss on themselves, people reject offers they view as unfair. $A$-players appear to anticipate this, and to reduce the risk of rejection they typically offer $B$-players ‘... 30–40 percent of the total, with a 50:50 split often the mode’ (Camerer and Thaler (1995, p. 210). This result is quite robust, and it has been replicated in experiments conducted in a number of countries. It also seems to hold for fairly high stakes of up to two months’ wages; see Camerer (1997).

Recent extensions of the ultimatum game incorporate an extra round of response. In gift exchange games player $A$ can either put a given amount of money in her own pocket, or give a larger sum to player $B$. Player $B$ is then free to allocate the larger sum between herself and player $A$. The normal finding in this experiment is that gift exchange is the rule rather than the exception. People trust that an act of kindness will stimulate an act of kindness in return. This belief seems to be justified – on average there is a positive return for $A$-players that choose the gift-option; see Camerer (1997). Can these mechanisms explain sticky wages and involuntary unemployment?

According to Fehr et al. (1993), and Fehr and Falk (1997), the answer is yes. In these experimental studies there is a gift exchange game between ‘firms’ and ‘workers’. In the first stage there is the gift from firm to worker (how high a wage to offer), and in the second there is the reciprocal gift from worker to firm (how much costly effort to provide). The striking result is that the gift exchange motive was strong enough to prevent the experimental labour market from clearing. In all sessions, there was involuntary unemployment, and a strong positive correlation between wages and effort. In anticipation of a reciprocal effort-bonus in the second stage, firms offered wages that were substantially above the market-clearing level. Interestingly, and in line with the evidence from some of the field surveys, Fehr and Falk also find that the unemployed try to underbid employed workers, but that firms refuse to hire them.

1.2. Implications for Labour Market Reform

In my view the important finding of field studies and experimental investigations is that reciprocity appears important for the workings of the labour market. A firm that raises the wage above the competitive wage induces a positive effort response from workers, that justifies the wage hike. A firm that cuts wages in an ‘unfriendly’ manner provides workers with an incentive to retaliate. These basic aspects of human behaviour appear to provide important

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3 In Fehr et al. the wage is determined in a one-sided oral auction, with firms as wage-makers. In Fehr and Falk the wage is determined in a double auction (both workers and firms are allowed to present bids and counter-bids). In either case the firm was not allowed to condition the wage on effort, i.e. the setting was one of incomplete contracts.
constraints on economic transactions, operating alongside the legal and budget constraints emphasised in the standard analysis. The gift exchange approach suggests, as was implicit in the *General Theory*, that inflexible wages and persistent unemployment are phenomena of an essentially social nature. Unless special circumstances apply, wage competition is deemed to be socially improper. This norm works against wage flexibility, and against the forces of demand and supply.

How do some often proposed labour market reforms look from a gift exchange perspective? One does not need to think hard to see that a number of interesting possibilities open up. The discussion about the need for labour market deregulation has focused exclusively on reforms that are intended to alter economic incentives. But in a situation where the social norm binds, relaxing various legal and economic constraints is of no immediate significance.\(^4\) Measures that seem particularly prone to clash with established social constraints are those that are designed to promote wage flexibility at the level of the firm.

Consider the case of job security laws. These laws, designed to protect employees against unfair dismissal, are often considered to generate excessive wage claims, as they strengthen the position of incumbent workers. However, it could well be that most provisions of job security legislation simply serve to formalise established norms of proper conduct. For firms that care about labour relations, and about their reputation among prospective job-seekers, replacing incumbent employees with unemployed underbidders would probably be a bad idea, even if the law permitted so. Another example concerns the employment effects of minimum wage laws, an issue which has caused much controversy among labour economists. The gift exchange approach provides a simple explanation of why most firms choose to pay wages above the minimum wage, in spite of persistent unemployment. It also explains why the elimination of minimum wage laws may have a very small effect on unemployment.

But there are also reforms that are less likely to interfere with the game of gift exchange between firms and workers. A popular class of policy proposals are those that aim to improve the employment situation for unskilled workers by tax cuts, directed at the lower end of the income distribution. It is hard to see why such schemes would create a problem from a fairness point of view. Other reforms may work because they relax the fairness constraint. Several years ago Martin Weitzman argued that unemployment could be reduced by arrangements in which workers got some of their compensation in a form which was tied to the fortunes of the firm, i.e. profit sharing. As first noted by Solow (1990, chapter 3) the gift exchange approach is an alternative way of making sense of profit sharing. By stimulating a closer worker-firm identification, profit sharing may enhance work morale and productivity.

\(^4\) In the following I disregard the fact that there are mutual interactions between social norms and legal and economic institutions. Via the political system the prevalent social norms among the electorate will affect the design of legal and economic institutions. But there are also dependencies that go in the other direction – in the long run legal and economic institutions will affect social norms in the labour market. For an analysis of these interactions, see Lindbeck *et al.* (1998).
It is important to note that the gift exchange approach does not rule out ‘harsh’ policy measures. Less generous unemployment benefit is an unattractive policy option for those who prefer an egalitarian income distribution. But from the gift exchange perspective, lower benefits may have a positive side-effect. In assessing the attractiveness of the gift offered by the firm (i.e. the wage), the worker presumably makes a comparison with outside options, like wages payable in other firms, or benefits payable to the unemployed. When benefits decrease, workers increase their appreciation of any given wage offer, which leads to a positive effort response.

1.3. A Summing Up

In an economy with perfect labour contracts, firms need not bother about how to motivate their employees. In the real economy, however, incomplete labour contracts are the rule rather than the exception, and the mutual exchange of trust between firm and worker is an important motivating force. What an outsider interprets as a wage rigidity may then in fact be the result of an ‘invisible handshake’ (to borrow a term invented by Arthur Okun), for the good of both worker and firm. This handshake suggests why certain types of labour market reform may have a hard time promoting wage flexibility, and it provides a simple explanation – alternative to the recently popular argument about ‘policy complementarities’ – of why the reforms that have been implemented so far appear to have had limited success.

2. Labour Market Institutions as a Way of Remedying Market Failures

A more standard way of addressing the popular view of the virtues of deregulated labour markets is to introduce the market failures of welfare economics. A Pareto efficient allocation of resources emerges if all agents act as price takers, and if there is a complete set of markets. Efficiency is then best served by having a government that does no more than guarantee property rights. But as any prospective social engineer knows, markets may not exist, and agents may have market power. Because of externalities, public goods, increasing returns, and asymmetric information, there is, at least in theory, a case for government intervention.

The very same market failures may also explain why labour market institutions can improve efficiency. Judged against the yardstick of a perfectly competitive equilibrium model hardly any of today’s institutions make sense. But judged against the yardstick of an economy where some markets are missing, or some agents are price makers, matters look rather different. A classic example, due to Stigler (1946), is that of the employment and welfare effects of a minimum wage in a labour market characterised by monopsony. When introduced in a first-best economy a minimum wage is bound to reduce efficiency. But when the minimum wage is introduced in a labour market where the firm has all the market power, the firm is provided with the incentive to increase employment towards the first-best level.

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Another example is the argument of Freeman and Medoff (1984) that unions may enhance efficiency by providing employees with a collective voice in communicating with management. There are a number of aspects of the work environment that share the distinguishing characteristic of a public good, that one individual’s consumption of a commodity does not diminish the consumption of others. Because of the classic free-rider problem, individual bargaining between management and worker may easily lead to a situation where commodities like safety regulations, lighting and heating on the factory floor, grievance procedures, and layoff policy are provided in a suboptimal manner. To provide a proper aggregation of the preferences of employees, collective bargaining institutions might be called for.

In the last few years labour economists on both sides of the Atlantic have been busy exploring the policy implications of models of the labour market that accommodate all the standard market failures of welfare economics. A main theme of these papers is that many of the institutions that are pictured as the bad guys according to the received wisdom may have a more appealing appearance when analysed from the perspective of incomplete markets. Under certain conditions unions, minimum wages, and unemployment benefits may promote an efficient resource allocation. This is not the time to review this extensive literature at length. I will limit myself to discussing under what conditions the prototype distortion in the form of an institutionally compressed wage structure may have advantageous effects. Wage compression can take place along several dimensions. I will concentrate on three of them: pay compression across production sectors, pay compression across skill groups, and pay compression across everything.

2.1. Pay Compression Across Production Sectors

Are competitive wage differentials an obstacle to growth and structural change? The answer provided by two of the leading architects of the ‘Swedish model’, the trade union economists Gösta Rehn and Rudolf Meidner, in the late 1940s and early 1950s was in the affirmative. In the words of Rehn labour is not ‘... like mercury, requiring only small level differences between two areas in order to float quickly, and in large quantities, from one of them to the other.’ As a consequence firms in the dynamic segments of the economy have

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5 What I mean by the received wisdom is a large number of papers that explore the effects of labour market institutions in models where the introduction of unions, insider bargaining power, and government regulations is bound to reduce economic efficiency. Representative examples include Flam’s (1987) analysis of union pay compression, Saint-Paul’s (1993, 1996) analysis of rent-seeking and political equilibria, Coe and Snower’s (1997) analysis of the case for fundamental labour market reform, and Ljungqvist and Sargent’s (1998) search-theoretic analysis of European unemployment. These papers are quite useful in mapping out the potential costs of various labour market institutions, but they have nothing to say about the potential benefits. At a more applied level, Siebert (1997) may typify policy advice based on the view that the appropriate benchmark when discussing European labour markets is an equilibrium in a classically clearing labour market.

6 The following draws on Agell and Lommerud (1993). For related discussion about the Rehn-Meidner model, see Moene and Wallerstein (1997). For an analysis of pay compression that stresses various political interactions, see Paldam (1989).

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to pay a competitive wage differential to attract workers from firms in stagnating sectors. But by acting like a tax on expansion, this wage premium slows productivity growth, and the rate of structural change.

The Rehn-Meidner recipe for higher productivity growth was ‘solidarity’ wage policy. The Swedish blue collar union should strive for national wage bargains that honoured the principle of ‘equal pay for equal work’, regardless of the profitability of the individual firm. A high wage pressure in low-wage sectors should force low-productivity firms to shut down, while wage restraint in high-wage sectors should allow high-productivity firms to expand. To ensure the speedy transfer of redundant workers from stagnant to expanding firms, Rehn and Meidner also advocated the use of a whole battery of new tools, which since have become standard: mobility grants, active job counselling, and extensive training programmes.

How can a modern-day economist make sense of the Rehn-Meidner approach? In the absence of market failures, competitive wage differentials reflect the true opportunity cost of intersectoral labour mobility. A system of competitive markets then provides the right speed of structural change, and wage compression can only lead to inefficiency. But every theorist knows that cleverly assigned externalities are the way to rationalise unorthodox policies. A standard assumption in a large class of models of endogenous growth is that there are increasing returns to scale and positive externalities from producing in certain sectors. These assumptions imply that structural change will be suboptimal in a laissez-faire economy, and that there is a case for subsidising the externality-generating sectors.

Rehn-Meidner style pay compression can be analysed in the same way. There is a very close conceptual similarity between wage compression and an industrial policy of subsidising the wage costs of high-productivity firms. Compared with the laissez-faire equilibrium, both pay compression and industrial policy lead to a downward shift in the marginal cost curves of expanding firms. The only cosmetic difference is that the shift is engineered via restrained union wage policy in the former case, and via a cash subsidy from the government in the latter case. If the growth externalities are concentrated to the high-productivity sectors, both policies are conducive to growth.\(^7\)

From the viewpoint of the worker’s mobility decision, it is important to note that solidarity wage policy replaces the carrot with a stick. Under competitive conditions a compensating wage differential rewards workers for the trouble of moving to a new job, or to another part of the country. Under solidarity wage policy workers move to the externality-generating sectors because they have to – their old jobs disappear. But if this push-incentive is to be operational, it must be unpleasant to be unemployed. Giving generous passive income support to

\(^7\) For empirical evidence suggesting that Rehn-Meidner style pay compression had positive productivity effects on Swedish manufacturing until the early 1970s, when Swedish unions began to opt for a more aggressively egalitarian wage policy, see Hibbs (1997). Also, Edin and Topel (1997) conclude that union wage policy speeded up the decline of low-wage Swedish industries.

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the unemployed for long periods, as is a common practice today, is very much against the spirit of the Rehn-Meidner model.

2.2. Wage Compression and the Incentives for Skill Formation

A very common claim in the debate about the structure of European labour markets is that a compressed wage structure reduces people’s incentive to acquire human capital. As governments and egalitarian unions attempt to raise the income of those at the low-end of the skill distribution, they also reduce the return on investments in education and training; thus, there will be too little investment in skill formation.

Recent theoretical work suggests that this argument is too simplistic. A main lesson from the Rehn-Meidner model is that an institutionally compressed wage structure can initiate push-effects, which counter the conventional disincentive effect. The schooling decision depends on the return to schooling. But it will also, which is often forgotten, depend on the skill requirements of firms. If the relative wage of unskilled workers increases, firms hire fewer unskilled workers. To avoid unemployment, again supposing that this is an unpleasant state, people will then have to acquire more schooling. As shown by Cahuc and Michel (1996), Agell and Lommerud (1997), and Ravn and Sørensen (1997), it is easy to write down models in which this unemployment threat implies that a binding minimum wage for unskilled workers may encourage schooling. If the initial human capital stock is too low because of some market failure, such compression of the wage structure from below may lead to increased welfare.8

Additional underpinning for the idea that a compressed wage structure may encourage human capital formation is provided by Acemoglu and Pischke (1998), who concentrate on on-the-job training. Like Agell and Lommerud, they develop a model in which firms have \textit{ex post} bargaining power. As workers realise that part of the return to skill formation will be appropriated by the firm, they may end up not investing in general training. Acemoglu and Pischke show that the firm may want to compensate for this by investing in the general skills of their employees. They also show that such firm-sponsored investments in general training should be more common when the wage structure is compressed against skilled workers.

The preceding arguments have bearing upon the recent discussion about the role of institutional factors versus market forces in explaining cross-country differences in earnings inequality. According to the standard view, the fact that pay differentials are smaller in some countries than in others mainly reflects the impact of unions and minimum wage laws on the earnings of the unskilled; see Blau and Kahn (1996). According to the alternative view, institutions play a subordinate role – some countries have compressed earnings distributions

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8 Cahuc and Michel (1996) and Ravn and Sørensen (1997), consider a market failure in the form of a positive production externality from the aggregate human capital stock. Agell and Lommerud (1997) assume that the firm has market power and can appropriate part of the private return to schooling in the wage bargain. In either case a suboptimal amount of schooling will come forth in a laissez faire equilibrium.

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simply because their schools and training programs produce a compressed
distribution of skills; see Nickell and Bell (1996). The push-analysis of com-
pressed wage structures suggests that this dispute might be more apparent
than real. The Rehn-Meidner model conveys the logic that a wage structure
that is compressed from below may provide low-ability individuals with strong
incentives to acquire schooling, and to participate in training programmes.
That the evidence suggests that the skill distribution is more compressed in
Sweden than elsewhere may thus be the result of unions’ striving to keep up
unskilled wages.

2.3. Wage Compression as Social Insurance
My final point about the benefits from wage compression is perhaps the most
general one. The intuition is as follows. When risk-averse individuals face
uncertainty concerning their place in the wage distribution, there is a clear
insurance incentive. But the private market is less likely to accommodate this
demand for human-capital-related risk sharing – a fact that is often attributed
to problems of adverse selection and asymmetric information. Since human
capital is the by far most important asset for most individuals, this lack of
private insurance markets raises important policy issues. In particular, it
suggests a well-known role for government redistribution policy. By reducing
the variance of disposable income, redistributive taxation may improve welfare
by providing an insurance effect in addition to the conventional equity and
incentive effects; see Diamond et al. (1980), Eaton and Rosen (1980), and
Varian (1980).

But income redistribution schemes sponsored by the government are not
the only means of providing insurance against wage risk. A more direct form of
insurance can be provided through labour market institutions – unions,
minimum wage laws, unemployment insurance – that narrow the wage distri-
bution. As shown by Agell and Lommerud (1992), under quite general
assumptions the insurance benefits from a ‘small’ compression of the wage
structure will outweigh any efficiency losses imposed on the economy.9 The
representative worker is willing to exchange a lower expected wage for a wage
structure that offers insurance against uncertainty concerning who-one-will-be
in the wage distribution. It is also easy to show that the result that pay
compression has desirable effects carries over to the case when workers face
different risks ex ante. As long as all workers face some uncertainty concerning
future relative wages, everyone will support at least a modest amount of wage
compression.

The social insurance rationale for pay compression has an important
implication that I will explore in the next section. In periods when workers
become more uncertain about their future position in the wage distribution,
the insurance demand for a narrow wage distribution ought to increase. In

9 The idea that wage levelling provides relative income insurance is also explored by Ljungqvist

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times of rapid structural change, or when greater openness disrupts established economic relations, a larger share of the workforce will need insurance against a rainy day. As a consequence, union members may then vote for a more egalitarian wage policy, while the electorate at large may vote for more income redistribution.

2.4. A Summing Up

Needless to say these three examples of socially beneficial pay compression should not be construed as a normative argument for government intervention. Market failure is no worse than political failure. Also, a government that wants to address the market failures that I have discussed might be well advised to rely on policy instruments other than direct interference in the process of wage setting. After all, Pigouvian taxes and subsidies are the standard policy instruments of welfare economics. But viewed as an exercise in positive economics, my examples suggest that the common argument about the harmful effects of an institutionally compressed wage structure is incomplete.

A final observation is that the market failure approach to labour market rigidities provides no unconditional policy recommendations – optimal policy will depend on the precise nature of the market failure under scrutiny. For an example, consider the case of unemployment benefits. The Rehn-Meidner model of pay compression presupposes that unemployment benefits are sufficiently low to induce people to move to the externality-generating sectors. But according to the social insurance argument for pay compression, generous unemployment benefits may play a useful role in providing insurance against downside income risk.

3. Will Labour Markets Become less Rigid in the Future?

A common argument is that globalisation increases the costs of European labour market institutions. Because of increased competition from low-wage regions the labour of the advanced economies is under pressure to adjust to changing market conditions. The costs, in the form of low-skill unemployment and low growth, of maintaining institutions that hinder labour market flexibility are on the rise. As a consequence, governments will sooner or later have to relax strict job security laws, abolish minimum wage legislation, and implement measures that restrict the influence of rent-seeking unions. Here, I will argue that just the opposite may happen.

There are both costs and benefits to current labour market institutions. On the one hand globalisation probably tends to increase the costs of some labour market institutions. On the other hand the social insurance benefits of certain labour market institutions will probably also increase. Because of greater exposure to the uncertainties of the international marketplace the decisive voter might be perfectly willing to pay a higher price for any given labour market distortion. Whether the net impact of these increases in the costs and benefits of current labour market institutions – as perceived by the decisive
voter, or the decisive union member – will be a more or less rigid labour market is impossible to say. The insurance argument points to a more rigid labour market, while the cost argument points in the opposite direction.

The idea that increased openness increases people’s demand for collective intervention to mitigate risk is an old one. Economists and political scientists have long\textsuperscript{10} suggested that the vulnerability of the open economy, and the onslaught of economic crises originating from abroad, provide governments with strong incentives to increase the scope of the public economy. As argued by Cameron (1978), the high degree of industrial concentration that accompanies trade may also facilitate the formation of employers’ associations and strong trade unions. In a simple test of these ideas, Cameron (1978) showed that openness in 1960, measured as the sum of exports and imports divided by GDP, appeared to be the best single predictor of the growth of public revenues relative to GDP in a sample of 18 OECD countries in the period 1960–75. He also found a positive correlation between openness and a measure of the scope of collective bargaining. More recently, a strong empirical association between openness and the scope of government has also been reported by Rodrik (1996), who examines a much broader sample from the Penn World Tables (PWT).

3.1. Labour Market Institutions and Openness: Some Simple Plots

In the figures below I show the simple scatter plots, together with the bivariate (ordinary least squares) regression lines, of the relationship between often-discussed dimensions of a rigid labour market and openness for that sub-set of 20 OECD-countries for which there are comparable measures of the structure of labour market institutions. Much of this information is taken from Nickell and Layard (1997), and it typically refers to the situation towards the end of the 1980s, or the early 1990s.\textsuperscript{11} My measure of openness is (the logarithm of) the average of the sum of exports and imports divided by GDP in 1980–4.

A first observation, in line with the finding of Cameron, is that there appears to be a correlation between exposure to international trade and the scope of collective bargaining. Fig. 1 shows that there is a positive relationship between openness and union density, and Fig. 2 shows that there is a negative relationship between openness and the well-known ranking of Calmfors and Driffill (1988) of the centralisation of wage bargains (note that a lower rank signifies that the wage bargain is more centralised). In both bivariate regressions the slope coefficients are highly significant. On average countries that are more open to trade are more likely to have sizable unions, and to have centralised their institutions of wage bargaining.

\textsuperscript{10} In discussing the impact of international economic crises, Myrdal (1960, p. 15) argued that ‘... to protect ... the employment of the workers, the welfare of the farmers, and, in general, the undisturbed continuation of production and consumption, all states have then felt themselves compelled to undertake new, radical intervention, not only in the sphere of their foreign trade and exchange relations, but also in other sectors of the national economy.’ I owe this quote to Cameron.

\textsuperscript{11} See the Appendix for further discussion of the data.

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Fig. 1. Union Density vs. Openness in OECD

Fig. 2. Centralisation Ranking vs. Openness in OECD

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Figs. 3–5 plot openness against three notorious rigidities: minimum wages (measured as the ratio of the minimum to average wage); job security laws (measured according to the OECD employment protection index, which gives a higher rank to countries imposing strict limits on hiring and firing); and the generosity of the system of unemployment benefits (measured as the product of the replacement rate and the benefit duration in years). On average, we note that more open economies are more likely to have high minimum wages, strict job security legislation, and generous unemployment benefits. However, the scatter plots are dispersed, and it is only in Fig. 3 that openness is significant at the 5% level in the bivariate regression.

Figs. 6 and 7 show the scatter plots for two measures of income inequality, the 90/10 percentile ratios of earnings and disposable income inequality. The data on wage inequality (available for 15 of our 20 countries) are reported in OECD (1993), while the data on disposable income inequality (available for 17 countries) are reported in Gottschalk and Smeeding (1997), who base their calculations on the Luxembourg Income Study Data Base. Both inequality measures exhibit a strong, and highly significant, negative correlation with openness. In the OECD countries trade appears to promote earnings and disposable income equality – correlations that are at odds with the standard conjecture that international trade ought to lead to wider wage differentials, and to a diminished scope for government redistributive policy. However, these correlations fit quite nicely with a social insurance interpretation of union wage policy, and of government tax-and-transfer policy.
Fig. 4. Generosity of Benefits vs. Openness in OECD

Fig. 5. Job Protection Rank vs. Openness in OECD
Fig. 6. Wage Inequality vs. Openness in OECD

Fig. 7. Income Inequality vs. Openness in OECD

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Clearly that these simple correlations do not constitute proof. The sample is small, openness is clearly correlated with a number of factors not accounted for in the plots, and there is certainly reason to worry about outliers. Moreover, my measure of openness is based on the actual volume of trade, which is an endogenous variable that can be affected by country-specific labour market institutions. Yet the patterns in the plots are so strong, and so uniform across a variety of dimensions, that it still seems quite reasonable to conclude that there is much more to rigid labour markets than the rent-seeking behaviour of unions and other special interests. All the correlations are perfectly consistent with the idea that labour market institutions, and the degree of centralisation of wage bargaining, can be interpreted as devices of social insurance. It seems much less clear how to reconcile these plots with a story that assigns a prominent role to rent-seeking behaviour.

3.2. A Summing Up

To the extent that historical cross-sectional patterns are informative about the future, the scatter plots convey the surprising message that increased openness may lead to increased institutional involvement in the labour market. Is this a plausible prospect for the labour markets of the global economies of the next millennium? The social insurance argument is a narrow economic one, paying no attention to the complex interactions of history, economics, and politics that shape the structure of the institutions of the real world. In the United States, for example, labour markets have been flexible for a long time, and recent decades have seen a steady decline in the demand for unions. It seems unlikely that increased openness will reverse this tendency in the foreseeable future.

In continental Europe, tradition and politics appear to be less likely to go against an increased demand for income protection. The Social Chapter of the Maastricht Treaty, talk about ‘social Europe’ within the corridors of power in Brussels, and (at least nominally) leftist governments in a number of countries, bear witness to a political milieu with, for better or for worse, a natural inclination for political interference in the market. The United Kingdom, finally, might be a borderline case. On one hand the succession of reforms during the 1980s have given the British labour market a quite flexible outlook. On the other hand, the recent introduction of a national minimum wage, and

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12 The correlations shown in Figs. 1–7 survive some elementary sensitivity analysis. First, to deal with the possible endogeneity of the trade shares I computed the correlations between labour market institutions and the two measures of ‘natural openness’, developed by Frankel and Romer (1996, columns 2 and 3 in the appendix). These instruments turned out to be more highly correlated with labour market institutions than the actual trade shares. Second, when I controlled for (the log of) GDP per capita in 1985, according to PWT (Mark 5.6), openness remained significant in the OLS-regressions in 5 out of 7 cases. Third, when I also added a control for country size, (log) population in 1985 according to PWT, actual openness was significant in 3 out of 7 cases (at the 10% level), while the Frankel-Romer instruments of natural openness were significant in 4 out of 7 cases.

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4. Concluding Remarks

In a recent paper Agnar Sandmo (1998) cautioned that

\[ \ldots \text{there is always a danger that criticisms of past policies may be carried too far, and that expectations of success for the new approach may be overoptimistic. The weaknesses of current} \]
\[ \text{policies are always visible, whereas alternative systems tend to be evaluated more on} \]
\[ \text{the basis of theoretical blueprints.} \] ... As economists, we should perhaps look upon
\[ \text{ourselves as built-in-stabilizers in the public debate, with part of our} \]
\[ \text{mission being to warn against policy overreactions. (p. 14)} \]

Sandmo’s immediate concern was the current debate about the future of the welfare state. But in my view the quote is just as applicable to the current debate about labour market reform.

The recent emphasis on disincentive mechanisms and rent-seeking behaviour has undoubtedly generated a wealth of useful insights. It has done much to eliminate naïve conceptions about the workings of the political system, and I am in no doubt that stories based on rent-seeking have potential in explaining certain aspects of the structure of European labour markets. It also seems most likely that some institutions do help in explaining the persistent nature of European unemployment. There is much evidence suggesting that long-lasting unemployment benefits create problems, and that the same goes for strong but uncoordinated unions. There also seems to be a convincing case for moving to a system where unemployment benefits are financed via fees payable by unions, rather than via general tax money (e.g. Holmlund and Lundborg, 1988).

But not all rigidities represent the wasteful influence from strong special-interest groups. Some types of intervention in the labour market can be thought of as harmless reflections of more basic social norms, and some may even serve a useful purpose in improving the workings of the economy. By focusing almost exclusively on the cost side of labour market regulation, and by ignoring much of the fine-print, supporters of the big-bang approach to labour market reform have an unbalanced case. A main problem of the exaggerated nature of some of their claims is that they generate strong counter-forces, that in the end may block also quite well-motivated reforms.

A decade from now, the average European voter may still vote for politicians that promise to maintain the status quo in the labour market, and the average European employee may still take to the street when someone tinkers with unemployment benefits or minimum wages. These eventualities may indicate nothing less than the pervasive nature of the rent-seeking activities of strong pressure groups. But they may also signify a genuine demand for economic security in times of uncertainty. If there is some truth in the latter interpreta-
tion, some unconventional implications for labour market reform seem to open up.

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**Appendix**

The data sources for Figs. 1 to 7 are as follows. Nickell and Layard (1997), NL, report extensive information on the structure of labour market institutions in 20 countries: Austria, Belgium, Denmark, Finland, France, Germany (W), Ireland, Italy, Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, the United Kingdom, Canada, the United States, Japan, Australia, and New Zealand. For these countries I compute average openness in 1980–4 from the variable OPEN (the sum of imports and exports divided by GDP), included in Penn World Tables, Mark 5.6.

The variable union density (union members as a percentage of all wage/salary earners in 1988–94) in Fig. 1 is from NL, Table 3, column 1. The centralisation ranking of Calmfors and Driffill (1988) in Fig. 2 is from NL, Table 3, column 5. The ratio of minimum to average earnings in Fig. 3 is from NL, Table 5, supplemented with information for Switzerland from Dolado *et al.* (1996), Table 1. This variable refers to the situation in 1991–4; there are missing values for Japan and Australia. The unemployment benefit index in Fig. 4 is computed as the product of the replacement rate (NL, Table 6, column 1) and the benefit duration in years (NL, Table 6, column 2); the index refers to the situation in 1989–94. The OECD job protection ranking in Fig. 5 is from NL, Table 2, column 2; it refers to the situation in 1990.

The 90/10 percentile ratio of earnings inequality in Fig. 6 is taken from OECD (1993), Table 5.2; this variable refers to male wage inequality, or, when available, overall wage inequality. For most countries wage inequality is measured in 1989–91; there are missing values for Finland, Ireland, Spain, Switzerland, and New Zealand. The 90/10 percentile ratio of disposable income inequality in Fig. 7 is taken from Gottschalk and Smeeding (1997), Fig. 2. For most countries income inequality is measured in 1991–2. There are missing values for Japan, New Zealand, and Portugal.

**References**


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