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*Comments on Are Protective Labor Market
Institutions at the Root of Unemployment? A
Critical Review of the Evidence* by David
Howell, Dean Baker, Andrew Glyn, and John
Schmitt

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In many areas of research, conventions are established and then blindly followed. A working paradigm emerges, which attracts adherents. Numerous papers are written that are refereed by followers. First movers guard their property rights and claims of priority. Usually they become leaders unless a clearer vision is articulated by a later entrant. The groups so formed are mutually supportive and successful as long as they share a common paradigm and respect pecking orders. Outsiders who challenge the convention face an uphill task. Success in many fields is often gauged by the size of the band formed through group activity and the frequency of citations received, and not through the empirical or predictive success of the activity of the group.

Because of the weakness of its data base, macroeconomics is particularly vulnerable to this phenomenon, though it is by no means unique among fields of economics. Howell, Baker, Glyn, and Schmitt (HBGS) challenge the consensus view (the "orthodox" view, as they call it) on the causes of European unemployment trends. Numerous papers in this literature examine essentially the same data base. The authors construct alternative measures of incentives or disincentives created by institutions—usually some index or indices of regulatory activity. HBGS and the unpublished papers they cite perform a valuable professional service by carefully studying the robustness of the evidence on the role of protective labor market institutions (PLMI) in creating European unemployment. HBGS are convincing in showing the fragility of the evidence on the role of labor market institutions in explaining the pattern of European unemployment, using standard econometric methodology. Their use of rigorous econometric methods contrasts with the casual empiricism used in the real business cycle (RBC) literature that picks parameters out of a hat and does not subject models to a rigorous test.¹

The major sources of weakness in the European unemployment literature are: (a) the short, often nonstationary, time series on unemployment and its determinants; (b) the poor quality of the basic data — intertemporally incomparable measures are often used, reflecting improvements in the basic data collection over time; (c) use of *ad hoc* measures of incentives (a variety of crude proxy measures for a diverse array of policies are used); and (d) inadequate attention to the problems of reverse causality. The revisions in institutions that are used to explain outcomes are often caused, in part, by macroeconomic crises that affect the "dependent" variables used by European unemployment analysts.

To their list of problems, I would add the problems associated with the lack of explicit econometric measurement models where the effects of the "institutional variables" on outcomes are carefully delineated, and dynamics and asymmetries

¹As Watson (1993) shows, when standard predictive criteria are applied to RBC models, they fail badly to account for many features of the macro data.

produced by different regulations are carefully articulated. The empirical models used in this literature are statistical models only weakly motivated by economics. They do not recognize policy feedback and they do not model general equilibrium effects. For example, payroll taxes may have little effect on employment if firms can pass on the tax costs to consumers in the form of higher prices.

In the absence of better data, and better measurement frameworks, prior beliefs will continue to dominate how one interprets the evidence. This is not as much about dogmatism or conspiracy as it is about good science. In the absence of empirical evidence, logically consistent stories that accord with intuition have great appeal. At both an intuitive level and at the level of formal economic theory, incentives matter. If a person is paid not to work, the person will likely not work. If the costs of hiring a worker rise, fewer workers are likely to be hired. The microevidence supports these basic predictions of theory. Like the controversy over the effects of minimum wages, disagreements are not over qualitative predictions of the theory, but are about quantitative empirical responses.

HBGS are splendid critics. However, they do not offer a constructive empirical alternative to existing practices in the literature. They have not proved that institutions do not cause the pattern of European unemployment. They have, instead, shown that the current data base and models are too weak to decide the issue.

Progress in this field requires a lot more empirical effort than has been exerted to date. It requires deriving comparable measures of outcomes and incentives across countries and over time for the same country. It also requires developing better measures of the incentives generated by institutions and capturing the full array of institutions at work, instead of just a few selected institutions with easily measured characteristics. The indices currently used do not directly measure the cost of labor, which is the key issue in the debate. The only valid index of the effect of institutions on the labor market is the cost of labor, or better, the dynamic schedule of labor costs. All institutions operate on this cost. Instead of creating a panoply of newer, more refined indices to represent the magnitude of various institutional forces, as characterizes the current empirical literature, it would be more constructive to quantify the effects of the *entire edifice* of labor institutions on demand and supply of labor through their effects on a single measure — the labor cost schedule. All institutions affect costs and alternative institutions within an economic environment raise or lower costs. Once the incentives of protective institutions are properly measured, they can be used to estimate economic responses.

Since some labor market institutions affect the dynamics of hiring and firing, it is important to measure state-contingent labor costs and to estimate dynamic relationships. As much recent research shows (see, e.g., Haltiwanger, Brown, and Lane, 2006), at a point in time, some firms are hiring and others are firing, and

sometimes the same firm is doing both. It is necessary to disaggregate firms in different demand states to carefully measure incentive effects.

Unlike HBGS, I argue that *more* theory is needed to guide measurements, the construction of indices and the construction of response to regulation functions. Theory-guided empirical research will conserve scarce degrees of freedom and at the same time provide a much sharper test of the orthodox theory. It will entail subjecting empirical models to predictive tests and integrating macro data with micro data; macro theory with micro theory. Until sharper versions of the models are estimated and tested, ambiguity about the appropriate explanation for the evolution of European labor markets will remain. Calibration with made up parameter estimates that show that PLMI *might* explain European unemployment (as in Ljungqvist and Sargent, 1998) only suggests possibilities and does not prove anything.

For this exercise to be successful, it is also necessary to deal with the political economy of how policy reforms are implemented. One of the strongest parts of the HBGS paper is the evidence on reverse causality. Institutions that affect incentives are often changed in response to economic crises. Accounting for such responses can greatly affect the interpretation of the evidence. For example, Heckman and Pagés (2004, , pp. 1-109) show that accounting for the economic environment in which reforms are launched powerfully affects the size and statistical significance of estimated incentive effects of policy reforms. Thus, Chile, after it democratized and economic growth had been underway for about a decade, passed more restrictive labor legislation as a dividend.

For this case and many others like it, simple correlations, and many of the econometric frameworks used in the European policy debate, would show that perverse incentives "caused" growth. Sweden, after the crisis of the late 1980s, reformed its tax system and promoted incentives in the labor market. Simple econometric methods would show that tax cuts "caused" the recovery, even though mean reversion would be a complementary, or even alternative explanation.

The essay by Heckman and Pagés (2004) and the other essays in their book show that using large cross sections of data for multiple time periods can greatly sharpen estimates of the effects of institutions on the labor market. Heckman and Pagés (2000) (2004) perform a prototype for the type of analysis I am advocating by measuring the effects of institutions on the cost of labor.

They begin the task of developing a true cost of labor measure for both Europe and Latin America. With their measure of the true *cost* of job security provisions, they show robust impacts of certain components of job security costs on unemployment and employment. They also find strong negative effects of payroll taxes that depend on the level of rigidity in other markets. This finding is

counter to the evidence reported by HBGS. Recall that they show improved *ad hoc* indices generally become statistically less precisely determined.

In summary, I commend the critique of HBGS, but wish they had done the hard work of providing constructive evidence on the effects of regulation on European labor markets. I agree with them that the evidence currently in play in this literature is weak.

The next step forward is to expand the data base, pooling time series and cross section evidence. Regulation and policy effects on costs should be quantified. The effects of incentives on demand and supply should be estimated and general equilibrium and policy feedback effects should be estimated. This is an ambitious research program, but one that will advance knowledge beyond the logical possibilities suggested by a calibration approach or the confusing and conflicting evidence suggested by the studies of the effects of labor market institutions based on arbitrary indices. I advocate the construction of one index, or one schedule—for labor costs—to capture the vast array of institutions that affect labor markets. Heckman and Pagés (2004) discuss these issues in greater depth.

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