WHAT MODEL FOR THE SOUTH AFRICAN LABOR MARKET? LESSONS FROM THE OECD AND LDC’S

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WHAT MODEL FOR THE SOUTH AFRICAN LABOUR MARKET?

Lessons from the OECD and LDC’s#

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Abstract

South Africa faces many difficult problems in designing economic institutions in the post apartheid era. No sub-set is more controversial than those which condition and structure exchange in the labour market. What set of institutions will help to solve the key social problems of inequality and unemployment in a way which is compatible with economic growth and prosperity? In this paper we examine what South Africa can learn from the contrasting experiences of the OECD economies and other LDC’s. We ask: What do we know about the relationship between the institutional structure of the labour market and economic outcomes, such as inequality, unemployment and productivity growth? Should the South African government attempt to adopt “corporatist” style labour market regulations, support strong unions and collective bargaining, introduce minimum wages and employment protection legislation, or instead should it seek to deregulate the labour market and attempt to approximate the workings of a competitive labour market?

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I. INTRODUCTION

In this paper we examine what is known about the relationship between labour market institutions and labour market outcomes, in particular, employment, productivity growth, and inequality. We appeal to both empirical evidence and theoretical arguments (since the latter are clearly important in defending or attacking particular sets of institutions). Our aim is to try to address the question: What is the right model for South Africa? What is the best way to structure labour market institutions given the policy goals of reducing poverty and inequality, stimulating employment and increasing productivity? Should South Africa aim to replicate the institutional features of the ‘American Model’ or should instead it try to adopt the ‘European Model’? What can be learned from the labour markets of the LDC’s? Perhaps South Africa should adopt the Chilean, South Korean or Japanese model?

A discussion of the first comparison might appear irrelevant or ‘academic’ given the seeming consensus that the European model is dead, or in irretrievable decline. Even accepting this, there could be many reasons for it. One, favoured by the OECD, is the idea that the European model was discovered to be a disaster during the 1970’s and 1980’s and must be dismantled (see in particular the OECD’s Jobs Study report). This view suggests the highly regulated nature of European labour markets has increased the costs firms face in hiring additional workers and has lowered the level of employment and slowed the rate of structural adjustment, such that labour allocations between sectors has become increasingly inefficient. The conclusion drawn from this argument is that labour markets must be reformed or deregulated. Another is the view that, whatever the pros or cons of the European model, it is no longer sustainable because of changes in the structure of the world economy (for example, ‘globalisation’), which has effectively made labour market regulations more costly to firms (see, for example Erickson and Mitchell, 1995). Whatever the results of the autopsy, the only possible policy option for South Africa, so this argument runs, is to adopt the American model.

In this paper we shall argue against this view. We argue, first, that there is very little evidence supporting the superiority of the American model. In fact, for much of the post-War period, the European model ‘vector dominated’ the American one by producing lower unemployment, lower poverty, lower inequality and higher productivity growth.

As Nickell (1997) has recently stressed, it is rather absurd to talk about the “European Model”. For example, Sweden is as different from Britain and Greece as it is from the US. Nevertheless, we adopt this terminology since it has become so standard. In section 2 we clarify exactly what we mean by these terms.
Notwithstanding a partial reversal of this conclusion for the period after the oil shocks, we shall argue that there is very little convincing evidence to link the structure of labour market institutions associated with the European model with the rise and persistence of European unemployment. Moreover, OECD countries which have attempted to take this diagnosis seriously and have deregulated the labour market have not witnessed rapid improvements in either unemployment or productivity growth. There has been no British or New Zealand miracle. Indeed, most economists who have studied this issue are now abandoning the idea that labour market regulation causes unemployment and searching for other candidates (such as real interest rates, or impediments to entry into product markets). We conclude that it would be inappropriate for South African policy-makers to adopt this approach at the very time when its efficacy is increasingly viewed as questionable.

Even if this interpretation of the experiences of OECD countries is accepted, one might in any case argue that this is not the correct benchmark. South Africa is, according to the World Bank’s classification, an upper middle income country. In 1994, the average real Gross Domestic product (GDP) in Sub-Saharan Africa was US$460, while in South Africa it was $3,040 (figures from the 1996 World Development Report). This income level puts it into a group of countries which includes Brazil, Malaysia, Chile and Hungary (see Knight, 1988). These are not very poor, but they are far below the income levels of the OECD (which was about $23,000 in 1994). Perhaps the European model has not performed as badly as some have argued, nevertheless, this does not mean that it has any relevance for a country like South Africa which is about to embark on an ambitious path of export oriented development. However, we argue that the available evidence, though much more sparse than for the OECD, does not suggest labour market regulation impedes development, or that deregulation does much except increase inequality. Indeed, while there may have been an East Asian or Chilean miracle, exactly why this is, is the subject of extreme controversy and there is little evidence that it is causally related to the approaches that were taken to the labour market (for example the suppression of unions). Moreover, the evidence does not suggest that a necessary condition for a country to compete internationally is that it deregulate the labour market.

There is no doubt that the intricate web of government labour market regulations which characterised the apartheid era caused misallocation of resources and promoted inequality and unemployment (see Standing et al., 1996). However, this does not establish the case
that all regulation is bad\textsuperscript{2}. We shall argue that the balance of evidence does not suggest either that the existing labour market regulations in South Africa are the prime cause of the tremendously high unemployment, or that removing them would solve this problem. Indeed, we argue that the most convincing piece of evidence about labour market regulation is that it reduces inequality and that deregulation increases inequality. It hardly needs to be said that South Africa does not need any further increases in inequality. Moreover, we shall also argue that labour market regulation may be important in generating social consensus and diffusing distributional conflict, both of which seem prerequisites for ‘catch-up’ growth.

The paper proceeds as follows. In section II we summarise some pertinent facts about the South African labour market and review some of the key questions on which we hope to shed some light. In section III we discuss more generally the outlines of the different competing institutional models of the labour market and how they correspond to different theoretical approaches to the labour market. The importance of this issue is that much of the drive to deregulation coincides with a renewed belief amongst economists that economic outcomes can be understood on the basis of a simple competitive view of the labour market. In such a world it is certainly true that regulation is harmful. Our argument is that this is a poor way to think about the labour market. In contrast to this view, we argue there are some very plausible second-best arguments which suggest that regulation can improve employment and productivity. In section IV we then move to evidence and take up the issue of what the post World War II history of OECD countries tells us about the mapping from labour market institutions to labour market outcomes. We pay particular attention to the issue of what we have learned from the various experiments in labour market deregulation in the last 15 years in various countries. We also discuss where the European model came from. One of our key arguments against the view that labour market regulations impede economic efficiency is that regulations long predate the productivity slowdown or the rise in European unemployment. Section V aims to put this evidence in an even wider context by examining the issue of labour market regulation in countries outside the OECD. These arguments lead in section VII to a discussion of positive accounts of labour market regulation and deregulation. We urge that the

\textsuperscript{2}The issue is not really regulation or no regulation, but actually what type of regulation. When we use the term regulation we mean government regulation as opposed to market regulation.
discussion of labour market institutions should be embedded in a more sophisticated understanding of the political economy of labour market regulation.

Finally we conclude by stressing that the evidence that we have supports the views put forward by the Labour Market Commission about the desirable set of institutions in the labour market. There are good theoretical arguments as well as a considerable body of evidence to support the view that a version of the “European model”, suitably and carefully adjusted and interpreted to meet the unique circumstances on the post-apartheid economy in South Africa, provides the best chance of creating a setting to meet the policy objectives outlined above.

II. THE SETTING: SOUTH AFRICAN LABOUR MARKET, INSTITUTIONS AND ISSUES

Providing an in-depth analysis of trends in the South African labour market is not our comparative advantage, so here we briefly collect some pertinent facts. During the 1950’s and 1960’s the rate of growth of the South Africa economy was respectable but by the 1980’s the growth rate of real GDP per-capita was persistently negative (the average rate over the period 1980-1995 was -1%). Moreover, the average annual growth rate of total factor productivity was a startling -1.02% over the period 1972-1990 (Kaplinsky, 1995). The most recent period has also seen a large fall in employment, with private sector employment falling by 11% between 1989 and 1995 (Standing et al., 1996). Total African unemployment is estimated to be 41.1% in 1994 and 64.6% for Africans in the age group 16-24, the corresponding rates for White unemployment are 6.4% and 11.2%, respectively. Inequality in South Africa is amongst the greatest in the world (at least for countries where it can be reliably calculated) with a Gini coefficient of 0.65 reported by the Labour Market Commission Report (LMCR, 1996).

The current government inherited a diverse set of, relatively interventionist, labour market institutions from the apartheid era. The Basic Conditions of Employment Act of 1983 regulates the conditions of employment for workers not covered by industry councils and there are various methods for determining minimum wages and terms of employment (such as wage boards set up under the Wage Act of 1957). Trade unions are relatively strong and about 12% of workers are covered by unemployment insurance (LMCR, 1996). The real

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3Or indeed absolute!
issue in South Africa is that, given the desire to adopt a relatively open economy development strategy, how can a set of labour market institutions be designed to be both consistent with a rapid growth rate, lower unemployment and falling inequality and poverty. Advocates of the deregulationist view (such as the South Africa Foundation) argue that for South Africa to grow fast, it must become competitive, which implies that unit labour costs must be kept low. They must argue that this implies labour market deregulation. What about the inequality implications of this? In their view, the experience of countries like South Korea should be focused on. Korea did not heavily regulate the labour market but nevertheless wages rose rapidly. On the other hand, others, such as the LCMR, advocate an extension and adaptation of current interventionist institutions to guarantee incomes, employment protection and some degree of job security. They agree that while unit labour costs are important for competitiveness, they can be more effectively and equitably lowered by making workers more productive, and wage cutting will have just the opposite effect. Moreover, it is not clear how relevant the experience of South Korea or Hong Kong is. For example, the dictatorship in Chile instigated an extensive deregulation of the labour market and banned trade unions, yet the economy performed disastrously for the first 12 years, real wages dropped precipitously and inequality rose significantly. Moreover, the subsequent Chilean miracle since 1986 has been based mostly on forestry, fishing and agriculture, industries in which the unions were never of great importance, and where the commercialisation of agriculture rather than labour market deregulation seems to have been the main stimulation.

III. MODELS OF THE LABOUR MARKET
All exchange takes place within particular sets of institutions. Institutions and regulations come in many forms, both informal (such as norms) and formal (legally enforced property rights), some created in a decentralised manner, and some created by government intervention. In the context of the labour market the debate is about the extent to which government legislation and interventions are required to promote the equity and/or efficiency of this market. If the employment relationship was a competitive one where contracts were complete, information and commitment perfect, with no problems of ‘hold-up’ or ex post enforcement, moral hazard and adverse selection, with no discrimination along lines of race or gender, then economic theory would imply that the wage rate would adjust to clear markets and generate a Pareto optimal level of employment. The distribution of wages and income which emerged from such an equilibrium would reflect
differing levels of (acquired or innate) skills and the productivity endowments of individual workers. Moreover, if capital markets were competitive, perfect and complete, and there were no market failures or externalities connected with population growth or the accumulation of human or physical capital or technology, then such an allocation of labour could be part of an intertemporally efficient allocation of resources with a Pareto optimal rate of productivity and per-capita income growth.

If the economy could be understood in such a way then it seems hard to imagine that there would be a role for government interventions in the labour market (once property rights were well defined). There might be some role for interventions to achieve equity goals but in general this would be more efficiently organised through taxes and transfers (such as a negative income tax policy). There would be no need to restrict dismissals (caused perhaps by bad shocks or innovations), since these would be mutually agreed upon and could be insured against. Unemployment would be efficient matching. Minimum wages would be either irrelevant, or would cause unemployment by forcing employers to pay more than the market clearing wage. Similarly, trade unions would be monopoly suppliers of labour who inefficiently restricted the supply (and lower equilibrium employment) to raise the wage. How could one understand government labour market regulation in such an economy? Clearly it reduces efficiency (typically employment and possibly growth since it misallocates resources – for example, if learning by doing were linked to employment, as in many models, then an economy where employment was lower would experience slower total factor productivity growth) so why would it happen? A number of competing hypotheses have been advanced to explain such interventions. If lump-sum taxation is not feasible then it is possible that intervention would be necessary to achieve distributional goals (for example if it were thought that wages were too low then unions might be encouraged). More typically, as we shall see later (in section VII), regulation is explained on the basis of stupidity, mistakes and unintended consequences, or on the basis of some interest group theory of redistribution.

The desire to promote labour market ‘flexibility’ can be thought of in terms of the above theory of the labour market. Regulations and interventions causes distortions and deviations from the conditions characterising an efficient allocation of resources and need to be removed.
Yet, this view of how the labour market functions can hardly be thought to accurately describe the world in which we live. Indeed, as many economists have long recognised, it rules out as irrelevant many of the institutions central to the operation of a market economy, such as firms. The modern approach of microeconomics is to understand institutional features of the economy as responses to problems with the above vision. For example, Coase (1937) argued that the replacement of markets by firms as a mechanism for organising transactions was due to the fact that some types of exchanges had higher “transactions costs” than others, and exchanges where transactions costs were high might be more efficiently organised by authority. The modern articulation of this approach, due to Hart and his co-authors (e.g. Hart, 1995, and Hart and Moore, 1988, 1990), is to argue that firms are a response to problems of contractual incompleteness. This methodological approach has generated important insights, such as the implicit contract literature which argued that wage rigidity was an optimal contractual response to incomplete insurance markets, and which explained the existence of non-market clearing wages and unemployment as a result of worker moral hazard models (Bowles, 1985 and Shapiro and Stiglitz, 1984).

In our view, exchange in the labour market is plagued by many, if not all, of the causes of market failure raised above, and we believe that many types of regulations we observe can be understood as welfare and even efficiency and employment promoting, in this context. If this is so, then why is there dissent on this issue, why are their calls for labour market deregulation? We believe this is because policies which improve efficiency and employment are not necessarily Pareto improving. The simplest example of this is monopsony (see Manning, 1996, 1997). If a labour market is monopsonistic then employment can be increased by imposing a minimum wage. Nevertheless this is not Pareto improving. While workers are better off, firm profits fall. The incomplete contracting model itself can be applied to this issue. In this model both firms and workers typically underinvest because they are unable to contract on investments and have to bargain over the returns ex post. In this model the structure of labour market institutions influences relative bargaining power and relative investment incentives. It can be shown

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4 This is the only view which is consistent with much micro evidence about the labour market, for example the robust empirical finding that unions improve productivity (Freeman and Medoff, 1984).

5 The introduction of a minimum wage does represent a potential Pareto improvement. The workers who benefit could be taxed and firms compensated in such a way as to make everybody better off. Nevertheless, for reasons that economists do not really understand, and to which we return in section VII, this type of fiscal compensation is rarely observed in practice.
(Robinson, 1993) that labour market regulation, by increasing the bargaining powers of workers can induce human capital accumulation and can be a potential Pareto improvement. In terms of the distribution of income, much of the inequality we observe in the labour market cannot be explained by human capital, experience and other pertinent measures, but appears to represent rents unrelated to productivity or opportunity costs. These models also isolate a key fallacy in the flexibility argument which is to associate lower wages and higher profits with higher employment or productivity. That lower wages are not necessarily associated with higher employment follows from models of monopsony as well as from models where labour productivity is endogenous and depends on the distribution of bargaining power between firm and workers.

The comparison between the European and American models is usually couched in terms of inflexible and flexible labour markets. Flexibility is typically defined with respect to outcomes (see OECD, 1994). For example, the labour market might be thought to be flexible if real wages adjust rapidly to fluctuations in unemployment. The problem is not in these definitions as such, but rather with the idea that the relationship between labour market institutions and flexibility as depicted in standard models of employment will produce optimal outcomes. Outside of the perfect competitive model there are strong theoretical reasons to suggest why wage flexibility of this nature will not produce efficient outcomes. For example, if there is a commitment problem having the ‘flexibility’ to renege on an agreement may have a disastrous effect on investment incentives, both in terms of a firm’s decisions to invest in productive capacity and worker investments in human capital.

Are these arguments relevant for South Africa? We do not know the extent to which there is monopsony in South African labour markets, or the extent to which labour market deregulation would cause worker productivity to fall pari passu with wages. Indeed, this latter argument may not apply in a market dominated by unskilled workers. However, there are related arguments, such as nutritional models of efficiency wages (see Dasgupta, 1996) which may be relevant here. Perhaps most importantly, the existing structure of wages in South Africa is surely heavily influenced by the legacy of institutionalised racial discrimination. This can be thought of as a social norm which prohibits whites from paying blacks high wages. This norm was supported by many institutions aimed at influencing wages directly and indirectly (via the supply of labour - job reservation and pass laws). In such a world the standard intuition about why market wages would represent marginal
productivities does not apply\textsuperscript{6}, workers could receive less than their marginal products and institutional interventions which raised their wages would not affect employment, just distribution.

There are, therefore, theoretical arguments for both the American and European model. Proponents of flexibility argue that interventions are distortionary, costing jobs and lowering productivity. Proponents of the imperfections perspective argue that interventions help complete markets, reduce imbalances of bargaining power, make workers more productive and can have quite the opposite effects. What type of theoretical argument that one finds convincing is not necessarily a scientific issue so the debate can only be settled by appeals to evidence.

\textbf{IV. REGULATION AND DEREGULATION IN THE OECD}

\textit{The Background to the Labour Market Deregulation Debate}

After the steady growth rates and low unemployment rates of the 1950s and 1960s, the 1970s was a decade of turmoil for most OECD economies. Although this turmoil subsided in the 1980s, certain economic problems were perceived as being more intractable. For example, the worldwide slowdown in productivity and the rise in unemployment, which were widely regarded as transitory in the 1970s, came to be viewed as more permanent. While the economic history of this period is well known there is as yet no accepted interpretation of what happened. Following the first oil price shock many economies experienced rising unemployment and in attempting to ameliorate this found themselves with rising inflation. The OECD’s \textit{Jobs Study} charts the seemingly inexorable upward movement of estimated Non-accelerating Inflation Rate of Unemployment (NAIRU) for the European economies over this period (OECD, 1994). Most governments eventually responded to rising inflation with strongly contractionary monetary policies in the late 1970’s (the “Volcker deflation”) or the early 1980’s (as in the UK) following the second oil price rise, which seemingly led to a further rise in unemployment. During the 1970s most economists attempted to explain the macroeconomic instability and assumed that unemployment would revert back to its previous level once the shocks to the system had

\textsuperscript{6}Workers are expected to receive their marginal product as a wage because of competition between firms in the labour market. If one firm attempted to pay a worker less than this another firm could entice that worker away by offering a little more and still make a profit. Such a logic does not apply in a monopsonistic labour market, and we believe that it is unlikely to hold in a model where there is racial discrimination. A social norm to pay blacks less can be supported by punishing whites who offer them more with the threat of social ostracism.
died down.\(^7\) This view seemed plausible given the variety of shocks. Apart from the rise in oil and commodity prices there was the advent of the era of floating exchange rates which led to wide swings in real exchange rates. There were also large fluctuations in real interest rates and government budget deficits.

The prevalent economic theories of output and employment fluctuations also suggested that these macroeconomic problems would be temporary. Both Keynesian theories, which rested on price inflexibility, and monetary misperceptions models (following Lucas, 1972) suggested this. The economics profession had gradually accepted the notion of an equilibrium rate of unemployment (the “natural rate” proposed by Friedman, 1968) which was essentially impervious to business cycle phenomena. However, these views could not withstand the persistence of unemployment during the 1980’s. All OECD economies successfully deflated, and while most models predicted that disinflation could cause temporary increases in unemployment (at least if the contractionary policies were unanticipated or not credible), none were capable of accounting for the extreme persistence of unemployment.\(^8\) These phenomena launched a concerted research initiative to account for it.

Before discussing this research it is important to place the more recent experiences of Europe and the US into a longer run perspective which accounts for introduction of specific labour market institutions, the motivation for their introduction and the effects of such institutions over the entire period of their existence. We begin by reviewing the post-War employment and growth trends in the OECD. Table 1 provides estimates of unemployment, employment to population ratios, real GDP per capita and real growth rates for a number of OECD countries for the period 1960 to 1996. From this data (and that contained in the OECD’s *Job Study*) a simple stylised story emerges, which can be summarised as follows. In the immediate post-War period (1950), unemployment stood at around 5 percent in both the US and European Community (the US slightly above this number and the EC average slightly below). Between 1950 and the mid-1970s, however, the average rate of unemployment was substantially lower in EC Europe than in the US.

\(^7\) Some studies also attempted to demonstrate that corporatist countries were able to adjust to such shocks more effectively. See Bruno and Sachs (1985), Flanagan, Soskice and Ulman (1982) and Soskice (1990).

\(^8\) Estimates for 1996 show just over 36 million people unemployed in the OECD, representing around 7.5 percent of the labour force in member countries. Where these numbers are estimated for the European Community (EC) alone, the problem is more acute: some 18.7 million persons, representing 11.3 percent of the EC labour force, were unemployed. (These estimates are calculated from the OECD’s *Economic Outlook* (1997), ‘Statistical Annex’.)
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<td>1.1</td>
<td>0.9</td>
</tr>
<tr>
<td><strong>Real Growth</strong></td>
<td></td>
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<td></td>
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<tr>
<td>(Av. Annual % Change)</td>
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<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>1960-1968</td>
<td>5.0</td>
<td>5.4</td>
<td>4.1</td>
<td>5.7</td>
<td>10.2</td>
<td>4.4</td>
<td>3.0</td>
<td>4.5</td>
<td>4.7</td>
<td>5.1</td>
</tr>
<tr>
<td>1968-1973</td>
<td>5.4</td>
<td>5.4</td>
<td>4.9</td>
<td>4.5</td>
<td>8.7</td>
<td>3.7</td>
<td>3.4</td>
<td>3.2</td>
<td>4.8</td>
<td>4.6</td>
</tr>
<tr>
<td>1973-1979</td>
<td>2.7</td>
<td>2.8</td>
<td>2.3</td>
<td>3.7</td>
<td>3.6</td>
<td>1.8</td>
<td>1.5</td>
<td>2.4</td>
<td>2.5</td>
<td>2.7</td>
</tr>
<tr>
<td>1979-1989</td>
<td>3.2</td>
<td>2.1</td>
<td>1.8</td>
<td>2.5</td>
<td>4.1</td>
<td>2.0</td>
<td>2.3</td>
<td>2.8</td>
<td>2.2</td>
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<tr>
<td>1990-1996</td>
<td>2.8</td>
<td>1.4</td>
<td>2.6</td>
<td>1.2</td>
<td>2.3</td>
<td>0.7</td>
<td>1.2</td>
<td>1.9</td>
<td>1.7</td>
<td>2.1</td>
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</tbody>
</table>

**Sources:** OECD (1991) and (1997). *The estimates for Germany are for West Germany only before 1989.

Following the oil shocks of the early 1970s, this established relationship was subsequently reversed. Unemployment in both the US and Europe increased in response to the oil crisis and the economic uncertainty it generated, but following a period of adjustment, unemployment rates within the EC settled at levels significantly above that found in the US, and have remained persistently high. (See OECD, 1997, for an overview of the contrasting histories of unemployment in Europe and the United States.) A slightly different picture emerges when the comparative growth trends for Europe and the US are
examined. For the entire post-War period until the end of the 1970s, most European countries performed better than the US economy (the major exception being the UK, where growth rates were similar or inferior to the US). However, there was as a distinct convergence of growth rates and GDP per capita over the whole period, such that by the 1980s, the growth rates of European countries was not significantly different, or only marginally better than the US. (For the EU as a whole, growth rates were in fact marginally less than the US for the period 1979 to 1996.)

Table 2 records some basic statistics on inequality. With the possible exception of France, the US was much more unequal during the post war period and the Table also records the steep rise in inequality experienced by the UK since 1980. Interestingly, while the rise in wage inequality in the US and UK has been well studied (along with the fall in the real wages of unskilled workers in the US) even more significant changes in factor share have been happening. As Blanchard (1997) records, while wage inequality and income inequality as measured by the Gini coefficient has not risen much in most European countries, the share of labour in national income has fallen a great deal (indeed more than in Britain and the US).

<table>
<thead>
<tr>
<th>Year</th>
<th>France</th>
<th>W. Ger</th>
<th>Sweden</th>
<th>UK</th>
<th>US</th>
</tr>
</thead>
<tbody>
<tr>
<td>1960</td>
<td></td>
<td></td>
<td></td>
<td>25.3</td>
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<tr>
<td>1970</td>
<td>39.8</td>
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<td>25.5</td>
<td>19.4</td>
<td>25.3</td>
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<tr>
<td>1990</td>
<td>26.0</td>
<td>21.9</td>
<td>33.7</td>
<td>42.8</td>
<td></td>
</tr>
</tbody>
</table>

Source: Atkinson et al. (1995).

Explanations for Rising European Unemployment

The Layard, Jackman and Nickell model

In the 1980’s it became apparent that theories emphasising short-term fluctuations around an impervious trend were inadequate. The most natural approach was then to suggest that the trend, the equilibrium unemployment rate, had itself changed. Theories of how this might have happened are embodied in standard models of equilibrium employment as presented in Layard, Jackman and Nickell (1991) (henceforth LJN). In their model unemployment exists because of imperfectly competitive wage setting by trade unions and because the generosity of social insurance induces a high ‘reservation wage’ and thus
makes the decision to work unattractive. In this model, the rate of unemployment depends directly on the bargaining power of trade unions and firms, as well as factors which determine their relative bargaining strength, such as the legal environment. These factors include support and immunities for unions to impose costs on employers through strike action (for instance the difficulty for the firm to replace insiders), and legally imposed costs of adjusting the labour force (such as restrictions on the recruitment and dismissal decisions of firms). The supposedly deleterious effect of much labour market regulation can be seen as strengthening the bargaining power of workers relative to firms (in any number of the above ways) and consequently inducing a rise in wages and unemployment (since the cost of workers unambiguously rises relative to their productivity).

Can such a model explain either the time series behaviour of European unemployment or Cross-Country differences in unemployment rates? We argue that without additional arguments (which we come to below) it cannot. The model suggests that the rise in unemployment must have been caused by either: (1) an increase in union density or some factor which increased union bargaining power, (2) an increase in the generosity of social insurance, (3) an increase in the real minimum wage, or (4) an increase in employment protection legislation such as compulsory notice of dismissal or mandated severance pay (so called ‘firing costs’). Even accepting the premise that all of these things create unemployment (which we do not necessarily do) the rise in European unemployment cannot be explained by these factors. For example, in Britain the union density fell from 54% in 1980 to 32% in 1995 (Machin, 1997), the replacement ratio fell, minimum wages were abolished, and employment protection legislation was weakened. Given the direction of all these changes, the LJN model would predict a substantial fall in the equilibrium level of unemployment, yet unemployment failed to return to anything resembling the levels it had been before the late 1970s. The story is the same for other variables, the evidence on ‘firing costs’ in Lazear (1990) shows that only in France is there a close relationship between an increase in these costs and the rise in unemployment (see also Alogoskoufis et al. (1996), for related evidence on payroll taxes and other potential explanations).

Careful examination of the empirical work in LJN reveals that the story that they end up telling has little to do with the above model. The second oil shock and disinflationary policies caused a contraction in output for standard Keynesian reasons, which raised the unemployment rate. The reason that unemployment did not then revert to the previous equilibrium level is that the rise in unemployment became persistent through a number of
channels of ‘hysteresis’ or path dependence\(^9\). A key role is also reserved for a dummy variable which measures ‘an exogenous increase in wage push’! It is also revealing that rather than attempt to explain the time series behaviour of unemployment, Nickell (1997) concentrates on Cross-Country comparisons with data restricted to the 1980s and 1990s only.

Thus, while the model presented by LJN provides a logical environment in which labour market reform may reduce unemployment and increase productivity in the economy (for example if union bargaining power is used to block the introduction of new technology), it turns out that these aspects of the model are not capable of explaining the key time series properties of the data. To do this they find it necessary to appeal to short-run price rigidities and hysteresis mechanisms\(^{10}\).

What about the Cross-Country evidence? Again there are problems. Casual empiricism suggests that the first-order facts are wildly inconsistent with the implications of the model. This is so since Scandinavian countries have the strongest unions and the most extensive social insurance in the world and yet have also experienced very low unemployment rates. These observations are reconciled by appealing to the Calmfors and Driffill (1988) model. On the one hand, increasingly centralised bargaining enhances the bargaining power of unions and therefore their capacity to extract wage concessions which may have unemployment and inflationary consequences. On the hand, however, centralisation of bargaining involves the internalisation of a bargaining eternality: as the bargain covers a larger proportion of the workforce, unions are forced to take into account the social costs of their wage demands. Thus, while highly centralised bargaining arrangements provide unions with considerable bargaining power, unions exercise wage restraint to limit the

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\(^9\)The notion that the equilibrium rate of unemployment might depend on the history of unemployment through hysteresis mechanisms is due to Phelps (1972). Phelps stressed the idea that spells of unemployment may atrophy the human capital of the unemployed and weaken their search behavior or degree of labour market attachment. These ideas were developed in the 1980’s along with insider-outsider models (see Lindbeck and Snower, 1989) where shocks to employment can persist because of effects on trade union membership, and models where deflationary shocks reduce the capital stock and this constrains future employment.

\(^{10}\)LJN also introduce ‘corporatism’ as \textit{a deus ex machina} to help the model explain Cross-Country differences in unemployment. The framework of Calmfors and Driffill (1988) is used to justify this explanation. This model, widely accepted in economics and political science, is problematic for a number of reasons. First, it is difficult to justify the rankings provided to individual countries (for example, Japan is ranked as highly decentralized, despite evidence to contrary. Once this case is removed the inverse U-shaped relationship they hypothesize disappears). Second, it is not clear that a single measure or ranking can capture the multi-faceted concept of corporatism. Third, the results appear to be sensitive to the time period over which countries are examined. Where the 1950s and 1960s are included in the analysis, the hypothesized
unemployment and inflationary effects on their members. In contrast, enterprise unions need only take account of a small proportion of the total unemployment and inflationary effects of their wage demands, but do not have sufficient bargaining power to extract large concessions. The ‘intermediate case’ – typified by industry-level bargaining – generates the worst unemployment and inflationary outcomes: industry unions have considerable capacity to extract wage concessions, but their members do not incur the full social costs associated with their wage demands.

Thus the Cross-Country regressions of LJN, though they suggest that ceteris paribus a higher rate of unionisation increases unemployment, they also suggest that if unions and firms engage in centralised bargaining the unemployment rate is lower than under laissez faire. Thus it is not unions per se that cause unemployment, but rather unions in specific institutional settings. The other main empirical finding here is that there is a weak positive effect of the replacement ratio and benefit duration on unemployment.

**Insider-Outsider Models**

A similar story is put forward by ‘insider-outsider’ models of unemployment (Blanchard and Summers 1986, Lindbeck and Snower, 1989). In these models, labour markets imperfections arise from the capacity of already employed workers (insiders) to influence wage outcomes, while outsiders – the unemployed – cannot. Insiders, however, do not take account of the interests outsiders or the effects of their wage demands on the capacity of firm to make additional hires. Such insider power results from a number of sources, including firm-specific human capital, ability to reduce effort, or through any institutional arrangements which create costs of replacement hires or turnover. An obvious policy implication of this model is to reduce turnover costs.

Models which take this view have focused on regulations which affect the capacity of firms to hire or fire at will. Compared with the US, European countries have developed far more extensive laws which limit the capacity of firms to recruit and dismiss employees at will. Higher levels of European unemployment are therefore seen to reflect the relationship once again breaks down (an relationship between the level of bargaining and unemployment and inflation emerges, rather than the inverse U-shaped one which they hypothesize).

11 Here, ‘at will’ refers to the capacity to hire without reference to meritocratic criteria (such as race or gender), to fire without giving notice or observing a fair procedure or for reasons unrelated to performance or taking the effects of such dismissals into account, or without advance warning and consultation with employees over mass redundancies.
relatively extensive regulation of recruitment and dismissal decisions of firms (Emerson, 1988). Indeed, many economists assert that such regulations have been the central cause of high levels of European unemployment (Bertola 1990, Bentolila and Bertola 1990, Lazear 1990, Scarpetta 1996, Saint-Paul, 1996 and 1997. For an exception to this argument see Gregg and Manning, 1995, and Büchtemann, 1991 and 1993).

However, there is a number of puzzling concerns about the insider-outsider interpretation of unemployment. First, there is a problem with the hypothesised relationship between labour market regulation and unemployment. As noted above, European economies generally performed much better than the US in minimising unemployment prior to the oil crisis (particularly those states adopting corporatist wages policies). The relatively superior performance of European states during this period has generally been viewed as the result of extensive labour market regulation, not its absence (Crafts, 1995, Crouch, 1985, Eichengreen, 1996, Flanagan et al., 1983, Katzenstein 1985). Moreover, it cannot be argued that the higher levels of unemployment and inferior economic performance of the US prior to the oil shocks were associated with more extensive labour market regulation. Yet this is clearly an implication (or expectation) of the insider-outsider analysis of unemployment after 1970 (Crouch 1993, Gregg and Manning 1995). A similar point can be made in relation to the experiences of Canada and the UK during the 1980s and 1990s. Canadian unemployment increased dramatically during the 1980s without any substantial changes to dismissal laws, while the available evidence suggests labour market reforms in the UK during the 1980s had little effect on the performance of the British labour market (this is discussed in more detail in the next section).

Second, research on the relationship between labour market regulation and unemployment often assumes the introduction of such laws coincided with the rise in unemployment, or that such laws have been time-invariant. For example, in a regression analysis of the effects of a range of labour market policies and institutional arrangements on unemployment in seventeen OECD countries over the period 1970 to 1993, Scarpetta (1996) uses an index of the ‘strictness of employment protection laws’ which is calculated

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12 A related question concerns the effects of those laws, such as discrimination and affirmative action laws, which effectively reduce the power of insiders. These laws are never viewed in this light, yet Manning (1993) has shown for the UK that equal pay legislation was associated with a rise in female employment not a decrease, and the US there is abundant evidence to suggest the Civil Rights Act 1964 had similar positive effects on the hire-rates for African-Americans. See Heckman and Payner (1989).
An historical investigation of such laws, however, reveals that recruitment and dismissal laws viewed as so detrimental to European employment have a much longer history than is often supposed. In some cases these laws date to ‘pre-modern’ labour codes. Germany provides a classic case in point: current dismissal laws can be traced to laws passed in the early part of the twentieth century, as elements of Nazi labour statutes, as well as laws of post-War reconstruction.\(^\text{14}\) Periods of dismissal date to the turn of the century (The Civil Code of 1896 and the Salaried Employees Act 1926), and limits on unfair dismissals date to the Works Council Act 1920,\(^\text{15}\) and the Federal Dismissal Act 1951. Both Acts regulated ‘socially unwarranted dismissals’, which the 1951 Act defined as any dismissal ‘not based on reasons connected with the person [such as insufficient physical capabilities, lack of skill, etc] or the conduct of employees [such as gross conduct], or on pressing operational requirement which preclude … continued employment in the undertaking.’\(^\text{16}\) German legislation also requires firms to consult with the Works Council over (among other matters) recruitment and dismissal decisions of firms.\(^\text{17}\) The dismissal provisions contained in the various Codes were subsequently consolidated in the Protection Against Dismissal Act 1969, which remains valid. An investigation of a number of other OECD countries suggests that in many cases, the regulation of recruitment and dismissal pre-dates

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\(^{13}\) Between 1975 and 1980, unemployment rose form 5.5 to 7.5 per cent, increasing to a high of 11.9 percent in 1983, and subsequently remaining around 10 percent over the 1990s. See OECD Labour Force Statistics, various years.

\(^{14}\) The regulation of dismissal decisions in Germany is particularly complicated: it divides employees into various categories on the basis of profession (commercial, business and technical), the nature of the services performed (workers, salaried, managerial) and whether or not an employee is covered by a collective agreement, or part of the corporate body. Dismissal is also governed by a number of statutes: employment contracts are seen as a sub-set of ‘service contracts’ governed by the Civil Code. The Commercial Code and Trade Code also contain provisions which restrict dismissal. In many respects, however, those Codes that do not specifically relate to the regulation of labour have become less important over time. See Gahan (1997) for a more detailed account.

\(^{15}\) This law was repealed by the National Labour Act 1934. However, this Act did contain some protections against arbitrary dismissal (section 5). The Fascist Acts were rescinded in 1946, and regulation of dismissal reverted to the provisions contained in the Civil Codes, until 1951.

\(^{16}\) Such dismissals are deemed socially unwarranted even in cases where proper periods of notice have been observed Full English text contained in the ILO’s Legislative Series.

\(^{17}\) These provisions were contained in the Works Council Act of 1920, which we noted was repealed by the Nazi Labour statute. The Works Constitution Act 1952 restored the right of consultation over dismissals in firms with more than five employees. A further Act, the Works Constitution Act 1972, increased the consultation rights of the Works Council with respect to collective dismissals (redundancies).
the rise of unemployment by decades.\textsuperscript{18} More puzzling for the ‘insider-outsider’ explanation is evidence that in some cases (e.g., Germany and Italy) these laws were introduced in response to demands from employer groups rather than unions (for a detailed account of country histories see Gahan 1997). This suggests that these laws served functions other than protecting insiders, and were potentially beneficial for employers (such as a means to restrict mobility and wage demands, or as a means to protect a firm’s investment in human capital).\textsuperscript{19}

\textit{Labour Laws as ‘Time Bombs’}

Thus, in many cases, the evidence suggests labour laws, which have been viewed as so detrimental during the 1970s and 1980s, did not have any such effects during the 1950s and 1960s. This provides strong support for the view that these laws cannot be held responsible for the rise in European unemployment. However, there is a counter-argument which says that even if labour market institutions were not very costly during the 1950s and 1960s and indeed did not become more strict or onerous during the 1980s, the economic environment in which they were embedded changed radically in the 1970s and 1980s in such a way as to make these institutions dysfunctional or more costly (Lindbeck, 1994 presents this view.) We shall refer to this as the ‘time bomb’ theory.

To be convincing this approach would need to articulate carefully what changed. There are no clear answers to this question, and unfortunately, precious little empirical work. By the mid-1980s the real price of oil had returned to the levels of the 1960s, but unemployment remained high. The other contenders seem to be (1) macroeconomic instability, (2) ‘globalisation’, (3) the productivity slowdown and the end of the post war boom, (4) fundamental changes in the nature of technology (such as skill biased technical change, or the beginning of the ‘post-Fordist’ epoch), (5) a break-up of existing political coalitions (perhaps related to (4), changes in the national and international division of labour and increased female participation in the labour force) leading to new and or more fragmented political cleavages which forced new political strategies on existing and surviving coalitions.

\textsuperscript{18} It is also clear that a focus on the formal laws governing recruitment and dismissal do not adequately capture the extent of regulation through collective agreements and company policies, and that there have been significant changes to such regulations over time (Emerson 1988 and Sengenberger 1992).

\textsuperscript{19} An even more complicating factor concerns the observation by Bean (1994) that non-EC European countries have generally experienced lower levels of unemployment, despite the fact that many have labour laws similar to those found in EC countries.
With respect to (1), it seems that the inability of governments to run a prudent fiscal policy or manage the exchange rate does not provide a basis for the reform of the labour market. Moreover, it is not clear that countering labour market deregulation with employment subsidies or negative income tax schemes is likely to have substantial employment effects for low-income workers. Globalisation has been viewed by many as undermining national systems of regulation. More competitive product markets and greater uncertainty about the nature and level of demand have been assumed to make these laws more costly as inflexible labour laws impede the capacity of firms to respond to changes in ‘global markets’ (see for example Erickson and Mitchell, 1995). However, there is little convincing evidence that globalisation has altered either the efficient or politically sustainable structure of institutions. Garrett (1996) provides a case to suggest that more substantive labour market regulation, including active labour adjustment policies, have historically been associated with small states exposed to world markets – that is, those economies which have been more ‘globalised’ (also see Katzenstein 1985 and Rodrik 1997). Thus while (1) and (2) are often discussed, they seem the least plausible to us.

More plausible arguments relate to the issue of the productivity slowdown from the mid-1970s and skill-biased technological change. Productivity growth has slowed in all industrialised countries since the early 1970’s. Interestingly, it is often argued that perhaps there was more need to re-allocate labour at the micro level than before during the 1980’s so that firing costs became more onerous. However, it seems plausible to us that the need to re-allocate labour at the micro level must be positively correlated with the aggregate rate of TFP growth.

A second structural shift often used to explain why labour regulations may have become more costly relates to the idea of skill-biased technological change (see Krugman 1993). Other researchers have linked these changing skill demands to a shift in production technologies which require high skilled and flexible workers. Krugman has argued that skill-biased technical change has been the dominant caused of rising inequality and a fall in the wages of unskilled in the US, while in Europe, where minimum wages have been

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20 There may also be a political economy considerations here: Even if labour market regulation has some negative effects on the probability of workers remaining unemployment, workers may prefer to have such regulations protecting their interests rather than relying solely on employment subsidies or negative income tax schemes. Reliance on a single mechanism would effectively place all their eggs in the one basket – there would be incentives for policy makers to reduce such payments after deregulation. Moreover, such deregulation could reduce the gains over the longer run if it reduced union capacity to organize and remain politically active. This is perhaps a key motivation in the deregulatory drives in the UK in the 1980s and in New Zealand in the 1990s.
maintained and unions have remained strong, such skill-biased change has been the primary cause of unemployment. However, the empirical evidence suggests this linkage is doubtful. Card et al. (1996), Krueger and Pischke (1997) and Nickell and Bell (1996, 1997) have demonstrated that the rise in European unemployment has occurred across skill groups and that the ratio of skilled to unskilled unemployment has moved in a remarkably similar way in the US and European countries.

In short, our conclusion from this survey is that various variants of the ‘time bomb’ hypothesis are not supported by empirical evidence. However, the argument does not end here. Credibility for the labour market deregulation policy has emanated from accounts of those countries which attempted labour market deregulation during the 1980s and 1990s, most notably Britain and New Zealand, as well as various labour market reforms in Europe. In the next section we therefore review the evidence to support this conclusion. We conclude that at best the labour market reforms have ambiguous effects. The only clear outcome that can be generalised across all cases is such policies generate greater income inequality.

**Labour Market Deregulation in Britain and New Zealand: Has it Delivered?**

What have we learned about the effects of labour market reform in the OECD economies? The evidence suggests that changing labour market institutions have ambiguous effects. In some cases it appears to have relatively little effect on unemployment, different measures of the efficiency of the labour market, or on productivity growth. In other cases, particularly the US, UK and New Zealand, the effects are large but not the ones anticipated. Changes in institutions have had a significant effect on changes in the distribution of wages and incomes\(^{21}\). These institutional changes are driven by policy designed to create, either directly or indirectly, an environment for firms to initiate change.

Virtually all European countries attempted to increase the degree of labour market flexibility during the 1980s, albeit to differing degrees (Emerson, 1988 provides an overview.) Belgium, France, Britain and Spain weakened dismissal laws. The Netherlands reduced, and Britain removed, the minimum wage. Italy eliminated wage indexation and France, Netherlands, Spain and Sweden all decentralised wage agreements (see OECD, 1990 for more specific details on these reforms). With respect to firing restrictions Treu
(1992) concludes ‘most European governments...have promoted concerted measures to increase the flexibility of the labour market.’ By this he means an increase in the ease and a reduction in the costs to firms incurred in changing their workforce. Treu stresses that ‘the introduction of different types of employment contracts... has played a leading role in increasing labour market flexibility.’

The precise form of deregulation has varied considerably between countries. For example, while short-term contracts have become very important in Spain, they have not been adopted by German firms (Büechtemann, 1989). Overall, employers in most Europe have far more freedom to organise work time (Blanpain and Kohler, 1988) and production (for example by subcontracting out tasks) in a firm-specific manner.

The results of this change in the legislative environment have been disappointing for their proponents. In an important survey of ‘changing labour market rules’, Blank and Freeman (1993) conclude ‘reforms to increase flexibility by weakening welfare state programs did not deliver what they had promised. The conventional wisdom of the 1980s – that social protection impairs flexibility in ways that harm economic performance – deserves a serious rethink’. A companion volume edited by Blank (1994a) contains a series of empirical papers trying to detail the effects of various social insurance and welfare spending programs (an important part of the structure of labour market institutions in different countries) on labour market equilibrium. The findings of this research are uniform: ‘these papers give little evidence that labour market flexibility is substantially affected by the presence of social protection programs, nor is there any evidence that the speed of labour market adjustment can be enhanced by limiting these programs’ (Blank (1994b))

21 While the US has remarkably few labour market regulations compared to European countries, it has witnessed a dramatic fall in unionization since the 1960’s and significant falls in the real minimum wage, changes which are qualitatively similar to labour market reform in Europe.

22 He argues that this has resulted in a large expansion in part-time employment and short-term contracts. The position in Britain is evidence of this. Gregg and Wadsworth (1995) analyze the fall in job tenure and rise in turnover which resulted during the 1980’s and 1990’s.

23 Summing up the findings of this large research project Blank (1994b) comments, "a possible explanation (for the conclusions of the project) is that the analysis of social protection programs as a primary cause of inflexibility and high unemployment was simply flawed from the beginning. The best counterexample is Japan, a country with extensive job security provisions and with less inter-regional mobility than the US that has consistently outperformed the US as well as its European competitors. Japan provides evidence that there is no inherent correlation between poor economic performance and the presence of welfare state programs and/or slower labour market adjustment in terms of employment and mobility. It is possible that the sluggish economies of Europe over the 1980s were due to quite different factors, such as a lack of useful cooperation and communication between the political system and the private sector".

22
From these more general tendencies the cases of New Zealand and Britain stand out as having attempted the most complete reforms of labour markets deregulation. It is instructive to review the available evidence in both cases.

*Labour Market Deregulation in New Zealand, 1984-1995*

The virtues of labour market deregulation policy has received considerable attention in the case of New Zealand. Evans, Grimes, Wilkinson and Teece (1996) have characterised these reforms as being in “the pursuit of efficiency.” After reviewing the evidence on more than a decade of reform, they conclude that: “qualifications aside, the reforms have markedly improved New Zealand’s economic prospects... Many lessons from the New Zealand experience are worthy of emulation by other countries.... After many decades of policy errors and investment blunders, New Zealand appears to have finally diagnosed its predicament appropriately and is on a trajectory to maintain its economy as a consistent high performer among the OECD” (pp. 1894-5).

Between 1984 and 1995, two successive government (the first a Labour government, the second a conservative government) abolished the system of compulsory arbitration and other long established labour market institutions over the period 1984 to 1995. These reforms included the removal of compulsory union membership and significant changes to the regulation of public sector labour markets. The important of these changes were introduced as part of the *Employment Contracts Act 1991*, which instituted a system of ‘individual contracts’ and removed almost all restrictions on a firm’s hire and fire decisions (for details of these reforms see Gahan and Robinson 1997).

The effects of these reforms are most evident in estimates of union density: between 1984 and 1990, union density fell by 25 per cent (Harbridge, Hince and Honeybone, 1995, and Kelly, 1995). In the seven months between May 1991 (when the Employment Contracts...
Act was introduced) and December 1991, union density fell by 14.7 per cent; and a further 33.9 per cent over the period (December) 1991 and 1994. Similarly, the coverage of collective bargaining has fallen by about half in the three year period between (May) 1991 to 1994, to a level of around 40 per cent of the workforce (and continues to decline). In turn, this has been associated with a dramatic growth in wage dispersion. Harbridge (1990) reported significant increases in wage dispersion (as a measure of wage flexibility) over the period in which the first phase of these changes were introduced, along with significant differences in conditions of employment, work practices, work patterns, and training provisions\textsuperscript{25}. The inequality effects are also evident in standard measures of inequality over the period 1985 to 1990: the Gini coefficient for New Zealand increased from 35.82 to 40.21\textsuperscript{26}.

Consistent with the literature reviewed above, a central aim of these reforms was to promote labour market efficiency. Along with a more general account of New Zealand’s economic performance, Table 3 provides a summary of labour market outcomes in comparative perspective. Unemployment over the period 1991 to 1995 averaged 10.9 per cent, compared with an average of 5.1 per cent over the period 1980 to 1990, and 1.5 per cent over the period 1965 to 1980. This worsening record is countered by a more recent decline in unemployment. However, our argument is that it is impossible to conclude that labour market reforms have had beneficial effects in New Zealand. The more recent falls in unemployment and increases in labour productivity coincide with an economic upturn, and given the pro-cyclicality of unemployment and productivity, nothing can be inferred. The sustainability of recent declines in unemployment is also questionable given a range of other factors that need to be taken into account. First, the rate of employment growth has been decelerating, and is expected to continue to decline (OECD, 1996a and 1996b). Second, the decline in unemployment has been associated with lower participation rates, which have still not yet recovered to those levels before the unemployment crisis (OECD, 1996b). Third, the fall in unemployment has also been associated with a substantial level of temporary migration to Australia.

\textsuperscript{25} Harbridge reports statistically significant differences in labour market outcomes by occupation, industry, region and the timing of agreements within a given bargaining round. Such differences were previously minimized under the system of centralized compulsory arbitration.

\textsuperscript{26} This increase represents a large increase in equality over a relatively short period. Gini co-efficients calculated from the Deininger and Squire data set on income inequality (see Deininger and Squire, 1996).
TABLE 3

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<th>United States</th>
<th>OECD</th>
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<tbody>
<tr>
<td><strong>Average Annual Growth Rates</strong></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>(Average Annual Real GDP)</td>
<td></td>
<td></td>
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</tr>
<tr>
<td>1960-1990</td>
<td>2.4</td>
<td>3.2</td>
<td>3.6</td>
</tr>
<tr>
<td>1979-1990</td>
<td>1.5</td>
<td>2.6</td>
<td>2.7</td>
</tr>
<tr>
<td>1991-1995</td>
<td>1.7</td>
<td>1.9</td>
<td>1.7</td>
</tr>
<tr>
<td><strong>Unemployment</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1960-1990</td>
<td>1.5(^1)</td>
<td>6.0</td>
<td>5.0</td>
</tr>
<tr>
<td>1980-1990</td>
<td>5.1</td>
<td>7.0</td>
<td>7.3</td>
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<tr>
<td>1991-1995</td>
<td>10.9</td>
<td>6.6</td>
<td>7.5</td>
</tr>
<tr>
<td>1996</td>
<td>6.1</td>
<td>5.3</td>
<td>7.3</td>
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<tr>
<td><strong>Inflation</strong></td>
<td></td>
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<tr>
<td>1960-1990</td>
<td>8.9</td>
<td>5.1</td>
<td>6.2</td>
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<tr>
<td>1979-1990</td>
<td>11.2</td>
<td>5.5</td>
<td>6.4</td>
</tr>
<tr>
<td>1991-1995</td>
<td>2.1</td>
<td>3.1</td>
<td>5.0</td>
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<tr>
<td><strong>Current Account Balance</strong></td>
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<td>(Per cent of GDP)</td>
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<tr>
<td>1980-1989</td>
<td>-5.3</td>
<td>-1.8</td>
<td>-0.5</td>
</tr>
<tr>
<td>1990-1995</td>
<td>-3.1</td>
<td>-1.7</td>
<td>-0.3</td>
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\(^1\) The estimate for New Zealand is for 1965 to 1980.

Sources: OECD (1992, 1996a, and 1996c)

We also argue that there is significant evidence that the reforms have had adverse effects on equality. The OECD’s most recent Economic Survey of New Zealand (OECD, 1996b) expresses concern over the changing distribution of unemployment among different ethnic groups after the introduction of the Employment Contracts Act.\(^{27}\) Unemployment among Maoris and Pacific Islanders has risen disproportionately and is currently around 15 per cent – or four times that for persons of European origin. Similar differences are observable in the growth of regional unemployment over the same period.

In summary, the evidence does not allow one to conclude that the Employment Contracts Act has lead to any sustained improvement in labour market performance. While unemployment has trended downward, and labour productivity has increased in the last few years, this represents primarily a cyclical movement rather than any structural shift. Moreover, the changes have exacerbated differences in unemployment between ethnic groups and by region which were previously less pronounced.

\(^{27}\) The basic ethnic composition of New Zealand’s population is as follows: Maoris, 10 per cent, Pacific islanders, 4 per cent, and persons of European descent, 83 per cent (OECD, 1996b).
The Thatcher Reforms in Britain

The British experience with labour market deregulation during the 1980s provides an obvious point of comparison to estimate possible effects of similar reforms in New Zealand. Wage councils were abolished, legislative protections for unions were removed from the statute books and replacement ratios collapsed (see Machin, 1996). Moreover, “firing restrictions” were reduced or removed altogether. Has this led to a revitalization of the British economy? In one wide-ranging survey of the issues, Blanchflower and Freeman (1994) conclude that policy changes during the 1980s and 1990s “may have marginally increased employment and wage responsiveness to market conditions,… but the reforms failed to improve the responsiveness of real wages to unemployment; were associated with a slower transition from non-employment to employment for men; a devastating loss of full-time jobs for male workers and produced substantial seemingly non-competitive increases in earnings inequality.” While unemployment in Britain has recently fallen, in the last recession (in 1992-1993) it rose above 10% despite over a decade of significant deregulation. Moreover, British unemployment has never once fallen back to any level experienced prior to 1979 (at least using comparable definitions.) In terms of productivity growth, Englander and Gurney (1994) find no change in the trend of British labour productivity growth between the periods 1979-1985 and 1986-1993. If labour market deregulation has caused a miracle in the British economy we do not know what evidence substantiates this.

These findings carry over to other OECD economies. After a decade of reform, the recession of the early 1990’s saw unemployment rates rising to levels as high as any experienced in the 1980s. At the same time policies to reform the labour market do seem to have had the desired effect of reducing the bargaining position of workers. The large rise in wage inequality which took place during the 1980's has been well documented (Freeman, 1993), while this occurred in most O.E.C.D. economies, the largest effects were in the UK and US (see O.E.C.D. (1993) and Freeman and Katz, 1994). The evidence suggests that while part of this phenomena can be traced to technological change favouring

28 Gregg and Manning (1995) summarize their empirical work by arguing “if the conventional analysis of labour market regulation is correct, we would expect to find labour market performance to be negatively correlated with benefit duration, replacement ratios, trade union density, the minimum wage…, yet when one looks at the results (of their regressions) the most striking thing is that it is very rare to find any significant relationship at all.”

29 Only in the US was this rising inequality accompanied by absolute falls in the real wage of low paid workers although, as Gregg and Wadsworth (1995) document, the real wage of new hires has been constant in the UK since 1980.
workers with higher skills (though there is no independent evidence that this effect is important and there has also been large increases in inequality between classes of workers with homogeneous characteristics (see the discussion in Katz, 1992), and the effects of increased international competition, a large proportion of this seems to be traceable to changes in labour market institutions. Blanchflower and Freeman (1994) and Freeman (1993) both suggest that this may be directly related to labour market reform. Pelletier and Freeman (1991), Gosling and Machin (1995), Gregg and Machin (1994), and Leslie and Pu (1996) analyse the role of the decline in the power of organised labour on the wage structure and find it to be highly significant (see also Schmitt, 1994). Freeman’s (1990) examination of international movements in unionisation rates illustrates the precipitous decline of unionisation in the US and UK since 1970, and the O.E.C.D. reports that it fell in many member countries during the 1980’s (particularly the Netherlands and France). Card (1996) estimates that at least 20% of changes in the variance of wages in the United States from the 1970's to 1987 is explained by the decline in unionisation and Lemieux (1993) has estimated that 40% of the differences in wage inequality between Canada and the US can be accounted for by their different union densities. DiNardo, Fortin and Lemieux (1996) find that both de-unionisation and falls in the real value of the minimum wage have had a significant and large impact on the increase in wage inequality in the United States. They conclude that “labour market institutions are as important as supply and demand considerations in explaining changes in the US distribution of wages from 1979 to 1988”. Pontusson (1996) also finds that those O.E.C.D. countries which experienced de-unionisation in the 1980’s were those which experienced large increases in wage inequality.

The countries where institutions were weakened the most, Australia, New Zealand, the US and the UK, therefore experienced the largest increase in wage inequality. Other countries where institutions changed in the same direction also experienced the same inequality trends (for example Sweden). However, there are exceptions. Italy, France and the Netherlands changed institutions to some degree but experienced no deterioration in wage inequality. The likely reason for this is that the effects of some institutional changes on labour market outcomes may not be large unless they occur simultaneously with other complementary changes. Since it may not be politically feasible for all changes to happen simultaneously the types of effects seen in the US and UK have not yet emerged in these economies.
A central issue in all of this is the comparison between Europe and the US. It is now standard to praise the unregulated US labour market for achieving low unemployment. Yet US unemployment only fell below the average European rate in 1981 and was uniformly higher than it during the 1950’s, 60’s and 70’s. Even the current situation is sensitive to how one defines unemployment. For example, as Gregg and Manning (1995) argue, because the safety net for unemployed workers is much smaller in the U.S. far more people drop out of it into various states not counted as unemployed (such as “out of the labour force”).

Other evidence bearing on the topic is mixed. Lazear (1990) finds some evidence that job security provisions have a negative effect on employment, but himself notes that the results are not robust (see also Addison and Grosso 1996). Bentolila and Betola (1990) and Bertola (1990) examine theoretical models of dynamic labour demand under adjustment costs as well as empirical evidence in order to assess the effects of job security legislation on employment. They find that the effects are ambiguous both theoretically and empirically. Emerson (1988) reports surveys of businessmen who were asked about whether or not “hiring and firing” costs were an employment constraint or whether or not obstacles to the “termination of employment contracts” were significant. British employers uniformly reported that these phenomena posed insignificant constraints, yet British equilibrium unemployment in the 1980’s appeared to move remorselessly upward.

There is much other evidence that standard models of unemployment are highly incomplete. Freeman (1988) documents that there is no relationship between union density and the proportion of the working age population that is employed. Indeed, there seems to be no robust evidence linking unions to unemployment despite the profusion of theoretical models with this result. The same seems to be true with respect to the generosity of

30 There is no simple theoretical relationship between larger flows of workers and efficiency. Larger flows are not necessarily good for employment and productivity nor are they unambiguously welfare improving. An interesting comparison (as noted above by Blank, 1994b) is the U.S. and Japan. The U.S. has a large amount of flux in the labour market but productivity performance which is significantly worse than most European countries and Japan, while Japan has very low mobility.

31 Some light on the relationship between labour market turnover and human capital accumulation is thrown by the O.E.C.D. (1993) which shows that countries where job tenure and labour turnover is lower (Japan, France, Germany) are those countries where skill training is higher. Even within the US, they show that there is a strong correlation between turnover and training. They conclude that “such correlations suggest that training and tenure can be mutually reinforcing...the important issues are...under what institutional conditions might a more virtuous circle of relative employment stability, training and the production of a more skilled workforce (be created).” Appelbaum and Schettkat (1991) document that the US “employment miracle” has been primarily the creation of low wage, low productivity, part-time service sector jobs in personal and
unemployment compensation (see Burtless (1987) and the authoritative survey of Atkinson and Micklewright, 1991). Barrell et al. (1994) find that in the UK, despite significant changes, for example a fall in the replacement ratio from 43% to 25% of average earnings, this seems to have had no positive effect on employment. This may be because of the effect of the benefit system on bargaining power and the productivity of workers (as in the theories I develop), or because benefits may aid the process of matching and job search (as suggested by Wadsworth, 1991).

V. LABOUR MARKET REGULATION AND GROWTH IN THE LDC’S

Perhaps it is a mistake to focus too much on OECD economies in evaluating the correct strategy for South Africa. South Africa is a relatively poor country. For example, Sachs (1996), in evaluating policy options for South Africa, compares it with the fast growing economies of Asia. In his discussion of the labour market he stresses the flexibility of the labour markets in these economies. In his discussion of Hong Kong he associates flexibility with a complete lack of union influence on wage bargaining and notes “labour legislation is very flexible...it does not generally mandate wages, working conditions, or restrictive practices for reductions of the labour force”. He goes on to note, “there is little reliance on minimum wage legislation (Hong Kong, Malaysia, and Singapore have no minimum wages at all).” Sachs also rightly notes that real wage growth has been rapid in these economies. Yet it is also clear that the lack of unions or minimum wages does not distinguish Asia growth miracles from other countries, particularly many sub-Saharan African “disasters”. There are few effective independent unions or labour market rigidities in sub-Saharan African countries.

In this section we try and focus on relevant comparisons amongst the LDC’s. It seems plausible that the unemployment and growth problem in South Africa is qualitatively different from the one in Sweden. Nevertheless, it may be just as different from the one in Korea and Taiwan. To name one significant difference, in both countries there were significant land reforms and much greater equality and educational attainment prior to industrialisation. It may well be that the type of labour repression strategies that they followed are simply not feasible (even if they were thought desirable) in a country with as much inequality as South Africa. These East Asian countries were also not emerging from recreational services and Streeck (1991) argues precisely that the effect of labour market institutions and regulations in Germany has been to lead to the virtuous circle described by the O.E.C.D.
the type of institutionalised discrimination that has blighted South Africa. Indeed, Latin American countries, which are also characterised by very high inequality have typically adopted more labour market regulations. Over the last 20 years there has been some attempts to deregulate these, first in Chile under Pinochet and then in other countries following the debt crisis and subsequent structural adjustment. Yet the record of these does not offer many positive pieces of evidence for deregulation. As mentioned above, the connection between labour market deregulation and growth since 1986 in Chile is moot, while the connection between deregulation and the massive rise in inequality has been established\textsuperscript{32}. Interestingly, labour market deregulation has also not stopped the informal sector growing in size relative to the economy. The work collected in Marquez (1995), Edwards et al. (1997) and Marshall (1994)\textsuperscript{33} does not suggest that deregulation provides a miracle cure and Berry and Tenjo (1997) conclude that the one country that did not experience and increase in inequality following structural adjustment was Costa Rica. What differentiated Costa Rica was that it did not undertake labour market deregulation.

Fields and Wan (1989) have praised the lack of labour market regulation in the East Asian miracle economies, yet it seems to us that, as argued by Freeman (1992) this is not a crucial factor differentiating them from other countries. Typically dictatorships suppress labour everywhere, yet we know that on average dictatorships are not good for development (Helliwell, 1995). Moreover, it would be hard to argue that Japan had labour marker institutions that resembled the competitive ideal (Japan had pretty high union density during the period of its most rapid industrialisation). Most scholars of East Asian development seem to place little weight on the particular types of labour market institutions. It could be that these are simply less important in an initially equal and educated society\textsuperscript{34}.

\textbf{VI. THINKING ABOUT REGULATION AND DEREGULATION}

\textsuperscript{32} The Gini coefficient increased from 0.45 in the early (pre-Allende) 1970’s to 0.55 in the late 1980’s). Conning and Robinson (1997) find that, controlling for openness (which has been thought to be the prime cause of rising inequality in Chile) both deunionization and the real minimum wage play an important role in explaining the rise in the Gini Coefficient.

\textsuperscript{33} Though Rama (1995) contends that the record supports the claims of deregulationists and Fallon and Lucas (1993) present evidence that employment protection legislation has negative effects on employment in India and Zimbabwe.

\textsuperscript{34} We here note the important finding that equality (of land and incomes) promotes economic growth, see Alesina and Rodrik (1995) and Persson and Tabellini (1994). Moene and Wallerstein (1997) have also shown how wage equality may promote productivity growth by effectively subsidizing new technology.
In this section we mention a few of the issues surrounding positive accounts of deregulation. The mainstream view of labour market deregulation (see Cohen, 1995, OECD, 1994) is that regulations were adopted in the 1950’s and 1960’s (actually, this is the well informed mainstream view, many people seem to believe labour market regulations miraculously appeared after the first oil shock in the 1970’s) either because workers lobbied for them and politicians didn’t really understand their implications, or because with the economy booming and unemployment low, workers were powerful and forced governments (and employers to concede to their demands). Saint-Paul (1993, 1996) is one of the more sophisticated exponents of this view. Deregulation is then caused either by governments realising their mistakes (which Robinson, 1995b, calls the ‘stupidity hypothesis’) or by the fact that shocks, high unemployment and political changes reduced worker political power and allowed employers and their political representatives to change institutions (one can think of many possible variations on these stories). The main problem with this literature is that it all assumes that regulation is bad, deregulation is good. We have argued that the evidence does not support this view. Indeed, if regulation is not correlated with poor economic performance and indeed may solve labour market failures but at the same time influences income distribution (recall that we do not believe that regulation is typically Pareto improving) then it is quite possible that labour market deregulation can occur even if it is inefficient. There is no presumption that, just because some OECD countries are deregulating their labour markets, this signals that they are doing so to promote efficiency (Robinson, 1994, 1995a, develops models of regulation and deregulation where deregulation can occur even if it is inefficient and Korpi, 1994, provides interesting complementary perspective’s). In fact, there is some evidence that regulation is not simply raising the income of labour at the expense of capital and is often supported by employers. This certainly seems to have been true amongst white employers in South Africa during the apartheid era and has been true in Scandinavia (see the important work of Pontusson, 1995a,b, Pontusson and Swenson, 1996, and Swenson, 1991a,b, 1997, see also Moene and Wallerstein, 1995).

No plausible positive theory necessarily implies that labour market institutions were any less appropriate in the 1980’s than they had been in the 1960’s in OECD countries, something which is typically implicitly assumed by exponents of deregulation view. What altered was the trade-off between costs and benefits of the institutions for certain individuals or groups in the economy and their ability to induce institutional change, or the
types of political coalitions or cleavages which assumed political power. Such models do not imply that labour market reform is efficient in aggregate, just privately rational for agents in a position to initiate institutional change.

VII. CONCLUSIONS

It is apparent that there is great uncertainty about the relationships between the institutional structure of the labour market and outcomes such as inequality, employment and productivity. We have tried to provide an overview of the empirical regularities as we understand them. We have interpreted these with theoretical arguments. Neither evidence nor theory supports the view that an attempt to create a ‘deregulated’ labour market in South Africa will automatically promote any of the policy goals to which the government has committed itself. We conjecture that it will almost certainly increase inequality. There seems to be no case where deregulation has reduced inequality. Our reading of the evidence suggests that policy ought to focus on improving education and human capital and direct measures likely to reduce inequality (perhaps land reforms). For example, there is some evidence that a major impediment to employment in the informal sector is the high level of violence and lack of property rights (Simon and Birch, 1992). It seems hard to believe that attempt to reduce wages could do anything except make this situation worse. Moreover, the history of ‘catch-up’ growth suggests that social consensus and the absence of distributional conflict is vital for a good investment climate. Abramovitz (1986) reminds us that ‘catch-up’ growth of the type envisaged by South African policy makers is conditional, not automatic. Most countries in sub-Saharan Africa have been diverging, not converging, in the last 30 years. An important reason for this appears to be distributional conflict and political instability. Social consensus is vital to avoid this outcome in South Africa. It seems highly plausible to us that the extraordinary post war growth experience of OECD countries was due to the social contract formed after World War II, which involve important social insurance and labour market regulation (for example, US manufacturing productivity levels were way ahead of those in Europe by the 1890’s so why did catch-up not start until the later 1940’s? see Crafts and Toniolo, 1996).

In a context where it is likely that major restructuring of industry and reallocations of labour will take place it is important that workers feel certain that they will not be losers (otherwise they may have an incentive to oppose changes, see Fernandez and Rodrik, 1992). In this case the setting of minimum standards and wages may be important.
Moreover, the support of unions gives the workers confidence in the future that collective action will be possible and helps to generate credible commitments that the gains from change will be equitably distributed in society.

While the tasks are obviously great, let us end on a note of optimism. Undoubtedly much wage inequality, unemployment and resource misallocation in South Africa is caused by the legacy of racial discrimination. By way of comparison, consider the extraordinary changes in female labour force participation in OECD economies. During the last 20 years female participation has risen massively, yet the male female wage differential has fallen. The unwinding of discrimination has not led to women being “priced out of a job”, indeed, the massive increase in labour supply has come along with a fall in wage differentials rather than an increase. Of course one could argue that there has been “women biased technical change” but this hardly seem plausible to us. We can similarly hope that the unwinding of the pernicious heritage of apartheid in South Africa may lead to a large increase in employment with falling inequality.
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