WHY ECONOMIES SLOW

U.S. Sclerosis?

Ronald Schettkat

The European Union, the European Central Bank, and other major institutions had some time ago come to believe that America's flexible labor markets were the sources of its rapid job creation since the 1970s. But, in the past few years, while gross domestic product has grown significantly, the number o f jobs in the United States has not. This European economist explains that it is not flexible markets but stringent macroeconomic policies that have most inhibited growth rates in Europe, and the United States cannot count on flexible job markets to produce new jobs now.

THE JOB-CREATION POTENTIAL OF THE U.S. ECONOMY is legendary. New employment records were set year after year. From 1970 to 2000, employment in the United States increased by about 2 percent annually, contrasting sharply with the meager employment growth in Europe, where in the biggest economy, Germany, employment grew by only .1 percent per year. Within three decades, U.S.

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Table I

Employment, Employment Rates, and Demand per Capita in the United States and in Germany, 1970 and 2000

	Employment (millions)	Employment rate (employed per pop. 15-64)	Demand per capita (PPP US$, 1999 OECD benchmark)
United States			
1970	78.7	0.62	18,254
2000	136.2	0.75	35,280
Germany			
1970	26.6	0.69	16,202
2000	36.3	0.65	25,381

Source: Computations are based on the OECD economic outlook database.

employment rose by 75 percent. In Germany, by comparison, employment increased during this thirty-year period by only 3 percent (adjusted for unification). Since employment growth and stagnation coincided with distinct institutional features of labor markets--a largely unregulated U.S. labor market but highly regulated labor markets in Europe it was natural to investigate the impact of institutions on employment. American unions have almost disappeared, workers in the United States can be fired for good reasons or for no reason, unemployed workers need to find a new job quickly since unemployment benefits are meager and eligibility periods are short, inequality in the United States is high and rising. In Europe, on the contrary, union membership is high, although declining, dismissals require advance notice and an explicit reason, unemployed workers receive benefits equal or close to their former wage and salary income, and eligibility periods can last three years and sometimes even longer. Finally, inequality has remained largely unchanged.

Guided by the advice of many economists, politicians tried to put one and one together. European labor markets were identified as being sclerotic: Firms do not hire because they fear high dismissal costs, and workers are not under pressure to accept new jobs because overly generous welfare-state measures cushion unemployment. In conse-

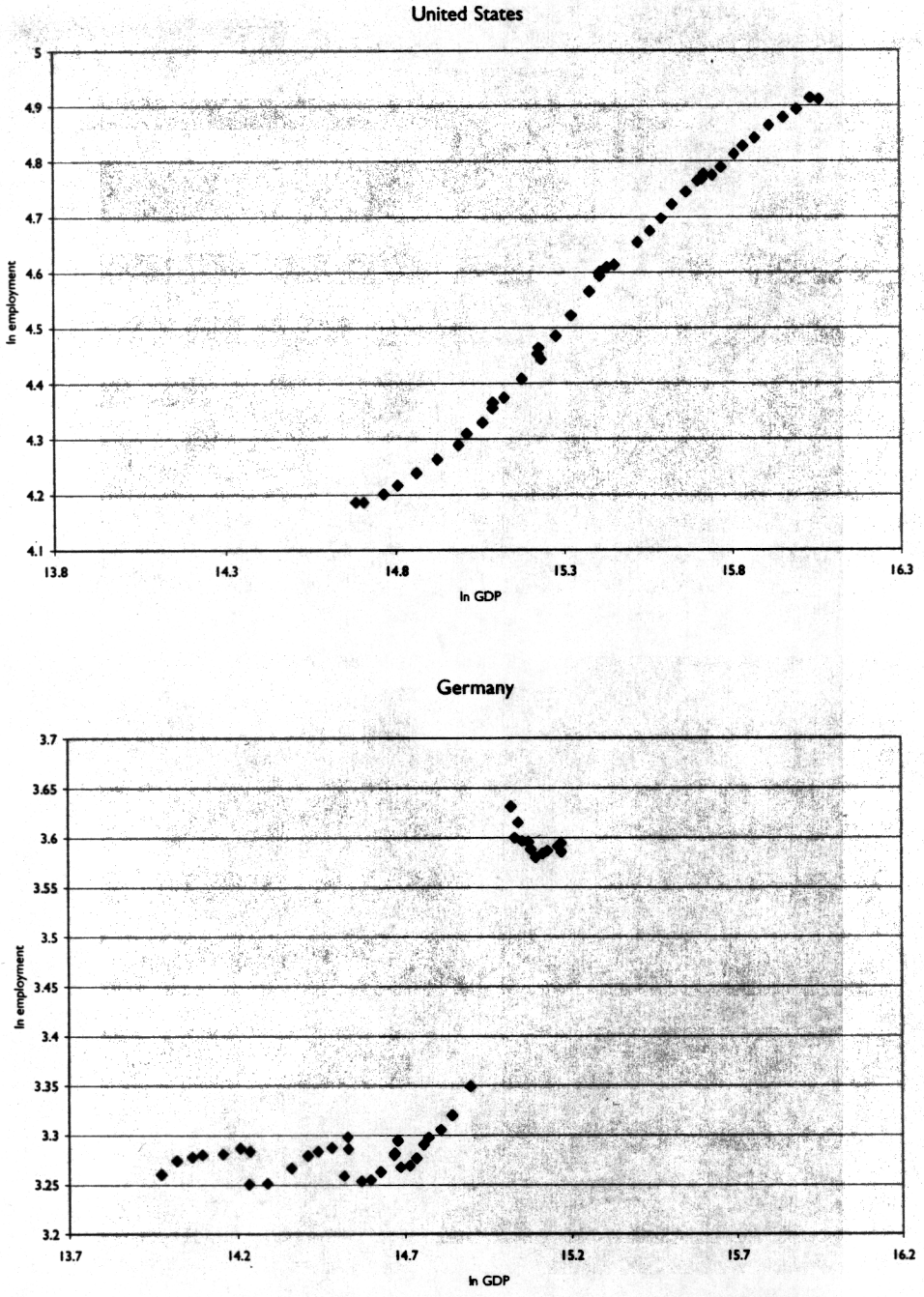

Figure 1. GDP Versus Employment in the United States and Germany, 1960–2002.

Source: OECD *Employment Outlook* database.

quence, economic growth did not extend to the labor market, a situation that has been called "eurosclerosis," indicating that the roots of the European employment problem are overly regulated labor markets. Although serious international comparative analysis failed to support the eurosclerosis hypothesis (see, for example, Schettkat 2003a and b; Freeman and Schettkat 2001; Krueger and Pischke 1997), influential economists in Europe pushed for a deregulation of labor markets, reinforced by the Jobs Study of the Organization for Economic Cooperation and Development (OECD), publications of the International Monetary Fund (IMF), and the European Central Bank (ECB), the successor to the national central banks and designed along the lines of the German Bundesbank. In the end, even governments elected with a social-democratic program, like the Schroeder government in Germany, changed their policies by 180 degrees, withdrew their own earlier legislation, and now are pushing for deregulationists' reforms that discourage their own parties and electorate. Conservative opposition parties do not know what to oppose anymore. It is like Lady Thatcher's late triumph over "old Europe."

What made even the skeptical European politician a believer in the job-creating power of unfettered labor markets? It was the mixture of certain trends and the continuously repeated statement that the root of European unemployment is labor market regulation. In the period from 1970 to 1996, the U.S. economy, as measured by gross domestic product (GDP), grew on average by 3 percent annually, which is equivalent to a doubling of all produced goods and services every twenty-three years!' The employment threshold, the rate of GDP growth at which employment remains constant, was only 1.1 percent in the United States. Every percentage point of economic growth above this level created additional jobs. With 3 percent GDP growth, employment was growing on average by 1.9 percent annually; that is, in the twenty-six-year period from 1970 to 1996, employment in the United States grew by 60 percent! This is a number too high even for the dreams of European politicians. In Germany, on the contrary, the employment threshold was twice as high. Additional jobs were cre-

ated only with economic growth exceeding 2.2 percent. Since the German economy grew only 2.4 percent annually, the number of jobs remained roughly unchanged.[2] The back side of the coin, of course, was low productivity growth in the United States but high productivity gains in Europe. Employment elasticity, the percentage change of employment in response to a one percentage point increase in GDP, was only half as high in Germany (0.3) as in the United States (0.6) from 1970 to 1995. In other words, 1 percent additional GDP growth raised employment by 0.3 percent in Germany but by 0.6 percent in the United States.

From 1996 on, since the United States returned to the economic growth path of the 1960s and productivity gains rose above 2 percent annually, the American employment threshold rose. Now the United States must achieve economic growth of 2 percent or more just to stabilize employment.' This was no problem in the euphoric period of the "New Economy," the "Roaring Nineties"' with its investment boom, until 2000, when the U.S. economy grew 4 percent per year. But since the beginning of the recession-which had started already in the first quarter of 2001 and not as a reaction to the terrorists' attacks of September 11.-employment declined by about 2 percent, although GDP rose by 4 percent over that period. Currently the U.S. economy is growing at a rate of 3 percent, and in the third quarter of 2003, GDP growth even reached more than 8 percent on an annualized basis. Despite such an exceptionally high increase in GDP, employment even showed a slight decline.' As we know, the same phenomenon, economic growth with stagnating employment, has been called eurosclerosis in Europe. The situation on the two sides of the Atlantic has been reversed: The United States has now a higher employment threshold than European countries, where the employment threshold fell to about 1.4 percent (see Figure 2).

Although the relation between employment, economic growth, and productivity is an identity, eurosclerosis proponents regarded productivity growth as artificially high in Europe, because-so the argument went labor market institutions in Europe push up productivity

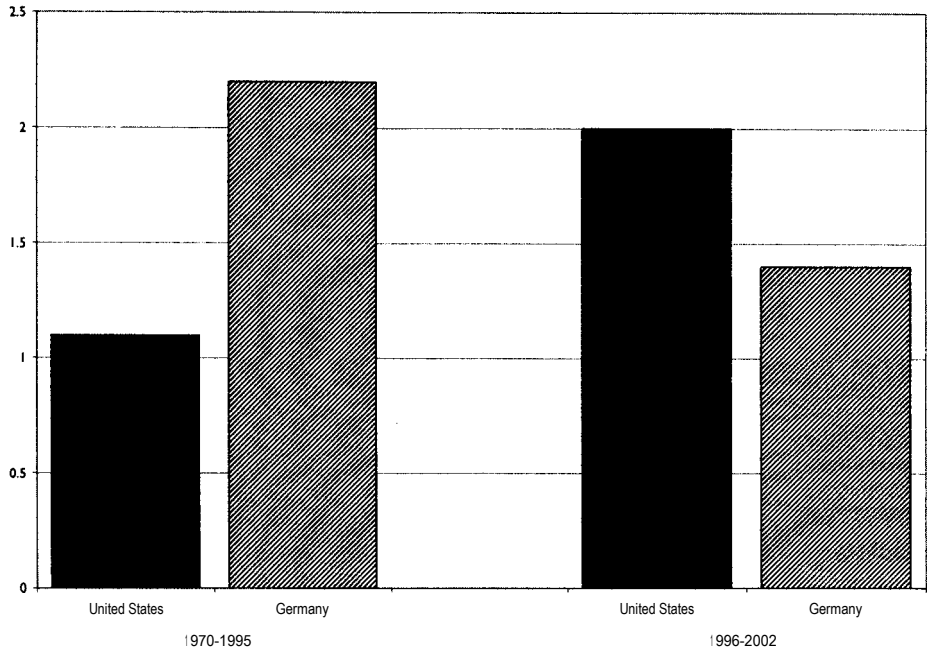

Figure 2. Employment Thresholds in the United States and Germany

Note: Computations based on OECD Economic Outlook database.

by squeezing out economic activities with lower productivity. With American-type institutions, so the argument goes, Europe would have seen less productivity growth and a lower employment threshold, and the same rates of economic growth' would have resulted in higher employment. Why did the level of the employment threshold on both sides of the Atlantic then reverse in the late 1990s? There must obviously be two possibilities: (1) the United States changed its institutions to European-style welfare states while Europe deregulated or (2) labor market institutions are not the driving force of productivity trends. Neither the fall of the employment threshold in Germany nor the rise of the employment threshold in the United States can plausibly be ascribed to labor market reforms. The United States did not adopt European-type welfare-state institutions, and in Germany the deregulation of labor markets has only been decided on in the parliament and could hardly have affected the development before 2003.

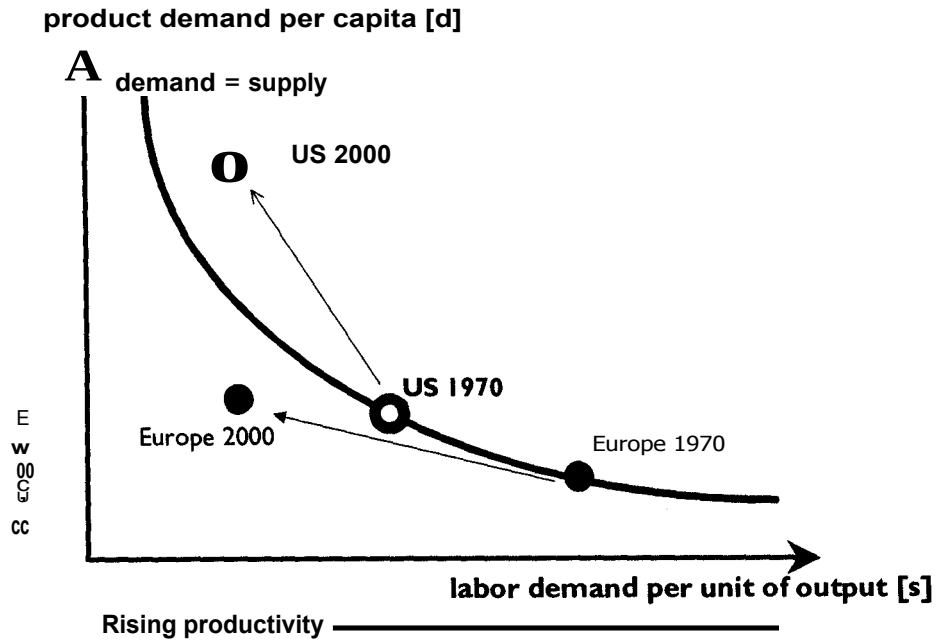

Figure 3. Productivity Growth, Demand, and Employment, Stylized Presentation of the United States and Europe, 1970-2000

Source: Ronald Schettkat, "Demand Patterns and Employment Structures: An Aggregate Analysis" (paper presented at DEMPATEM conference, Seville, Spain, October 2003).

Differences in Macroeconomic Policy and Employment

But what about U.S.-European differences in macroeconomic policy? Despite reminders by such outstanding economists as Robert Solow that Europeans may focus too much on labor market institutions and forget about macroeconomic policy as sources for high European unemployment, macroeconomic policy played almost no role in the European economic policy debate. In general, productivity growth leads to a rise in production capacity. With the same input, a larger output can be produced, and the same output requires less input. To hold employment constant requires demand expansion. Figure 3 illustrates the relation between supply (on the horizontal axis) and demand (on the vertical axis) and employment (the hyperbolic curve). Improvements in labor productivity (the inverse of "la-,

bor demand per unit of output") lead to a move toward the origin-that is, less labor is needed to produce a constant output. With unchanged demand and/or constant working hours, the economy moves to a lower employment-population rate.

Just to hold employment constant and to remain at the same employment-population rate, demand per head of the population must rise proportionally to productivity, or working hours must decline. The level of final demand in the economy must rise in line with the supply improvements (productivity growth) to keep employment constant. In theoretical models it is, by reference to Say's law, often assumed that demand automatically equates supply, but the two sides of the market actually follow different influences. As the Nobel Prize-winning Dutch economist Jan Tinbergen put it: Economic development is a continuous race between productivity improvements and demand expansion.

In 1970 the European countries and the United States had different productivity levels but they were all roughly on the same "employment curve." Income per capita and overall demand in the United States were higher because the U.S. economy produced at a higher productivity level with a similar labor input per head of the population. By the 1990s the United States and the European economies were on distinctively different "employment curves." In the United States, productivity increased less than in the European countries, leaving some European countries (France, West Germany, the Netherlands) at roughly the same productivity level as the United States. At the same time, however, demand in the U.S. economy grew substantially more than productivity, pushing the United States to a position above the original employment curve. Expressed in demand-supply space: The move of the United States in the vertical direction (demand) was bigger than the inward move along the horizontal (supply, productivity). The reverse trends occurred in Europe, where productivity growth was higher than the expansion of demand, which left these countries below the original employment curve.'

Rising employment requires an expansion of the economy by more than productivity growth, which may create price pressure in prod-

uct markets because additional workers may not be available or they may require a higher than current wage to take up employment. If one believes that the unemployed are unwilling to work or that their productivity is much lower than that of the current workforce, one expects the employment elasticity of rising demand to be low but the "inflation elasticity" (price changes) to be high. That is the position of New Classical macroeconomics, which argues that in a given institutional framework, rising demand cannot improve employment but can only cause inflation. This is the theoretical backbone for proposals of labor market deregulation and for the so-called stability pact of Maastricht. It is a theoretical world in which very low inflation is costless but in which expansionary policies are very costly or even ineffective. It is a comfortable theory for central banks because higher employment requires labor market reforms and supply-side policies instead of adequate monetary or fiscal policies to stimulate demand.

Do supply improvements necessarily result in higher output? Does a rise in potential output translate easily into actual output growth? In a theoretical model without frictions, supply increases result in immediate demand increases. Potential for economic growth will automatically become actual economic growth. In a dynamic perspective, however, real-world frictions may leave the potential for economic growth unutilized. An increase in capacity through production productivity growth may not automatically result in higher demand if employers are pessimistic and do not expect future demand increases, for example. In this case, workers may be dismissed rather than production expanded, and consequently investment may decline, creating a vicious circle. Automatic stabilizers, such as unemployment benefits, may prevent sharp falls in demand, but they are not sufficient to stimulate demand.

This is the situation of the large European economies. Public expenditures are constrained by the Maastricht treaty and a "small state is beautiful" ideology, a result of a strong belief in New Classical macroeconomics based on sturdy market-clearing assumptions, which the Bundesbank and now its progeny, the ECB, seem to follow (Issing 2000). The ECB requires the European governments to deregulate

labor markets before even thinking about a more expansionary policy, because they argue in accordance with New Classical macroeconomics that an expansionary monetary policy will result in inflation but not in higher growth or more employment. The fear of inflation and the fear that national governments may use the protection of the euro to relax budget discipline dominated discussion and led to the so-called Maastricht criteria, which limit the annual net debt of the general government to 3 percent of GDP. Since the 3 percent rule was made a fixed rule, independent of the economic situation, it now constrains the major European economies France and Germany-from following a more expansive fiscal policy. Both countries, however, did not meet the 3 percent standard and claimed exemption from retaliation measures because, so the German finance minister Hans Eichel argues, the German government is already applying a restrictive policy. But, if governments can run into deficits because they spend too much in periods of economic growth, they can also run into deficits because they spend too little in periods of stagnation. The latter condition seems to hold for Germany.

In the early 1990s-when the Maastricht treaty was concluded-New Classical macroeconomics was dominating economic policy in Europe, and demand-stimulating policies had been declared not only ineffective but even harmful. Indeed, if New Classical macroeconomists had been right, there would have been no role for fiscal or monetary policy to stimulate the economy. All that expansionary policies can achieve in that model is to push the economy out of equilibrium into inflation but not into higher growth. It has been shown at least as early as 1973 (Blinder and Solow 1973) that the assertion of New Classical macroeconomics that an expansionary fiscal or monetary policy does harm rather than good for the economy totally rests on the assumption of perfect markets and only holds in this highly abstract model. However, it is the constraint on expansionary fiscal policy from the Maastricht criteria, together with the ECB-which solely emphasizes price stability defined by the ECB board as euro zone mean inflation of 2 percent or less that tighten the macroeconomic perspectives of the European economies.

In the United States, economic policy is much more pragmatic than in Europe.[8] The Federal Reserve was prepared to balance the deficit reductions of the Clinton administration by a supportive, expansionary monetary policy, and in the last recession the Fed lowered interest rates quickly. The new Bush administration supported tax reductions, which turned the Clinton budget surpluses into deficits but which turned out to support an economy that was sliding into a recession. It seems that these expansionary policies have worked. GDP rose by the highest rate since the mid-1980s in the third quarter of 2003 (recently revised to 8.2 percent from 7.2 percent estimated earlier [U.S. Bureau of Economic Analysis 2003]). To have a lasting impact on employment, however, the U.S. economy must grow at substantial rates for a considerable time. The U.S. macroeconomic institutions seem to be less bound by ideology and more able to support an expansionary growth path. For example, the Fed tolerated inflation of 1.7 percent in the period from 1996 to 2002, whereas inflation in Germany was, according to OECD figures, only 0.9 percent (GDP price deflator, OECD 2003). Whether the U.S. policies are sufficient to restore high rates of employment growth in the U.S. economy remains to be seen.

Conclusion

Will the United States follow the European economies and enter a period of stagnating employment? Will America experience U.S. sclerosis?

This paper argues that not labor market institutions but rather misalignment of macroeconomic policy is at the root of the European employment problem. U.S. macroeconomic policy seems to be more prepared to support an expansionary growth path. However, is it likely that economic growth rates sufficient to raise employment by 2 percent the past employment growth in the United States will be achieved if productivity growth remains at 2 or 2.5 percent over longer periods? The "Roaring Nineties" experienced economic growth high enough to accomplish that level, although the rate of employ-

ment growth declined in the end of the 1990s. But the 1990s are labeled by some as the "world's most prosperous decade" (Stiglitz 2003), and in the process it experienced an overshooting of investment, which was the seed for the 2001 recession (Stiglitz 2003). By historical standards, growth rates of 4 or 5 percent annually over longer periods are rare, occurring only in a few periods (in the United States at the end of 1930 and in the early 1940s and early 1960s, in Europe in the mid-1950s to mid-1960s). In other periods, economic growth was much more modest.

Therefore, with higher rates of productivity growth, U.S. employment will most likely not grow at rates of 2 percent or more as in the past. In addition, U.S. employment growth was concentrated in some service industries, like retail trade and health, which are traditionally classified as technologically stagnant. The information economy now seems to show its benefits in the form of higher productivity gains in these industries (Triplett and Bosworth 2003). Although productivity growth can lower per-unit costs and prices and in this way stimulate demand, it is unlikely to happen in retail services because they are not demanded for their own sake but in connection with goods consumption. Productivity gains can be used to increase the output of the goods and services or to reduce working hours. The latter would seem to be a viable option for the United States, where working hours are substantially longer and where vacations are shorter than in other advanced economies.

As necessary as an increase in European employment seems to be, the drop in productivity growth behind the rate enjoyed in Europe's recent past, as well as behind the rate in the United States, should be a reason more for worry than for hope for renewed job growth. The decline in productivity gains may be related to a technology gap. However, productivity gains do not automatically result in higher demand to reap their benefits; this outcome requires an expansionary macroeconomic policy. In this respect the United States can be more optimistic than Europe because of the more favorable macroeconomic policy institutions. Europe needs to overcome sclerosis in macroeconomic policy-making.

Notes

1. Since the U.S. population was also growing, income per capita grew much less in the United States (cf. Schettkat 2003c).

2. Measured in hours worked rather than persons worked, the United States-Europe contrast is even stronger (cf. Schettkat 2003c).

3. In the United States the population in working age (age fifteen to sixty-four) is growing constantly, requiring continuous employment growth to stabilize the employment population rate.

4. Two books use "roaring nineties" in their titles are Krueger and Solow 2002 and Stiglitz 2003.

5. Small variations in the data are within the margin of error (Krueger 2003).

6. The identity problem is clear again: Would Europe have achieved the same rates of economic growth with lower productivity growth? The causation seems to run both ways: Higher rates of economic growth can result in higher productivity growth (Kaldor-Verdoorn relation), but continuous economic growth, for sure, requires productivity growth (Solow 1956). Economic development can best be understood as the interaction of both sides of the market, or demand and supply, as in evolutionary growth theory.

7. Taking hours worked instead of persons employed, these trends would even be more pronounced (cf. Schettkat 2003c).

8. Blinder (1998) argues that New Classical macroeconomics remained "academic" in the United States and was never influential in the Federal Reserve or in the White House. Nevertheless, the United States also saw attempts from Congress to institutionalize a "zero deficit" rule in the 1990s.

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