



Macroeconomic Policy, Labour Market Institutions and Employment Outcomes

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Abstract

The increase in income inequality and household debt of middle- and lower-income households in the US over several decades led to increasingly fragile financial institutions and set the stage for the most serious recession in last 60 years. The proximate cause of the economic crisis was the collapse of the housing bubble that caused both the recession that began at the end of 2007 and the financial crisis that erupted in 2008. The drop in GDP in the US, while steep, was not more severe than in most of the other OECD countries and the macroeconomic policy response was better. Yet the increase in the US unemployment rate was among the steepest. This paper examines this failure of US labour market institutions to respond to these policy initiatives and the implications of the analysis for economic policy.

Key Words: economic policy, inequality, recession, unemployment

Introduction

The Great Recession began in the US in December 2007 and did not reach its trough until 19 months later in June 2009. Exactly two years after the recession officially ended, the Bureau of Labour Statistics reported an unemployment rate of 9.2 percent. A little more than 14 million US workers are officially counted as unemployed, 6 million of them for 27 weeks or more. Using a broader definition that includes those who are working part-time because they can't find full-time work and those who have given up searching for a job, 25 million workers out of a labour force of 137 million are unemployed, underemployed, or have given up looking but are ready to take a job. Although policy makers responded early with a mix of macroeconomic and labour market policies that reduced the severity of the contraction and the extent of job destruction, a comparison of harmonized unemployment rates shows that the increase in the unemployment rate in the US was among the largest among the wealthy OECD countries. Nearly four years after the onset of the recession, the US labour market remains in a serious crisis; it is not expected to return to pre-recession levels of employment for several more years.

While policies to stimulate the economy were undertaken early in the recession, there has been only minor subsequent effort to address the jobs crisis. The reason for this failure of policy makers to act more aggressively to create jobs rests, in part, on the nature of mainstream macroeconomic models. These models have not provided a persuasive analysis of the underlying developments that led to the recession; do not include an accurate description of the proximate cause of the contraction; do not examine the role of labour market institutions in moderating or exacerbating the decline in demand; and cannot explain how such an employment contraction can persist. For example, in a recent issue of the *Journal of Economic Perspectives*, Robert E. Hall – president of the American Economic Association – wrote (Hall 2010: 3):

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“Existing macroeconomic models account successfully for the immediate effects of a financial crisis on output and employment. I will lay out a simple macro model that captures the most important features of modern models and show that realistic increases in financial frictions will generate declines in real GDP and employment of the magnitude that occurred. But the model cannot explain why GDP and employment failed to recover once the financial crisis subsided – the model implies a recovery as soon as financial frictions return to normal.”

In this article, we develop the argument that the increase in income inequality and household debt of middle- and lower-income households over several decades increased the probability of default on this debt. It also led to an increase in the size and importance of the financial sector which led to inflation in asset prices including, prominently, house prices. These developments fed on each other and made the financial system increasingly fragile. This set the stage for the Great Recession – an economic crisis whose severity was unparalleled in the previous 60 years. The crisis did not begin in financial markets; rather, the proximate cause of the recession, which began in 2007, was the bursting of the housing bubble. The collapse in house prices that began in 2006 had a two-fold effect. It reduced the ability of households to consume and, in particular, to borrow and purchase durable goods – cars, furniture, appliances – or houses. And it left residential construction companies with a large inventory of new homes that could not be sold at their offering prices. The result was a demand shock that triggered the recession. The collapse in house prices also reduced the value of assets – most directly mortgage-backed securities – on the books of banks and other financial institutions, and caused many of them to become technically insolvent. This created the financial crisis that began in the spring of 2008 and took hold in the fall of that year. The financial crisis that began in the U.S. quickly spilled over to much of the world economy, causing sharp declines in output (GDP) in many countries and a collapse in world trade. We note, but do not take up these world-wide ramifications.

The fiscal and monetary policy responses to the crisis were swift in the US and, at least with respect to monetary policy, innovative. Yet the performance of the US labour market in the aftermath of the economic crisis has lagged behind that of most other wealthy nations. In part, this reflects the inadequacy of the fiscal policy response to the demand shock and the challenges facing monetary policy as the US interest rate approached the zero lower bound. In large measure it is also the result of the relative weakness of US labour market institutions. As a result of this, the decline in GDP imposed higher costs in terms of unemployment than was the case for most OECD countries (Schmitt forthcoming). We argue that whether a demand shock that reduces the demand for goods and services leads to a fall in employment or to a fall in average hours of work (or to some combination of these two approaches) depends on the nature of labour market institutions. If employment protections are weak and the costs to employers of reducing employment are low, much of the adjustment to a lower demand for products will fall on employment rather than hours of work and much of the cost will be borne by workers. Absent a

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3 sufficiently large, positive demand shock, scarce jobs will be matched to job seekers in a process
4 that increasingly disadvantages those experiencing longer spells of unemployment. The result is
5 high and persistent cyclical unemployment (Diamond 2011:1087-1090).
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8 The paper proceeds as follows. The next section examines the literature on income
9 inequality and financial fragility to identify the source of the underlying developments that led to
10 the economic crisis. The third section examines the chronology of events to establish the
11 proximate cause of the recession and the macroeconomic policy response in the US. We briefly
12 discuss the challenge to the effectiveness of monetary policy as short-term interest rates
13 approach zero. The fourth section examines the role played by weak labour market institutions in
14 the failure of macroeconomic policies to create more robust job growth. The paper concludes
15 with a discussion of the implications for policy.
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21 **Income Inequality and Financial Fragility**

22 A compelling case can be made that rising income inequality in the US since the late
23 1970s and rising household debt led to increasingly fragile financial institutions and set the stage
24 for both the recession that began in December 2007 and the financial crisis that followed soon
25 after (Palley 2009 and 2011, Rajan 2010, Reich 2010, Blair 2010-2011). A great deal of work
26 has been done documenting the long run changes in the distribution of income and wealth in the
27 US (see, for example, Gottschalk and Moffitt 1994; Wolff 1998; Card and DiNardo 2004; Di
28 2007; Autor et al. 2008; Mishel et al. 2009). Wage inequality for men increased steadily from the
29 1970s, for women from the early 1980s. In the 1970s, the increase in the dispersion of hourly
30 wages occurred mainly at the bottom of the wage distribution; in the 1980s, throughout the
31 distribution; and since 1990, mainly at the top (Heathcote et al. 2010). With respect to household
32 income inequality, the most authoritative and widely cited study was carried out by Piketty and
33 Saez (2003, updated by Saez 2010) and finds that income disparities increased dramatically in
34 the US beginning in the 1980s, with incomes at the very top growing much more rapidly than
35 other incomes and top income earners capturing an increasing share of total income. The authors
36 show that for four decades, from the late 1940s until 1988, the top one percent of income earners
37 received about 10 percent of all income. After 1988, however, the share of the top one percent
38 grew steadily, and stood at 23.5 percent of total income in 2007. The top five percent of income
39 earners captured 34 percent of all income in 2007.
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48 Several writers have documented the rise in household debt over this period, arguing that
49 households in the middle and the bottom of the income distribution responded to the prolonged
50 period of falling real wages and stagnant household income by borrowing in order to maintain
51 consumption and living standards (Palley 2008, Rajan 2010, Reich 2010). Strong evidence that
52 households do indeed borrow in order to smooth and maintain consumption can be found in
53 Heathcote, Perri and Violante 2010). Using time series data from the Consumer Expenditure
54 Survey (CEX) for both income (adjusted for taxes and transfers) and for consumption (excluding
55 the purchase of durable goods such as automobiles or appliances) over the period 1980 to 2005,
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3 the authors find (1) that consumption inequality is less pronounced than income inequality; (2)
4 that the increase in consumption inequality has been less severe than the increase in income
5 inequality, although consumption inequality did track income inequality more closely in the
6 2000s; and (3) that there is less transmission from income inequality to consumption inequality
7 in the bottom half of the income distribution than in the top half. Household income at the 90th
8 percentile of the income distribution was nearly 4.5 times household income at the 10th percentile
9 rises in 1980; by 2005, it had increased to more than 6.5 times. However, the ratio of household
10 consumption at the 90th percentile, which was 3.5 times that at the 10th percentile in 1980,
11 increased to just under 4.5 times in 2005. Thus, dramatic increases in income disparities were
12 accompanied by more modest increases in consumption disparities. This suggests that poor and
13 middle-class households were able to borrow to maintain rising living standards, and that much
14 of the run-up in household debt preceding the economic crisis occurred among these households
15 (Heathcote et al. 2010).
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22 Household borrowing increased dramatically after 1983. The ratio of debt to personal
23 disposable income, which had increased only modestly from 55 percent of disposable income in
24 1960 to 65 percent in the mid-1980s, more than doubled over the next two decades. It
25 skyrocketed to an all-time high of 133 percent in 2007 (Federal Reserve Bank of San Francisco
26 2009). Viewed in relation to GDP, household debt nearly doubled from 75 to 140 percent of
27 GDP between 1983 and 2007. Mortgage debt accounted for most of the increase in debt-to-
28 income ratios preceding the economic crisis (Kumhof and Ranciere 2010). The increase in debt
29 enabled personal consumption expenditures to grow faster than disposable income and this
30 provided a significant boost to economic growth (Federal Reserve Bank of San Francisco 2009).
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35 This increase of debt in relation to income (i.e., increased leverage) greatly increased the
36 financial fragility of the economy. Declines in asset prices (e.g., house prices) have a large effect
37 on the wealth of highly leveraged households and increase the risk of default. This risk was
38 exacerbated by the dramatic increase in the share of mortgage loans to households that did not
39 qualify for conventional mortgages. The share of so-called subprime mortgages increased from 4
40 percent of mortgages in 2000 to 15 percent in 2006 (Kumhof and Ranciere 2010).
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44 The increase in household debt was facilitated by looser regulation of financial
45 institutions and by the rapid development of innovative financial products and vehicles.
46 Regulators allowed increases in leverage for investment banks and other financial institutions
47 that did not carry the explicit government guarantees that applied to commercial banks. In
48 particular, the Securities and Exchange Commission reduced capital requirements for investment
49 banks, leading to an increase in leverage in these institutions (see Blair 2010-2011: 308-311 for a
50 discussion of the regulatory changes that allowed financial institutions to take on excessive
51 leverage). Financial innovation – asset backed securities (including residential mortgage-backed
52 securities or RMBS), derivatives, and special purpose entities that moved assets off the books of
53 regulated banks – made it possible for unregulated financial institutions to provide credit and
54 liquidity to the economy. The historically low rate of default on residential mortgages allowed
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3 them to be pooled and securitized, with some tranches of these securities considered safe enough
4 for regulated financial institutions to invest in them. The result of this deregulation and
5 innovation was a rapid increase in the availability of credit to finance the purchase of homes
6 (Blair 2010-2011, Brunnermeier 2009). These financial innovations fuelled an expansion in
7 credit that outpaced the ability of the real economy to create new assets, leading investors to bid
8 up the price of existing assets – and families as well as speculators to bid up house prices. In the
9 process, asset bubbles were created (Blair 2010-2011: 268, Brunnermeier 2009: 78-79).
10 Moreover, high and rising house prices fuelled a boom in residential construction and led to
11 substantial overbuilding as contractors were able to secure financing for projects (commercial as
12 well as residential) based on the assumed appreciation in the value of real estate. Construction
13 peaked in 2005 (US Census Bureau 2010).
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19 This increase in the use of leverage by both homeowners and financial institutions
20 increased the financial fragility of the economy. While the housing market was rising, individual
21 homeowners and financial institutions could make themselves better off by using as much
22 leverage as possible. But the financial system as a whole was made more fragile, that is, more
23 likely to suffer a major financial crisis. Even a small fall in house prices can cause serious
24 problems for highly leveraged individuals who bought houses at inflated prices with little or no
25 down payment. The sharp decline in home prices that began in 2006 led to unprecedented rates
26 of default by homeowners and created severe problems of solvency for the highly leveraged
27 institutions that held the mortgage-backed securities that had financed home purchases, effects
28 that were quickly transmitted to other financial institutions.
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34 Taking the argument full circle back to the increase in income inequality over the last
35 three decades, Blair (2010-2011: 232) argues that asset bubbles are behind the growth in
36 compensation in the financial sector that fuelled the rise in incomes at the top of the income
37 distribution.
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40 “[B]y generating inflation in the asset classes they were financing, participants in the
41 financial sector were able, for an extended period, to show gains on the portfolios they
42 were managing that appeared to more than offset the costs of their own compensation.
43 Investors are more than happy to pay high fees, salaries, commissions and bonuses to
44 financial market actors [in these circumstances]As long as the bubble had not yet
45 burst, the illusion of value creation therefore caused investors to accept higher leverage
46 and to justify extraordinary compensation packages for the participants in the financial
47 sector”.
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51 Over the last three decades, average compensation in the financial sector has grown much faster
52 than in other parts of the economy. This timing parallels the rise in the share of income going to
53 the top income earners and this rise in compensation contributed to the dramatic increase in
54 income inequality in the US (Blair 2010-2011: 279-290).
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Economic Policy in the Great Recession

To anticipate the potential for a serious crisis and to devise policies capable of restoring growth and creating jobs after the demand shock would seem to require a clear understanding of the proximate cause of the economic crisis. The key point is that it was the collapse of the housing bubble that caused both the recession that began at the end of 2007 and the financial crisis that erupted in 2008 with the failure of Bear Stearns in the spring of that year and the demise of Lehman Brothers in the fall. To see this, consider the following.

Inflation-adjusted house prices in the US had been flat for a century, from 1895 to 1995 (Schiller 2006). Beginning in 1996, however, house prices began to rise faster than the rate of inflation. Low interest rates, lax underwriting, and a frenzy of innovative financial products, including residential mortgage-backed securities and collateralized debt obligations backed by subprime mortgages expanded the availability of credit and fuelled the rise in house prices. House prices, adjusted for inflation, increased by 70 percent between July 1996 and July 2006. The increase in house prices added \$8 trillion to household wealth – wealth that households would not have had if inflation-adjusted house prices had followed their historical path and remained flat (Baker 2008). The additional housing wealth had two effects – it added between \$400 billion and \$500 billion a year to household consumption spending (see Gramlich 2002 for an estimate of the wealth effect on consumption) and it led to a precipitous drop in personal saving out of disposable income to 1 percent (St. Louis Federal Reserve Bank 2010). The run-up in house prices encouraged builders to ramp up construction of new homes: housing starts peaked at 2.1 million in 2005, 50 percent above their pre-bubble level (US Census Bureau 2010). House prices fell substantially and housing wealth declined by \$6.4 trillion between 2006 and 2008, dragging down consumption spending. Uncertainty about house prices led to a sharp decline in the demand for housing and residential construction collapsed (US Census Bureau 2010).

The collapse of house prices undermined the financial calculations of highly indebted households and the default rate on residential mortgages spiked, causing the value of mortgage-backed securities – and complex financial products based on them – to decline precipitously. The result was the financial crisis that erupted in 2008 and a decline in the stock market as equity prices fell by half between late 2007 and early 2009. Thus, the collapse of the housing bubble had two effects – it led to the recession that began in December 2007 and it sparked the financial crisis that took hold in the fall of 2008.

By the time Barack Obama took office in January 2009, financial markets were in turmoil and the combination of a decline in housing and stock market wealth plus a decline in residential and non-residential construction opened up a hole in private sector demand of about \$1.2 trillion. Most economists had missed the housing bubble, did not expect real estate valuations to come down significantly, and did not consider that a decline in house prices could set off a major financial crisis (Hall 2010: 17-18). When the economy began to contract, they focused on the financial crisis; most continue to view the crisis in financial markets as the real culprit behind the

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3 steep contraction in output and employment. “The dominant view among macroeconomists today
4 is that a financial crisis causes real economic activity to collapse by raising frictions” (Hall
5 2010:6; see also Hall 2011 and Bernanke, Gertler and Gilchrist 1999). In this view, reducing
6 financial friction is the key to ending the financial crisis and restoring economic activity.
7 Monetary policy, including bold and innovative policies to bail out the financial sector, was
8 undertaken for just this purpose and was extremely successful in returning this sector to
9 profitability. Capital is available and corporate borrowing costs as well as mortgage interest rates
10 are low. The real economy, however, continues to struggle.

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15 In contrast to the dramatic steps taken by government to rescue the financial sector, fiscal
16 policy – while undertaken quickly – was timid and conventional. In February 2008, just 10
17 weeks after the start of the recession, President Bush signed a fiscal stimulus package that
18 provided a total of \$170 billion in tax rebates for lower and middle-income taxpayers and tax
19 incentives for business investment. This was followed a year later, after Obama became
20 President, by a second fiscal stimulus that passed with almost no support from Republicans. The
21 legislation provided \$784 billion in stimulus funds over two years or about \$400 billion a year.
22 In December 2010, a small effort was made to provide further fiscal stimulus, mainly through tax
23 breaks. The main provisions were an extension of the Bush era tax cuts, including those for the
24 wealthiest Americans, for 2 years; an extension of emergency unemployment benefits for 13
25 months; and a reduction in payroll taxes paid by workers for one year. These measures stopped
26 the free fall in output and employment (Council of Economic Advisors 2010), but were too small
27 in relation to the \$1.2 trillion hole in private demand to ignite robust job growth. The impact of
28 the collapse in house prices was too great.

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35 Mainstream macroeconomics is sceptical that a large fiscal stimulus can be effective in
36 closing output gaps and prefers the use of monetary policy for promoting economic stabilization
37 (Woodford 2011). In mainstream models, a big increase in borrowing by the government will
38 increase the demand for savings, cause interest rates to rise, discourage consumers and private
39 investors from borrowing, and offset most of the effects of government spending. Yet despite the
40 2009 fiscal stimulus, interest rates remain low and monetary policy has not been effective in
41 stimulating private borrowing in the US. The reason for this is that the hole in demand opened up
42 by the collapse of the housing bubble is so large that nominal interest rates would have to be
43 negative in order stimulate sufficient private spending to fill the output gap. This, of course, is
44 not possible. Indeed, the short-term interest rate that the Federal Reserve targets is currently
45 hovering near the zero lower bound so that it is not possible for the central bank to reduce
46 interest rates further.

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52 In these circumstances, even mainstream macroeconomic models find that fiscal policy is
53 both effective and urgently needed since it is no longer possible to stimulate the economy
54 through interest rate cuts (Woodford 2011: 15-16).
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“[W]hen monetary policy is constrained by the zero lower bound on the short-term nominal interest rate ... it is plausible to assume not merely that the real interest rate does not rise in response to fiscal stimulus, but that the nominal rate does not rise ... Hence, government purchases should have an especially strong effect on aggregate output when the central bank’s policy rate is at the zero lower bound.”

While the model finds that a large fiscal stimulus is effective in increasing output “when a disturbance to the financial sector results in insufficient aggregate demand even with the central bank’s policy rate at the lower bound of zero”, this policy is to be undertaken only “under Depression-like circumstances (Woodford 2011:23)”.

The Employment Response to Macroeconomic Policy

The drop in GDP in the US between the onset of the recession at the end of 2007 and the trough reached in 2009, while steep, was not more severe than in most of the other OECD countries that also experienced large, negative demand shocks. At the same time, the macroeconomic policy response in the US, while it fell short of what was needed to stimulate vigorous job growth, was, according to most accounts, better than in most other wealthy countries (see, for example, OECD 2009 and ILO 2009). The US implemented the largest explicit fiscal stimulus package over the period 2008-2010 as a share of 2008 GDP among the major OECD countries – almost twice the OECD average – and did so more quickly. It is true that transfer payments including unemployment insurance benefits are more generous in many other countries, making automatic stabilizers a more important component of the fiscal response elsewhere. Even so, it is likely that the fiscal response in the US was larger and faster than in most other countries. As for monetary policy, the actions of the Federal Reserve Board led interest rates to fall farther and more quickly in the US than was true of the European Central Bank and interest rates in the EU (ILO 2011: Figure 2.2). Yet, a comparison of harmonized unemployment rates among wealthy nations finds that the US experienced the third largest increase in the unemployment rate among these countries between 2007 (the year before the downturn in most economies) and 2009 (the year that GDP reached its trough in most countries), with only Spain and Ireland doing worse (IMF 2010, OECD 2010: Figure 1.10). An examination of the ‘jobs gap’ – defined as the increase in the number of jobs required to restore the employment-to-population ratio to its value in the fourth quarter of 2007 and that takes the growth of the working age population into account – shows that the US jobs gap is 5.5 percent of projected employment in the fourth quarter of 2011 compared to a jobs gap of 3.1 percent of projected employment in the Euro area and 3.3 percent in the UK (OECD 2010: Table 1.1). National labour markets performed very differently in translating declines in GDP into job loss and a rise in unemployment. The rise in unemployment and the decline in the employment-to-population ratio in the US suggest that labour market institutions in the US did not perform very well.

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3 A large literature has developed that examines the effect of labour market institutions –
4 wage setting, unemployment insurance, active labour market policies, and employment
5 restrictions governing hiring and dismissal – on labour market outcomes, with more protected,
6 presumably more rigid, labour markets generally expected to perform more poorly. The standard
7 view was captured in the OECD's 1994 *Jobs Study*. By the mid-2000s, this view was called into
8 question as some countries with apparently rigid labour markets performed well in terms of
9 labour market outcomes (OECD 2006: Chapter 3; Blanchard 2006; Layard et al. 1991 and 2005).
10 Some studies have found mixed results for strict labour market regulations and only weak effects
11 of employment protections on employment and unemployment (due partly to lower labour force
12 participation where employment protection is high) (Nickell 1997, Nickell et al. 2005), while
13 Howell et al. (2007) found no systematic effects at all.

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20 Employment protection regulations – i.e., the rules governing the involuntary separation
21 of workers from employment, both individual and collective – restrict employers' ability to
22 dismiss workers. They are usually justified on the grounds that they protect workers from
23 arbitrary actions by employers and that dismissal imposes costs on both employees and society.
24 Costs are imposed on workers in terms of job search, deterioration of skills, and retraining while
25 society experiences costs such as unemployment insurance payments and spending on training
26 and job placement programs. Employment protection statutes require companies to internalize
27 some of these costs and raise the cost to firms of laying off or firing workers. The statutes may
28 define the grounds for terminating employment, set out the procedures to be followed when
29 dismissing an individual employee, require that employees be given a specified amount of
30 advance notice, require the involvement of unions or works' councils, set minimum amounts of
31 severance pay for workers according to length of job tenure, and specify payments to workers
32 found to have been unfairly dismissed. Employers generally face additional requirements in the
33 case of mass layoffs (Venn 2009). Thus, employers face dismissal costs that may be substantial,
34 depending on the generosity of these provisions and the strictness of the regulations. The
35 emphasis in analyses of the effects of employment protections has been on the effects of higher
36 costs of firing workers on employers' willingness to hire. Severance payments, for example, may
37 make firms less likely to lay off workers when demand for their products or services declines,
38 but anticipation of this future cost may discourage them from adding workers when demand
39 increases. Where the costs of laying off workers are substantial, however, other institutional
40 arrangements may be developed that offset these costs e.g., institutions may evolve that support
41 the adjustment of hours of employees and provide employers with greater internal flexibility
42 with respect to hours of work (Addison and Teixeira 2003). In a comprehensive review of the
43 theoretical and empirical literature on the effects of employment protection, these authors note
44 that a surprising finding of the literature on employment dynamics is the apparent ability of some
45 nations with high employment protections to rather quickly adjust labour input to variations in
46 demand. They argue that this is partly due to their enhanced ability to substitute hours for
47 workers, although doing this imposes some cost.

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4 For US employers, the costs of employment protection requirements are minimal. The
5 US has the weakest employment protection requirements of any OECD country, far below the
6 OECD average. On an index of employment protections that ranges from 0 to 6, where 0 is
7 essentially no statutory employment protections, the US has a score of 0.2. The UK with a score
8 of 1.1, has the next lowest score while Germany scores a 3.0 (Venn 2009: 8). The ‘employment-
9 at-will’ doctrine means that US employers can usually terminate a worker’s employment without
10 having to justify or explain their action, except in cases where the dismissal is discriminatory or
11 the worker has a contract that restricts the employers’ actions (Venn 2009). Moreover, the nature
12 of employer-provided benefits in the US – especially health insurance – means that cutting hours
13 is less effective in reducing a firm’s total compensation costs than laying off workers. Thus
14 employers in the US are likely to respond to a demand shock by adjusting employment and
15 laying off workers.
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21 Newer work on the effects of employment protection legislation on labour market
22 outcomes examines the extent of internal flexibility with respect to hours of work in conjunction
23 with this and other labour market institutions. In a study of 25 countries that includes measures
24 of ‘internal numerical flexibility’, in which the enterprise responds to lower demand for goods
25 and services by internally adjusting employee hours rather than reducing staff, Eichelhorst, Feil
26 and Marx (2010) find that variations in labour market institutions generally play a weak role in
27 explaining the response of labour markets to macroeconomic shocks. The exceptions are the US
28 and Denmark, where employment protections are exceptionally weak and employers are much
29 more likely to immediately lay off workers in response to a demand shock than are employers
30 elsewhere. They find an important role for work-time flexibility in explaining superior
31 employment performance following a macroeconomic shock and a more limited role for
32 traditional labour market institutions. Möller (2010) makes a similar argument in a study of
33 Germany, stressing the importance of measures such as working time accounts and short-time
34 work and contrasting it with employment protection legislation, which he finds to be less
35 important. Short-time unemployment insurance programs were in effect in 17 US states at the
36 start of the recession, and the number has increased since then. But take-up rates have been too
37 small to have an impact. This is largely due to design problems with the programs – in most
38 states participants are not eligible for extended benefits beyond the initial 26 weeks of
39 unemployment compensation, and they are not eligible for emergency benefits if they are
40 unemployed for more than 52 weeks. For employers, the failure of the federal government to
41 subsidize employers’ increased costs for these programs during the crisis, as was done in several
42 European countries, limited the take-up of these programs.
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51 The recent studies suggest that institutions that support adjustments in working time –
52 working time accounts and employer agreements with unions and works councils as well as
53 short-time work arrangements – have reduced the significance of strict employment protections.
54 The ‘flexibility’ cluster identified by Eichelhorst, Feil and Marx (2010:6) includes Austria,
55 France, Belgium, Germany, the Netherlands and Finland – countries that also tend to have some
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3 of the strictest employment protection regulations. Experience with strict employment protection
4 requirements likely provided incentives to employers in some countries to implement enterprise
5 practices that facilitate short-time work, and some governments were willing, in the crisis, to
6 subsidize part of the added costs of these practices.
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10 The older literature on labour market performance viewed labour market institutions as
11 the major determinant of labour market outcomes. If it dealt at all with the relationship of
12 employment and unemployment to macroeconomic shocks, it was to argue that employment
13 protections and other institutions that make the labour market more rigid would limit the ability
14 of macroeconomic policy to improve employment outcomes by restricting job creation and
15 translating efforts to stimulate the economy into inflation (see Schmitt and Wadsworth 2005,
16 Baccaro and Rei 2007 for a critical discussion of this debate). The development of new labour
17 market institutions that facilitate employers' internal adjustments of employee hours in response
18 to a demand shock suggests that stricter employment protections in combination with internal
19 adjustments can help preserve employment in the face of macroeconomic shocks.
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25 **Discussion and Conclusion**

26 As we have argued, labour market institutions play an important role in determining the
27 extent to which a decline in demand for goods and services is transmitted into a decline in jobs
28 and high unemployment, they cannot restore job creation by firms facing a shortfall in demand.
29 That requires a new, positive demand shock – a large fiscal stimulus. In the US – and in much of
30 the rest of the world, however – the emphasis is on deficit reduction and the hope is for
31 'expansionary austerity'. However these policies may play out in countries that run surpluses in
32 their current account balance and are successful in exporting more than they import, they cannot
33 succeed in the US.
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38 Attempts to revive the labour market and create jobs in the US via measures to reduce the
39 deficit are bound to fail; the reasons for this are straightforward. The US runs very large trade
40 and current account deficits. The current account deficit peaked in the third quarter of 2006 at
41 6.3 percent of GDP, fell to its lowest point in the second quarter of 2009 at 2.8 percent of GDP,
42 and recovered by the first quarter of 2011 to 3.2 percent of GDP (BEA 2011a). It is likely to
43 remain at or above 3 percent of GDP for the foreseeable future. This large trade deficit, in which
44 the country as a whole consumes more than it produces means that either the public sector or the
45 private sector needs to spend more than its income to maintain employment and move towards
46 full employment. Households, however, are currently spending *less* than their incomes. They are
47 saving and/or paying down debt in order to repair their personal balance sheets. Personal saving
48 out of disposable income, which fell almost to 1 percent during the housing bubble, stood at 5.1
49 percent of disposable income in the first quarter of 2011 (BEA 2011b), or 4.4 percent of GDP
50 (BEA 2011c). Businesses are also reluctant to spend to expand operations and hiring because of
51 doubts about the recovery. Nonfinancial companies had \$1.84 trillion on hand in cash and other
52 liquid assets as of the end of March. This is an increase of 26 percent compared to a year earlier
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3 and equals about 7 percent of company assets, the highest level since 1963 (Lahart 2011) This
4 leaves only the public sector to take up the slack. At the current level of employment, the federal
5 government must run a budget deficit of about 9 percent of GDP to compensate for high private
6 savings of households and businesses (about 5.5 percent of GDP) and the large trade and current
7 account deficits (about 3.2 percent of GDP), and indeed, that is what has occurred. The federal
8 budget deficit in 2010 was 8.92 percent of GDP (Office of Management and Budget 2010: Table
9 1.3). Unless private saving decreases or exports increase dramatically, neither of which seems
10 likely in the short to medium term, actions by the federal government to reduce spending will
11 mean a decline in employment; it will not increase jobs. In the current circumstances it will take
12 an *increase* in the federal budget deficit – a positive demand shock that can offset the lingering
13 effects of the bursting of the housing bubble – to create jobs.
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20 Nearly four years after the onset of the recession, however, stimulus alone may not be
21 sufficient to absorb all of the unemployed in a timely manner and bring the unemployment rate
22 down to its pre-recession level. While such policies, if they could be enacted, are key to restoring
23 job growth, weak labour market institutions tend to dampen the immediate impact of such
24 policies on employment; the long-term unemployed can be expected to have a particularly
25 difficult time finding jobs. Policies that discourage layoffs and encourage the use of short-time
26 work programs in the public as well as the private sector can play an important role in improving
27 labour market outcomes. The US could do much more along these lines at minimal cost to the
28 public purse over and above current expenditures on extended unemployment insurance benefits.
29 The challenges lie in the low firing costs and weak unions that provide incentives to employers
30 to dismiss workers rather than reduce hours. Direct job creation by the federal government as
31 employer of last resort may be necessary to assist young people in the transition into
32 employment and to reduce the ranks of the long-term unemployed. In the absence of further
33 fiscal stimulus, policies that encourage the adjustment of employee hours rather than reductions
34 in staff may offer the only path forward at present.
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41 The recession and economic crisis of 2007-2009 is sometimes referred to as a ‘black
42 swan’ event – a rare and extraordinary occurrence that could not have been foreseen. Others see
43 this as only the latest – and biggest – contraction and financial crisis in a cycle that has recurred
44 with increasing intensity since the 1970s (Rajan 2006, Madrick 2011). I would argue that this
45 cycle of ever more severe financial crises has its roots in the reliance on debt to fuel economic
46 growth in the US and in the deregulation of the financial services industry to provide the easy
47 credit this growth model requires. Following the excesses of the dot-com boom of the 1990s,
48 fueled by a run-up in private debt as the Clinton administration moved the federal budget from
49 deficit to surplus, the dot-com bust threw the US economy into recession in 2001. That recession
50 ended quickly, however, as demand – fueled by the housing bubble – recovered. More such
51 boom and bust cycles, each more dangerous than the last, can be expected if the US fails to put
52 in place policies that support the growth of incomes in the middle and bottom of the income
53 distribution so that rising wages, rather than rising debt levels, can again fuel growth (Palley
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3 2010 and 2011). This is not a new insight, especially among development economists. For
4 example, Berg and Sachs (1988) found that unequal societies are more likely to experience
5 serious debt crises. Berg and Ostry (2011) found that inequality is a significant hazard to
6 sustained economic growth. Their results suggest that countries with more equal income
7 distributions experience significantly longer periods of growth and that “growth and inequality-
8 reducing policies are likely to reinforce one another” (p. 16).
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